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IN-DEPTH ANALYSIS

Economic policy coordination in the euro area under the European Semester

External author: Agnès Bénassy-Quéré

Provided at the request of the Economic and Monetary Affairs Committee

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EN

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Provided in advance of the Economic Dialogue with
the President of the Eurogroup
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Abstract

The European Semester is a well-intentioned attempt to foster macroeconomic policy coordination between Member states. However, the concept of euro area fiscal stance lacks operational instruments, the concept of macroeconomic imbalances is loosely defined, the Macroeconomic Imbalance Procedure (MIP) is weakened by its complexity, and its blurred frontier with respect to the Europe 2020 process further obscures the Semester. The euro area is still not well equipped to design a consistent macroeconomic policy and reduce the risk of long-lasting stagnation. We propose to use the future European Fiscal Board to promote an integrated view of fiscal policy, to make the MIP symmetric to the Stability and Growth Pact (SGP), with a flagship indicator (the current account) complemented with a limited number of indicators related to medium-term imbalances. Growth-enhancing policies would all fall under the Europe 2020 process ("integrated guidelines"), with alternating building blocks.

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LIST OF ABBREVIATIONS

AGS	Annual Growth Survey
BEPG	Broad Economic Policy Guideline
CSR	Country-specific Recommendation
ECB	European Central Bank
EDP	Excessive deficit procedure
EFB	European Fiscal Board
EG	Employment Guideline
EIP	Excessive Imbalance Procedure
ESRB	European Systemic Risk Board
ESM	European Stability Mechanism
EU	European Union
GDP	Gross domestic product
MIP	Macroeconomic Imbalance Procedure
MTO	Medium-Term Objective
REER	Real Effective Exchange Rate
SCB	System of Competitiveness Boards
SGP	Stability and Growth Pact
SME	Small and Medium-sized Enterprises
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
ULC	Unit Labour Cost

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EXECUTIVE SUMMARY

This report reviews the current European Semester cycle and suggests concrete steps and recommendations for its improvement. It covers the three processes encapsulated in the European Semester: the Stability and Growth Pact (SGP), the Macroeconomic Imbalance Procedure (MIP), and the Europe 2020 process ("Integrated Guidelines").

The European semester lacks the capacity to build up an active, counter-cyclical fiscal stance at aggregate level; it suffers from the complexity and opaqueness of the MIP and from a blurry assignment of tasks between the different tools:

- **The Country-specific Recommendations (CSRs) to the euro area concerning the aggregate fiscal stance are not operational.** Fiscal policy reveals a clear pro-cyclical fiscal stance in 2012 and 2013. This is inherently connected to the majority of countries still being under the corrective arm of the Stability and Growth Pact, while there was no operational tool to compensate for their constrained behaviour.

- **CSRs do not perfectly match the findings of the in-depth reviews under the MIP, the reviews being themselves loosely connected to the MIP scoreboard.** The link between the main scoreboard indicators and the assignment of the Member states in the different stages of the MIP is rather loose, with the exception of unemployment rates that are high for stage 4-5 countries. However, CSRs for stage 4-5 countries do not systematically insist on labour market reforms, compared the CSRs issued to the other countries.

- The **same recommendations can be found under any of the three processes: SGP, MIP and Europe 2020.** There seems to be some substitutability between the three processes. In particular, the same recommendations tend to move from a Europe 2020 to a MIP heading when moving up from stage 1 of the MIP.

In order to improve the European Semester this report proposes the following.

- **Operationalization of a euro area fiscal stance based on the future European Fiscal Board:** the EFB would provide guidance to the European Commission on temporary floors and caps on fiscal adjustment (possibly going beyond the SGP), or a suspension of SGP rules in extraordinary bad times.

- **Current account balance should be installed as the flagship indicator of the MIP,** in a similar way as the fiscal balance is currently the flagship indicator of the SGP. In-depth reviews would rely on a small number of additional indicators, such as public-private leverage, wage developments, or housing prices, while also accounting for the exchange-rate regime of each Member state. **The MIP should be made symmetric to the SGP through a replication of the preventive and corrective arms**. Like for fiscal imbalances, the adjustment paths would be defined in structural terms.

- **Refocus of the MIP on medium-term imbalances would allow a more coherent view of integrated guidelines** in the Europe 2020 framework**.** CSRs aimed at raising potential growth and inclusion would all fall under the Europe 2020 heading. It might also be useful to **alternate different areas of public policy** and devote i.e. year *n* to education and the labour market, year *n*+1 to regulations on goods and services markets, and year *n*+2 to private and public governance.

The report argues in favour of designing the future European Fiscal Board and System of Competitiveness Boards as a way to **promote an integrated view of macroeconomic policy in the euro area, in order to reduce the risk of a euro-wide stagnation.**

1. INTRODUCTION

The euro is a currency without a state: the members of the euro area have transferred national sovereignty in the area of monetary policy, but they have retained national sovereignty for fiscal policy and "structural" policies. This choice involves two key consequences.

First, the mismatch between monetary and fiscal frontiers means that de facto sovereign debts in the euro area are denominated in some "foreign" currency (De Grauwe and Ji, 2013): the European Central Bank (ECB) is not the "printer of last resort" of the Member States. In the United Kingdom, the United States or Japan, sovereign bond holders can be confident that they will be reimbursed: if not by the government himself, the debt can be reimbursed through its monetization by the central bank which ultimately can print money to buy domestic bonds in order to avoid a systemic crisis. Monetization would imply a weakening of the internal and/or external value of the domestic currency, hence a loss for debt holders, like in the case of a haircut but without similar market disruption. Unlike in "stand-alone" countries, euro area governments are in similar position as emerging countries whose debt is mostly denominated in foreign currency. A high debt-to-GDP ratio involves high vulnerability to market sentiment. The very fact that investors start questioning debt sustainability will raise interest rates, which in turn will make debt unsustainable. The euro area is prone to self-fulfilling sovereign debt crises.

The second consequence of a currency without a state is that the "federal" (or "central") level has no control on national debt-to-GDP ratios which nevertheless exert strong spillovers across Member States. The ratio is determined by national fiscal policy, growth rates, and interest rates. These three variables depend on national decision making and on market conditions. In the event of a sovereign default, home commercial banks will be severely affected given the weight of national sovereign debts in their balance sheets (the so-called bank-sovereign loop, see e.g. ESRB, 2015). They will suffer losses and will potentially go bankrupt; or they will fall short of collateral, which will prevent them from getting more liquidity from the Eurosystem. This may trigger a self-fulfilling currency crisis: investors might expect the national government to re-introduce a national currency in order to avoid a large banking crisis; such expectation would then imply even higher interest rates, not only in the country in crisis, but also in other countries deemed "fragile". On the top of this mechanics, direct spillovers may be observed since some commercial banks in other countries also hold substantial amounts of the sovereign debt.

Hence, a single currency for 19 Member States generates specific vulnerability and spillovers across the Member States. This means that national debt-to-GDP ratios are a concern for all Members of the euro area (see Eichengreen and Wyplosz, 1998). But policy interactions within the monetary union are not limited to debt ratios. When inflation is at very low level while interest rates are close to zero, governments should coordinate their fiscal policies in order to avoid weighing too much on euro area-wide aggregate demand (see Blanchard et al. 2015). Symmetrically, in booming times, the priority should be to restore the fiscal room for manoeuvre that will be useful to cushion the next crisis. Hence **fiscal spillovers within the euro area are twofold: they go through debt unsustainability and through the management of aggregate demand**.

The crisis of the euro area has shown that fiscal sustainability can suddenly become an issue, even in a low-debt country.[1] This is why fiscal surveillance has been complemented with the Macroeconomic Imbalance Procedure (MIP) that extends the surveillance to private leverage, house prices, unit labour costs, current accounts, etc. Extending the surveillance to any macroeconomic (rather than just fiscal) imbalances was a very good decision. The problem is that the boundaries of such surveillance are unclear. **In an integrated monetary union, any area of policymaking could potentially fall under the surveillance of the Commission**. But as already mentioned, at the time of the Maastricht Treaty, Member States chose to retain national sovereignty over non-monetary policies. As argued by Wyplosz

[1] In 2007, the gross government debt ratio was 25% in Ireland, well below the 60% threshold; the debt nevertheless peaked at 123% in 2013.

(2015), extensive intrusion in national affairs could be counter-productive by triggering severe political backlash. Hence there is a need to better delineate the surveillance.

At the European Union level, the spillovers are less systemic. Low growth or fiscal unsustainability in one Member State of the EU is a concern for those countries closely linked to it through trade and investment. But the spillovers through the banking system are more manageable with a distinct currency and monetary policy. For instance, should markets start speculating on an exit by one country from the monetary union, this would likely trigger a rise in interest rates in some other countries of the monetary union, but not necessarily in EU countries outside the euro. Likewise, a cumulated upward deviation of unit labour costs is less damaging in a country whose nominal exchange rate can depreciate to compensate the cumulated loss in cost competitiveness. It remains however that **robust growth in all EU members is of common interest**. This justifies Article 121.1 of the Treaty on the functioning of the European Union (TFEU): "*Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council*".

In 2011, the European Semester was introduced to make the coordination of national economic policies more effective. Prior to this date, economic policies were loosely coordinated through the Broad Economic Policy Guidelines (BEPGs, see Art. 121.2 of the TFEU) and Employment Guidelines (EGs, see Art. 148 of the TFEU) – an annual, relatively formal exercise. The objective of the European Semester is to transform BEPGs and EGs into a binding process through encapsulating three instruments: the Stability and Growth Pact (SGP), the Macroeconomic Imbalance procedure (MIP) and the Europe 2020 process ("Integrated Guidelines"). Of these three processes, two may involve sanctions for euro area Member states if the recommendations are not followed by decisive action. The whole process extends from November of year *n*-1 (when the Commission issues an assessment on draft budgets for year *n*) to July of year *n* (when Country Specific Recommendations – CSRs – are adopted by the Council).

For its 2015 cycle, the Semester was streamlined in order "to increase political ownership, accountability and acceptance of the process, to strengthen its credibility and comparability across Member states and to help improve the implementation of the country-specific recommendations".[2] In practice, the number of CSRs was reduced and better connected to the priorities set in the Annual Growth Survey. The Country reports were also delivered earlier to allow more time for discussions, and in-depth reviews (for those countries at risk of macroeconomic imbalances) were incorporated in the same Country reports. Finally, an effort was made to raise the level of national ownership through more involvement of national parliaments and social partners.

This report intends to review the European semester based on this last round, and to make suggestions to further improve the process.[3] We start by reviewing the 2015 semester cycle (Section 2), before making some recommendations for improving the effectiveness and pointiness of the semester (Section 3).

[2] Annual Growth Survey 2015, p. 16.

[3] We do not repeat here the suggestions made in Bénassy-Quéré and Ragot (2015) to re-organize the semester in two periods, (the first being devoted to the euro area and the second one to individual Member states), to introduce more systematic hearings of the Ecfin Commissioner before national parliaments, to coordinate national fiscal councils at the euro area level, to introduce competitiveness councils at national level and to coordinate them at European level, to incorporate macroprudential policy into the European semester. These proposals were largely taken over in the Five Presidents Report (Juncker et al. 2015), and made more precise in a communication by the Commission in October 2015. Here we rather focus on the macroeconomic content of the semester and on the complexity of the process.

2. THE 2015 SEMESTER CYCLE

As already mentioned, the European semester covers three different schemes: (i) the SGP, which itself includes a preventive and a corrective arm (the Excessive Deficit Procedure - EDP), with possible sanctions; (ii) the MIP, which is structured in six different stages, with possible sanctions at stage 6 under the Excessive Imbalance Procedure (EIP); and (iii) the "integrated guidelines" for implementing the Europe 2020 Strategy, that do not involve any sanction. The 2015 Semester intended to articulate these three different schemes around three strategic priorities enunciated in the Annual Growth Survey (AGS): investment, structural reforms, and fiscal responsibility.

2.1 Fiscal policy

Fiscal policy in the EU navigates between three different objectives or constraints: (i) re-establish debt sustainability where it is at risk; (ii) produce some macroeconomic stabilization at individual and aggregate level; and (iii) comply with the Medium-Term Objectives (MTOs) in order to get ready for the next crisis.

The formulation of CSRs for the euro area mirrors this ambiguity. In 2014, the CSR on public finances required the euro area countries to coordinate their fiscal policies "*in order to ensure a coherent and growth-friendly fiscal stance across the euro area*". But what is a "coherent" and "growth-friendly" fiscal stance?[4] The AGS 2015 defines a "growth-friendly" fiscal consolidation as a consolidation that relies more on spending cuts than on tax hikes, and that concentrates spending cuts on current expenditures rather than investment. But "growth-friendly" should also point to the cyclical conditions: given the output gap of still -2.8 percent in 2014, was the fiscal stance of 2015 (slight consolidation) appropriate?

In 2015, the CSR to the euro area on public finances became more specific: "*to ensure that the aggregate euro area fiscal stance is in line with sustainability risks and cyclical conditions*". The problem then was that those countries still under the corrective arm of the SGP[5] represented 38% of the area's GDP in 2015. Whatever the recommendation for the euro area, these countries could not deviate from their adjustment path, even if "cyclical conditions" would have required doing so. Consequently, the recommendation was in fact directed to the countries not under the corrective arm of the SGP. However, most of them where under the preventive arm of the SGP, with limited flexibility (see Box 1). In 2015, only three countries in the euro area where not constrained by the Pact: the Netherlands, Luxembourg and Slovakia, totalizing 7.6 percent of euro area's GDP. The fact that the aggregate fiscal stance was finally deemed "broadly neutral" by the Commission[6] was mostly the result of a pacing down of fiscal consolidations.

In order to assess the aggregate fiscal stance of the euro area, it is necessary to take a longer perspective. Figure 1 plots the contributions of three groups of countries to the fiscal stance of the euro area from 2009 to 2015: (1) countries under the Excessive Deficit procedure (EDP), including those under an European Stability Mechanism (ESM) programme; (2) countries under the preventive arm of the SGP; and (3) other countries. The graph also shows the aggregate output gap of the euro area over the same period. Four sub-periods can be distinguished:

- 2009: strongly negative output gap, expansionary fiscal stance from all three groups of countries;
- 2010, 2011: marked recovery of the euro area (output gap converging towards zero), neutral fiscal stance in 2010 followed by a contraction in 2011 led by EDP countries;

[4] The usual definition of the fiscal stance is the variation in the structural budget balance, in percent of potential GDP. It is a measure of the orientation of discretionary fiscal policy.
[5] France, Ireland, Portugal, Slovenia, Spain, plus the two countries still under an ESM programme (Cyprus, Greece).
[6] see press release 5 May 2015.

- 2012, 2013: second dip of the output gap accompanied by strong fiscal adjustment led by EDP countries plus countries under the preventive arm of the SGP (in 2013);

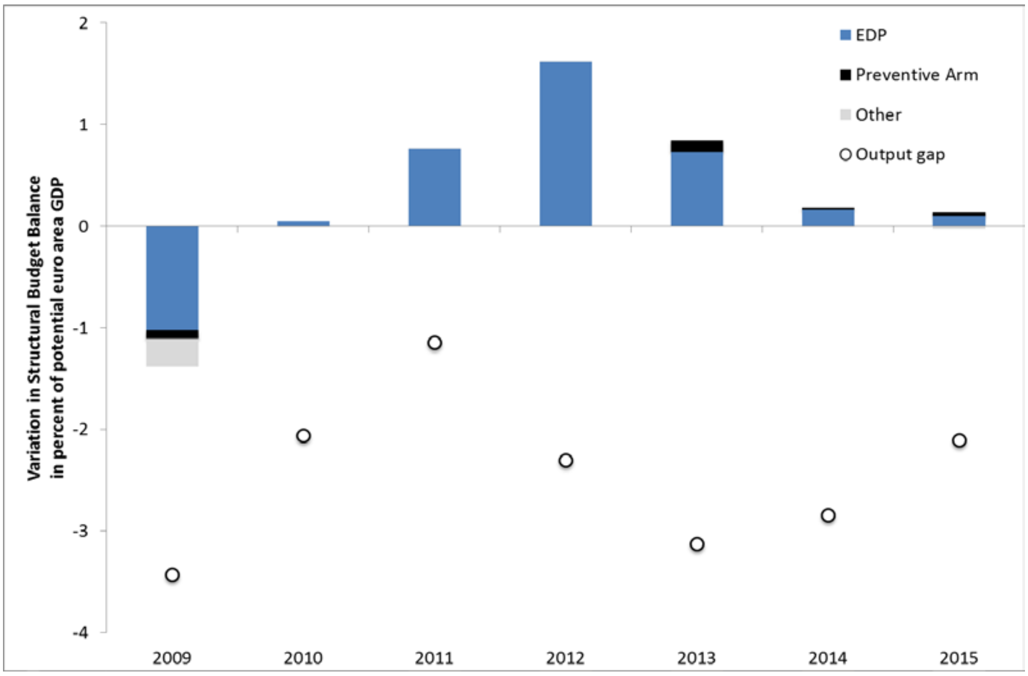
- 2014, 2015: neutral fiscal stance in the context of a slow recovery of the output gap.

Hence, **over this seven-year period, only in 2009 and 2011 was the aggregate fiscal stance clearly counter-cyclical,**[7] while 2012 and 2013 were clearly pro-cyclical and the other years roughly neutral. Could aggregate fiscal policy have been counter-cyclical in 2012 and 2013? This would have implied either for countries under the EDP to reduce their adjustment speed, or for other countries to compensate through fiscal expansions. The European Semester does not provide any tool to implement either of these two possibilities. **The CSR to the euro area concerning the aggregate fiscal stance is not operational**.[8]

It is interesting to compare the euro area with the United Kingdom, which has retained its own national currency. Over the whole period (except 2014), the British fiscal stance appears counter-cyclical (Figure 2).

Figure 1: Fiscal stance of the euro area

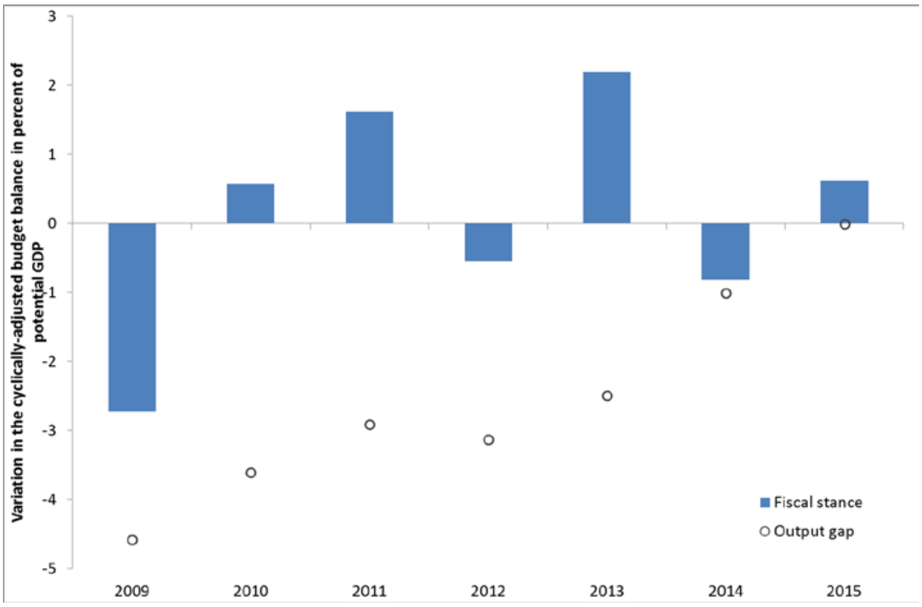
(Variation in structural budget balance in percent of potential euro area's GDP)



Source: Ameco and own calculations.

[7] In the latter case, counter-cyclicality comes from fiscal tightening while the output gap is less negative than a year before.
[8] This was already the conclusion of Darvas and Vihriälä in 2013: "The concept of the 'aggregate fiscal stance' is a largely empty concept" (p. 6).

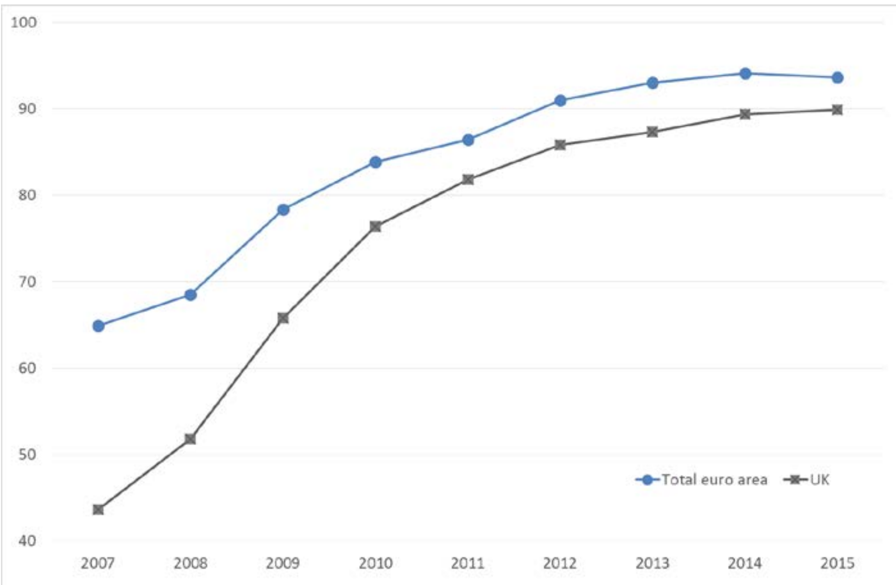
Figure 2: Fiscal stance of the United Kingdom
(Variation in the cyclically-adjusted budget balance in percent of potential GDP)



Source: Ameco and own calculations.

It may be argued that a pro-cyclical fiscal stance is the price to pay for curbing the debt-to-GDP ratio. At end-2007, the combined government debt of euro area countries was already above 60% of euro area's GDP, compared to 44% in the United Kingdom. Hence the UK had more room for manoeuver than the euro area as a whole. The British government let the debt ratio increase by 38 percent of GDP from 2007 to 2011, while the combined euro area ratio grew by only 22 percent of GDP (Figure 3). From 2011 to 2015, however, the debt ratio evolved in parallel in the two areas: +7 percent of GDP in the euro area; +8 percent of GDP in the UK. During the same period, cumulated fiscal tightening was more marked in the euro area (2.8 percent of potential GDP) than in the UK (only 1.5 percent): **pro-cyclical fiscal tightening did not end up with slower debt increase in the euro area than in the UK**.[9]

Figure 3: General government gross debt in the euro area and in the UK
(% of GDP)



Source: Ameco.

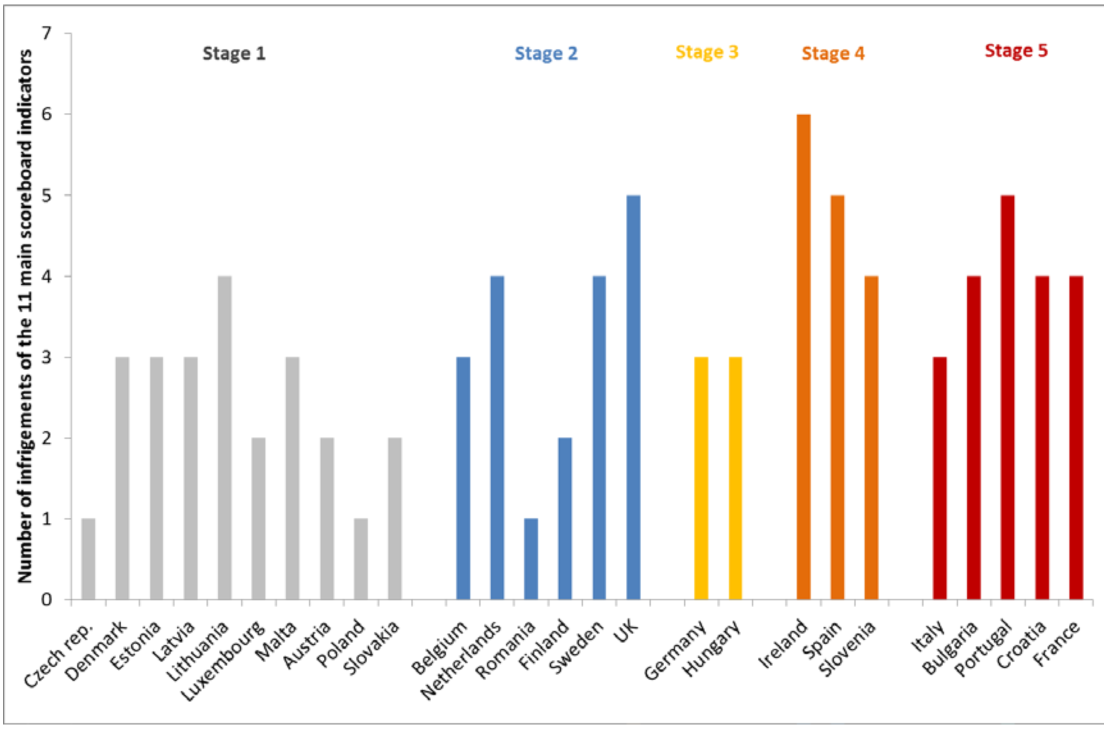
[9] During this period, monetary policy was also looser in the UK than in the euro area.

2.2 The macroeconomic imbalance procedure (MIP)

Each year, the MIP starts with an examination of the Alert Mechanism Report of the Commission, which itself relies on a scoreboard that scans 11 "main" indicators and 29 "secondary" ones for each of the 28 EU Member states. Then, in-depth reviews are carried out (now merged with the Country reports). And finally, Member states are ranked from stage 1 ("no imbalance") to stage 6 ("excessive imbalances, which require decisive policy action and the activation of the Excessive Imbalance Procedure").

Figure 4 reports the results of the MIP in 2015, with the number of infringements of the main scoreboard indicators. No country was ranked stage 6 (which would have involved possible sanctions). The link between the scoreboard and the six stages of the MIP is not supposed to be mechanical, which is apparent in Figure 4 where Italy (3 infringements) is in stage 5 whereas the UK (5 infringements) is in stage 2.

Figure 4: Screening of potential imbalances under 2015 MIP



Source: European Commission. Infringements of the 11 "main" indicators of the MIP scoreboard.

Table 1 summarizes the findings of the in-depth reviews that led to this MIP classification. For those countries assigned to stages 4 and 5, the main concerns seem to be public and private debts, and countries in stage 5 display low competitiveness on the top of debt overhang. For those countries in stages 2 and 3, private debts and net investment positions seem to be the main drivers. Finally, unemployment is mentioned only for the three countries just exiting an ESM programme: Ireland, Portugal and Spain.

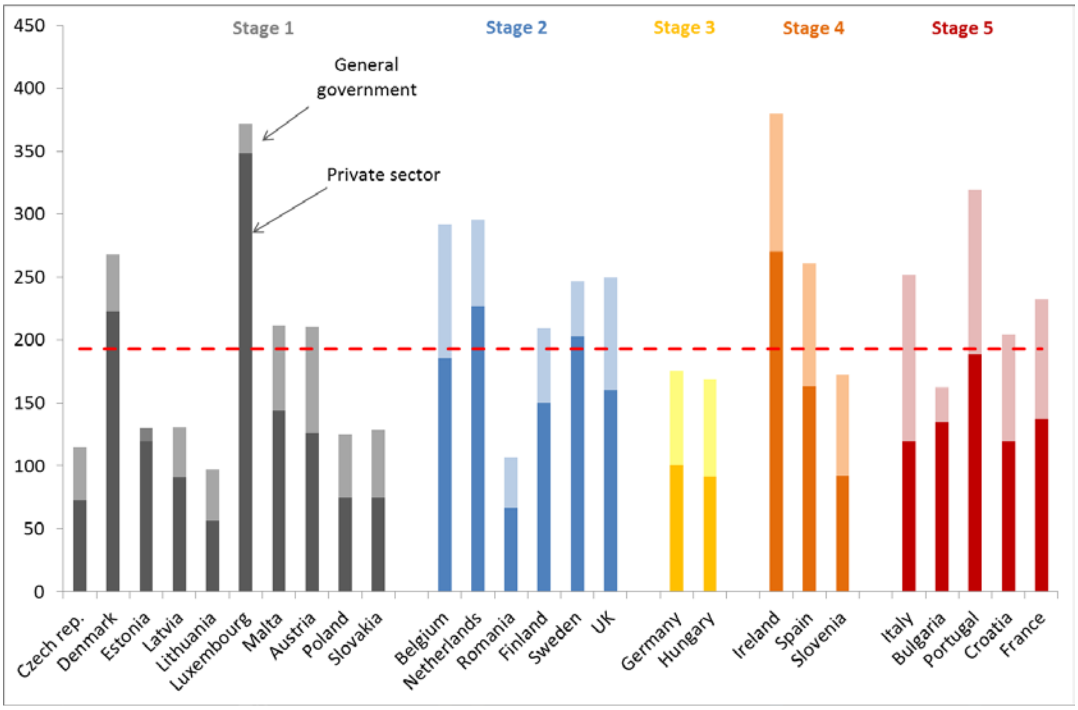
Table 1: Main risks according to the in-depth reviews for MIP 2015

Country	Main source of imbalances	Country	Main source of imbalances
Stage 2		**Stage 4**	
Belgium	Competitiveness	Ireland	Public and private debts, banks, unemployment
Netherlands	Private debt, current account	Spain	Public and private debts, net international position, unemployment
Romania	Net international position, banks	Slovenia	Corporate governance, state ownership, public and private debts
Finland	Market shares	**Stage 5**	
Sweden	Private debt	Italy	Public debt, competitiveness
UK	Private debt, house prices	Bulgaria	Banks, net international position, private debt
Stage 3		Portugal	Public and private debts, growth, unemployment
Germany	Investment, current account	Croatia	Competitiveness, public and private debt, governance of public sector
Hungary	Net international position, public debt, regulatory burden, non-performing loans	France	Competitiveness, public debt

Source: European Semester 2015: College decisions, 25 February 2015, Annex of the press release.

Figure 5 reports public and private debt-to-GDP ratios for the different groups of countries, with the same colour codes as in Figure 4. The recent debt crisis has exemplified the need to account for both public and private debts when assessing debt sustainability. Hence the graph cumulates the two indicators, with 133+60=193 percent the aggregate risk threshold. Most countries in stages 4 and 5 exceed the debt threshold. However, Slovenia and Bulgaria are below the threshold, whereas most countries in stage 2 and even some in stage 1 do exceed the threshold. In fact, what is specific of stage 4-5 countries (except Bulgaria) is not the aggregate debt ratio but rather the public debt ratio. Since public debt is already monitored through the SGP, the specific value-added of the MIP seems de facto rather limited in the area of the debt overhang.

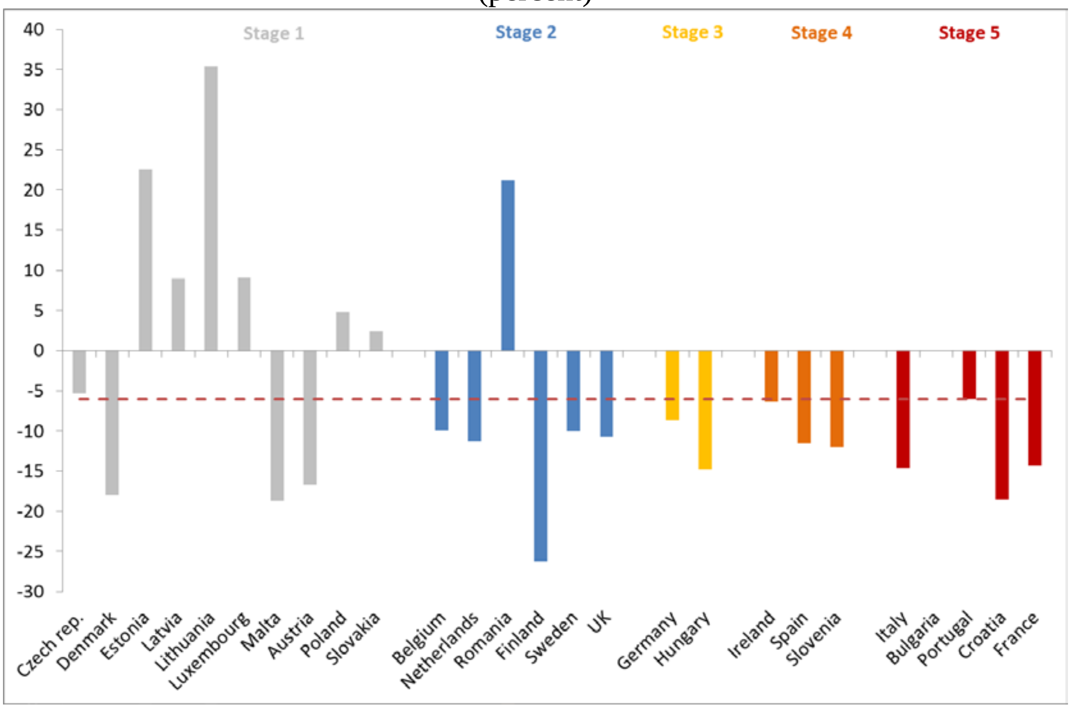
Figure 5: Public and private debt, 2015 scoreboard
(% of GDP)



Source: 2015 scoreboard. Dotted line: 193% threshold.

The second concern arising from Table 1 is the deterioration of competitiveness. Figure 6 reports the performance of the five groups of countries in terms of export market share variations over five years, together with the -6% threshold. The interpretation of this indicator is not straightforward since catching-up countries from the EU are expected to display rising market shares. In fact, the graph confirms that Finland, Belgium, Croatia, Italy and France have a problem of competitiveness. However the loss appears also important in Denmark, Malta and Austria, three countries that also exceed the debt threshold (see Figure 5) and are nevertheless considered without macroeconomic imbalances (stage 1).

Figure 6: Change in export market share over 5 years
(percent)

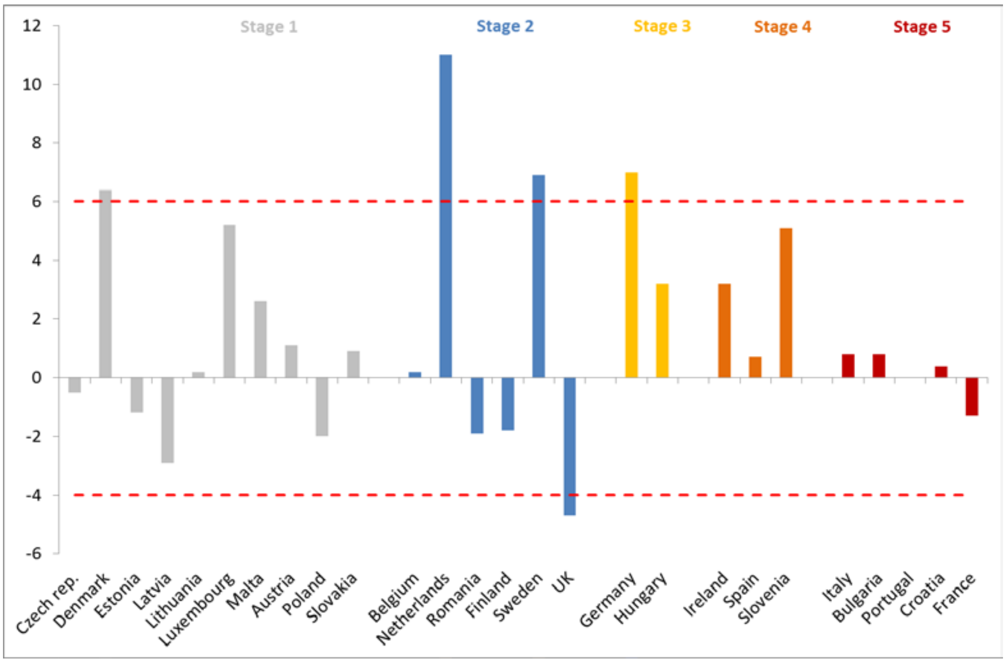


Source: 2015 scoreboard. Dotted line: -6% threshold.

The current account and the net international investment position are important indicators for countries in stages 2 and 3. Figure 7 concentrates on the current account which is more relevant to gauge current imbalances since it is a flow rather than a stock. Although the thresholds are asymmetric (+6%/-4%), four countries exceed the threshold on the upside, compared to only one on the downside in 2015. According to Table 1, however, the infringement is only considered problematic in the Netherlands and Germany. This can be explained by the fact that the other two countries in excess surplus (Denmark and Sweden) or excess deficit (the UK) are not in the euro area: their currency is expected to adjust to correct the imbalance. But then, the use of the same scoreboard to assess ins and outs may not be adequate (see Section 3).

Figure 7: Three-year average of current account balance

(% of GDP)



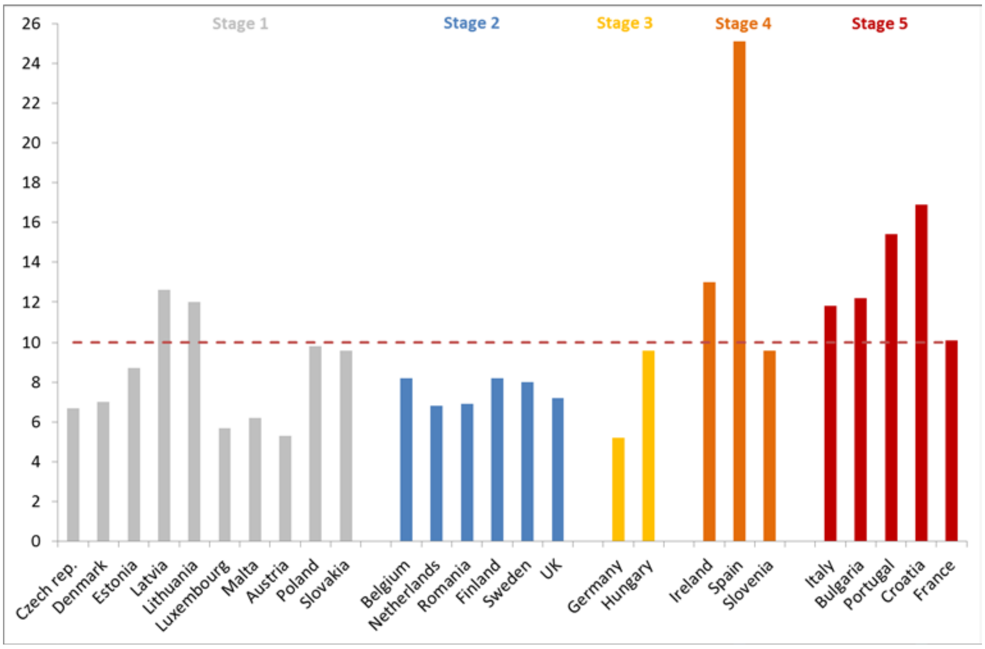
Source: 2015 scoreboard. Dotted line: +6/-4% thresholds.

Finally, Figure 8 reports the three-year unemployment average that is also mentioned as a major source of macroeconomic imbalance for three countries. Strikingly, almost all countries in stage 4-5 exceed the 10 percent threshold, whereas none of stages 2 and 3, and only two of stage 1 do exceed the threshold.

We conclude that **unemployment is the only scoreboard indicator that correctly identifies nearly all stage 4-5 countries as experiencing serious macroeconomic imbalances**. Then, CSRs for these countries are expected to insist on labour market reforms. Figure 9, that classifies CSRs in three categories, shows that this is the case for stage 5 (on average 1.5 recommendation per country concerns the labour market) but not for stage 4 (on average 0.8 recommendation per country, compared to 1.15 in stage 1).

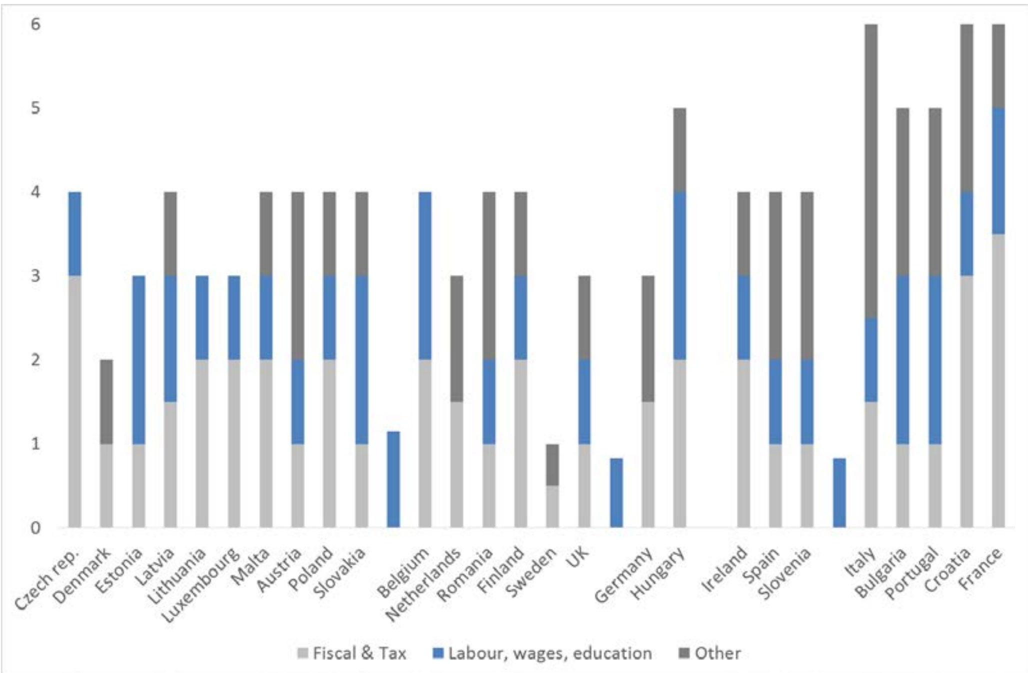
Figure 8: Three-year average of unemployment rate

(% of labour force)



Source: 2015 scoreboard. Dotted line: 10% threshold.

Figure 9: Number of CSRs per policy area in 2015



Source: European Parliament, "Country Specific Recommendations for 2014 and 2015: A comparison and an overview of implementation", 25 August 2015, and own calculations. Fiscal and tax includes pensions and social security contributions. "Other" includes deregulation of markets, investment, R&D, justice, housing, governance. When a recommendation belongs to two different areas, it is counted as 0.5 in each of them.

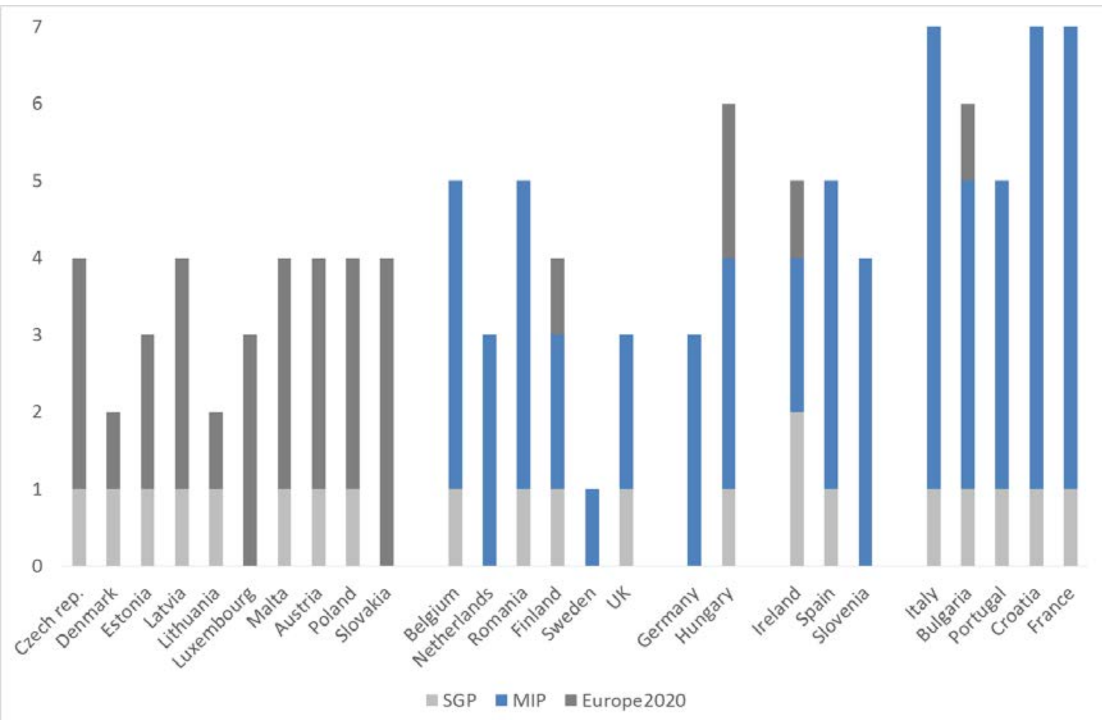
Hence, **the in-depth reviews do not seem to match the results of the scoreboard, and the CSRs do not seem to match the findings of the in-depth reviews**.[10] As for the three priorities enunciated in the AGS report (investment, structural reforms, fiscal responsibility), only two are extensively covered, whereas **investment is only mentioned for Slovakia, Bulgaria and Germany**.

In its October 2015 communication, the Commission acknowledged the loose relationship between the scoreboard and the country classifications, and between the latter and the CSRs.[11]

2.3 Europe 2020

The third purpose of the European semester is to monitor the implementation of the Europe 2020 strategy through the "integrated guidelines". In 2015, two countries (Luxembourg and Slovakia) received CSRs only related to these integrated guidelines. For instance, the CSRs to Slovakia covered (i) cost-effectiveness of the healthcare sector, (ii) long-term unemployment (activation measures, second-chance education, childcare facilities), (iii) education (teacher training, Roma children participation), and (iv) infrastructure and governance of public procurement. The same year, Hungary was also asked to improve the governance of public procurement, but this was under the MIP. Ireland was also asked to increase the cost-effectiveness of the healthcare system, but this was under the SGP heading. Italy was required to strengthen active labour market policies and vocational education, this time under the MIP heading. Hence, **the same recommendation can appear under any of the three processes: SGP, MIP and Europe 2020**. As illustrated in Figure 10, countries deemed without macroeconomic imbalances (stage 1) tend to receive a large number of recommendations under the Europe 2020 process, but these recommendations tend to disappear or to migrate to the MIP for countries at later stages of the MIP.

Figure 10: Number of CSRs under the SGP, MIP and Europe 2020 processes, in 2015



Source: European Parliament, "Country Specific Recommendations for 2014 and 2015: A comparison and an overview of implementation", 25 August 2015, and own calculations. Recommendations related to both the SGP and the MIP are counted twice here.

[10] This conclusion is confirmed by using a different classification of CSRs (see Annex 2).

[11] "*The Commission will stabilize the categories, clarify the criteria guiding its decision, and better explain the link between the nature of imbalances and how they are addressed in the Country-Specific Recommendations*" (EC 2015d, p. 9).

3. IMPROVING THE EUROPEAN SEMESTER

As illustrated in the previous section, the European semester suffers from (i) an incapacity to build up an active, counter-cyclical fiscal stance; (ii) a rather complex and illegible procedure for macroeconomic imbalances; and (iii) a blurred frontier between the different tools. Here we address these three problems through **a better delimitation of the MIP, more symmetry with the SGP, an equal treatment of all EU countries vis-à-vis the "Integrated Guidelines" of the Europe 2020 process, and the use of the future European Fiscal Board and System of Competitiveness Boards to strengthen the euro-wide leg of the semester**.

3.1 SGP, MIP and Europe 2020

One difficulty of the European semester is that the concepts of fiscal discipline, macroeconomic imbalances and economic efficiency are not well defined and assigned.

Fiscal discipline

The SGP considers fiscal discipline as a limitation of fiscal deficits and debts. Lower deficits and lower gross sovereign debts are always a good thing. When inflation is close to zero, however, one should be more careful about fiscal adjustment since there is a risk of debt deflation. In such circumstances, debt sustainability may sometimes involve less adjustment, not more. Symmetrically, in good times, one may not be satisfied by mere fiscal balance, since this may involve inflation or the accumulation of financial risks in other parts of the economy.

Fiscal discipline may alternatively be defined as a contribution to common prosperity and stability. This would involve using existing room for manoeuvre to boost aggregate demand in case of a downturn (or reduce it in an upturn) while at the same time insuring long-term debt sustainability through appropriate commitments.

Existing "flexibilities" of the SGP are insufficient in this respect, as illustrated in Box 1. In order to operationalize a euro area fiscal stance, one possibility could be to **rely on the European Fiscal Board** envisaged by the Five Presidents' report (2015) **to provide guidance to the European Commission on temporary floors and caps on fiscal adjustment**, or even a suspension of SGP rules, in extraordinary bad times (when they would lead to strongly pro-cyclical policy).[12] The advisory European Fiscal Board decided by the Commission on 21 October 2015 (European Commission, 2015e) goes a long way in this direction, since "*It may advise the Commission on the appropriate national fiscal stances that are consistent with the advice on the aggregate fiscal stance of the euro area within the rules of the Stability and Growth Pact*" (p. 3). However, the "within the rules of the SGP" provision means that the EFB will have no margin for those countries under the corrective arm of the SGP, and only limited one (see Box 1) for those under the preventive arm.

Box 1. The flexibility of the SGP

In January 2015, the Commission published a communication clarifying the use of "the flexibility within the existing rules of the Stability and growth pact", along three lines: (i) investment (in relation with the "Juncker plan"), (ii) structural reforms, and (iii) cyclical conditions (see European Commission, 2015a). Here we focus on the latter provisions.

In case of "a severe economic downturn in the euro area or in the Union as a whole", the pace of fiscal consolidation may be adjusted for countries under the preventive arm of the SGP (through explicit

[12] Symmetrically, in extraordinary good times, the EFB could advise the Commission to impose fiscal surpluses, i.e. a fiscal rule that goes beyond the SGP.

departures from the adjustment path) and for those under the corrective arm (through revised recommendations). This provision was not applied in 2012 and 2013 when the economic conditions were not considered a “severe” downturn. Hence the aggregate fiscal stance turned pro-cyclical (see Section 2).

In case of “an unexpected fall in economic activity under the corrective arm of the Pact”, the Commission focuses on consolidation “actions” (i.e. structural adjustment) rather than “outcomes” (i.e. nominal adjustment). Hence a downturn in an EDP country does not alleviate the requirement in terms of the fiscal stance, although it allows automatic stabilizers to play their role. For those countries under the preventive arm of the SGP, however, the fiscal stance may be modified according to a matrix that specifies the required structural adjustment depending on (i) whether the debt level is below or above 60% of GDP, and (ii) five different cyclical situations.

In order to gauge the implications of the latter flexibility on the aggregate fiscal stance, let us consider a schematic euro area composed of only two countries A and B of equal size, both being under the preventive arm of the SGP. Country A suffers from a -3.5% output gap and is thus considered “in very bad times” (output gap between -4% and -3%); meanwhile, country B displays no output gap and is thus considered in “normal times” (output gap between -1.5% and +1.5%). The aggregate output gap then is -1.75%, hence the euro area is in “bad times” (output gap between -3 to -1.5%). Still, whatever the level of the debt, the aggregate fiscal stance needs to be contractionary by 0.25 pp (if debts are below 60% of GDP) or more than 0.375 pp (if debts are higher than 60%), see Table 1. By comparison, a country considered “in bad times” would need to adjust by 0 (if growth if below potential and sovereign debt is below 60%) or 0.25 pp (growth below potential, debt higher than 60%).

Table 1: Required structural fiscal adjustment: two countries A and B under the preventive arm of the SGP

	A: very bad times output gap = -3.5%	B: normal times output gap = 0%	Average: bad times output gap < -1.75%
Debt/GDP<60% in both countries	0	0.5	0.25
Debt/GDP>60% in both countries	0.25	> 0.5	> 0.375

Source: Based on European Commission (2014). Two countries of equal size. Structural fiscal adjustment in percent of GDP.

Macroeconomic imbalances

Contrasting with fiscal imbalances, macroeconomic imbalances are ill-defined. They refer to external imbalances, excess leverage in some sectors of the economy, deviations of some key prices (unit labour costs, housing prices) from their “fundamental” level, imbalances on the labour market (i.e. unemployment). Further extending the concept to public and private governance, education, innovation policies or the judicial system, as it is done currently, does not help to identify the concept of “macroeconomic imbalances”.

The difficulty here is that low growth in a country may well trigger all kinds of imbalances and possibly a crisis at some point. Hence there is a temptation to incorporate all public policies in the MIP process. The temptation is reinforced by the existence of an Excess Imbalances Procedure (EIP) with sanctions, which is not the case of the Europe 2020 process. At some point, though, the MIP is so broad that it becomes illegible and even illegitimate.

Rather than trying to monitor growth policies through the MIP, it would be more appropriate and legitimate to ask Member states to make the necessary reforms so as their fiscal and social systems are

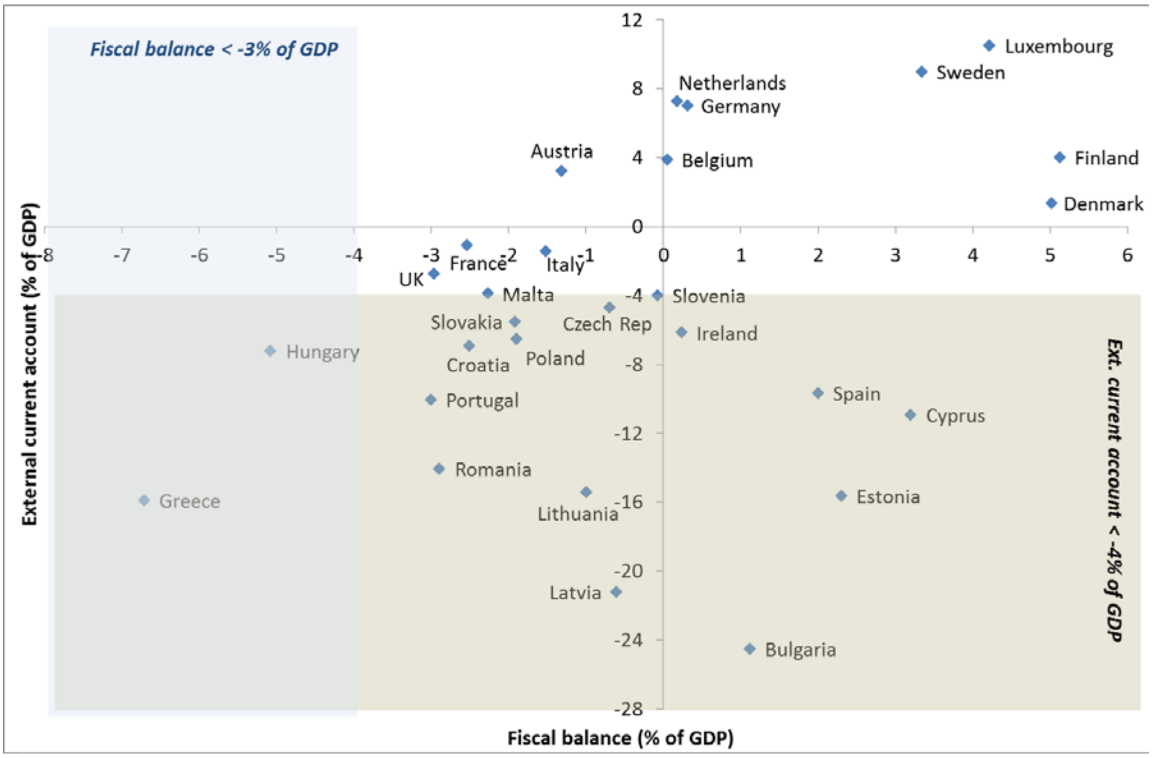
immune from any surprise concerning potential growth. Simultaneously, **the concept of macroeconomic imbalances should be re-focused on a small number of medium-term issues** that are key to a smooth-functioning euro area and for Member states in a fixed exchange-rate regime: public-private debt sustainability, aggregate supply-demand balance, wage developments compared to productivity, housing prices and unemployment.

Accordingly, the MIP would be streamlined and better separated from the Europe 2020 process. One way to do so would be **to rely on the current account balance as the flagship indicator of the MIP, in a similar way as the fiscal balance is the flagship indicator of the SGP**. This does not preclude using other indicators (adjusted current account, unit labour costs, leverage…) in the process. Indeed, the SGP itself uses several indicators (debt-to-GDP ratio, Medium Term Objective, structural balance), but the 3 percent deficit limit is well known and understood by national politicians, which helps building ownership.

In fact, the current account is the most accurate synthetic measure of macroeconomic risks.[13] Looking back to 2007, it seems that current account deficits were a much more accurate predictor of the crisis in Europe than the fiscal deficits (Figure 11).

Figure 11: Fiscal balance and external current account in 2007

(% of GDP)



Source: Ameco.

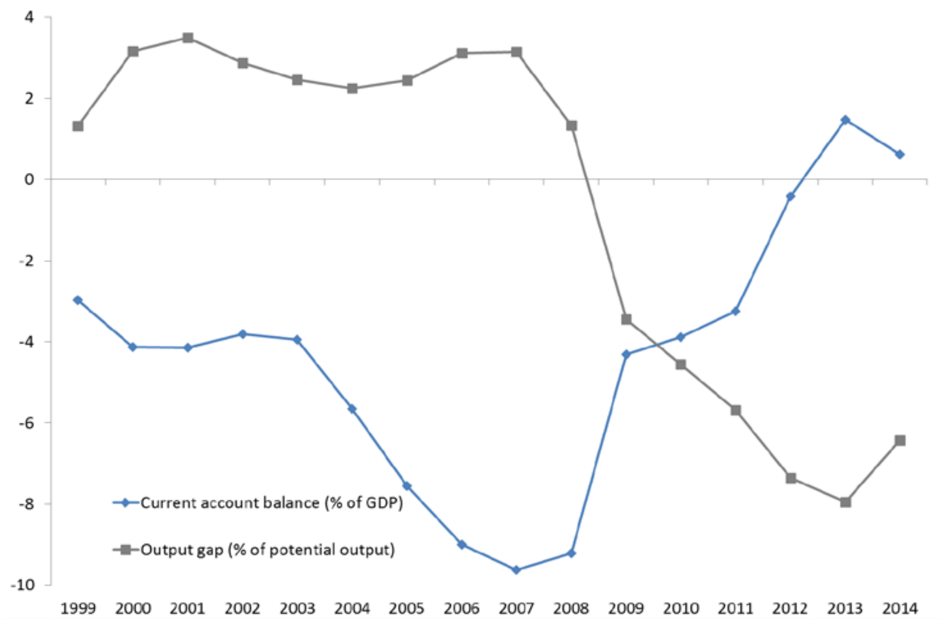
Because it sums up net private savings (i.e. gross private savings in excess of private investment) and net public savings (i.e. the fiscal balance), the current account covers both private-sourced and public-sourced imbalances. Furthermore, it accounts for the fact that a given government debt may have different implications depending on whether the debt is owned by domestic or foreign agents.

[13] We agree with Dabrowski (2015) that the current account imbalance is never the cause of the crisis in a monetary union. However, it reflects internal imbalances like a housing bubble, excess leverage, or cumulated losses of competitiveness (see Giavazzi and Spaventa, 2010; Wyplosz, 2013). It also makes the country vulnerable to a sudden stop of foreign capital inflows.

The current account may display excess deficit (as in a number of peripheral countries prior to the crisis) or excess surplus (as in the Netherlands today). In the former case, the risk is that of a sudden stop of foreign capital inflows, as has been observed in several European countries since 2008. In the latter case, the current-account imbalance amounts to an excess of aggregate supply over aggregate demand. Hence, it puts downward pressure on prices and makes it more difficult for deficit countries to adjust.

When current-account deficits are related to high investment in traded, high productivity sectors (rather than to a construction bubble), they may be deemed "good" imbalances. Similarly, when current-account surpluses result from demographic change (rather than under-investment), they may also be considered justified. It would be the purpose of "in-depth reviews" to isolate the contribution of productive investment (in relation with a catch-up process) or demographic change in the current account imbalance. Furthermore, in-depth reviews should aim at **correcting observed imbalances for the output gap**, in a similar way as the correction made on fiscal balances to calculate the structural balance. Figure 12 illustrates this point on the case of Spain. The Spanish external account rose from -10 percent of GDP in 2007 to slight surplus in 2014. During this period, however, the output gap fell dramatically, which impacted negatively on Spanish imports. Should the output gap come back to zero, the Spanish current account would probably become negative again.[14]

Figure 12: Current account and output gap: the case of Spain



Source: Ameco.

Other variables, such as unit labour costs, credit or housing prices, would also be useful to identify current or incoming imbalances. However, some variables currently included in the 11 "main" indicators of the scoreboard do not bring any insightful information in the process, and should therefore be dropped (see Appendix 1). Additionally, it is important to keep some hierarchy in the analysis, in a similar way as what is being implemented for SGP.[15]

[14] Correcting the current account for cyclical effects is at the basis of the calculation of the fundamental effective exchange rate (Williamson, 1983).

[15] In its October 2015 communication, the Commission rather suggested to extend the list of indicators to be used for the 2016 Alert Mechanism Report. Three indicators (activity rate, youth employment, long-term employment) would be added to the 11 "main" indicators already in the scoreboard. The total number of indicators would then be as high as 14+29=43, for each of the 28 Member states, hence a total of 1,204 indicators.

CSRs under the MIP heading should **make it explicit how the recommendations are expected to reduce the detected imbalances**. In particular, some structural reforms may have ambiguous effects on the current account balance, while unambiguously stimulating growth and employment in the long term.[16] The creation of National Competitive Boards in euro area countries (see European Commission, 2015f) will allow the European Commission to formulate its recommendations as objectives (e.g. closing a cost competitiveness gap) rather than detailed recommendations that need to be adapted to the specific context in each country. Less intrusion in the details of each wage-setting and social system will favour national ownership. However, it should be acknowledged that in many cases, wage developments are a consequence of other imbalances, e.g. on the housing market. Therefore, **macroprudential analysis should also play a key role in the efforts to reduce macroeconomic imbalances**, and rely on existing national macroprudential authorities.

Re-focusing the MIP would involve applying it mainly to euro area countries, for which macroeconomic imbalances cannot be erased through exchange-rate adjustment. The MIP should be considered as a collective "survival kit" in the euro area rather than a growth strategy, which is the purpose of the Europe 2020 process.

Europe 2020

Re-focusing the MIP on medium-term imbalances rather than long-term issues would allow reestablishing a more coherent view of integrated guidelines. It would also put all countries on equal footing, since a given CSR would appear under the same heading for any Member state. It would also draw a separation between two different objectives concerning the labour market: (1) a higher employment rate (Europe 2020); and (2) limited cyclical unemployment (MIP). Youth unemployment, which is in large part a structural issue, would be treated under the Europe 2020 heading, whereas Keynesian unemployment, which requires aggregate demand policies, would fall under the MIP.

To raise national ownership of the Europe 2020 process, it may be useful **to alternate different areas of public policy** in order to offer a more transparent benchmarking of Member states and involve the corresponding Ministers. For instance, year n could be devoted to education and the labour market, year n+1 to regulations of the goods and services markets (including energy), year n+2 to private and public governance. This could give a chance for a shared European strategy to emerge and for best practices to be encouraged.[17] It would also reduce the frequency of the reviews of the same policies, and allow all the concerned Minister to be involved. Reforms of education or justice take time. Reviewing them every year may end up with a repetition of the same recommendations, with limited value-added and some administrative *fatigue*.

3.2 SGP and MIP on equal footing

Once the MIP is streamlined and made more transparent, it should be positioned on equal footing to the SGP. It should always be remembered that most crises in the euro area did not originate in violations of the SGP. **In terms of systemic risk for the euro area as a whole, there is no reason to focus more on the SGP than on the MIP**. It is sometimes argued that the MIP cannot be brought to the same level as the SGP since macroeconomic imbalances are beyond the control of national governments. This is only partially correct. On the one hand, only the structural fiscal balance may be directly attributed to government decisions, whereas the financial balance, and even more the debt ratio, are largely out of its control. On the other hand, governments do have instruments to address macroeconomic imbalances: they

[16] Supply-side reforms will generally affect the current account positively, except in the short term if they concern the non-tradable sectors and/or trigger a wave of investment.
[17] Consistent with the wish of the Commission to promote convergence by benchmarking, see Commission (2015d).

can use fiscal policy (to the extent that this does not impinge on the SGP);[18] they can tighten the regulations on mortgages (e.g. reduce loan-to-value ratios); they control public wages and minimum wages; they can change sector regulations so as to shift production between traded and non-traded sectors. The fact that these instruments may affect macroeconomic imbalances with some delay is no reason why giving up on the MIP.

One way to rebalance the two schemes would be **to replicate the preventive and corrective arms of the SGP for the MIP**: Any country exceeding the current-account thresholds could be put under the Excessive Imbalance Procedure (EIP) if other key indicators do not point to another direction. The country would then be required to reduce the imbalance at a given pace that would account for cyclical conditions. The adjustment may or may not go in the same direction as the required fiscal adjustment, or it may be asked while no fiscal adjustment is required under the SGP. The government may have to mobilize other policy tools such as macro-prudential policy (e.g. curbing domestic credit), public sector wages or sectoral deregulations. A relatively long delay should be allowed to implement the adjustment. When the current account is back to the "safe" band, further adjustments may be required under the preventive arm of the MIP.

The combination of the SGP and the MIP would result in different levels of policy awareness and central monitoring (Table 2). The 'dark red' aera (squared excessive imbalances) would involve very close monitoring. Moving from dark red to green would imply going through intermediate steps, each one being rewarded with less intrusion.

Table 2: Combination of SGP and MIP

Stability and Growth Pact (SGP)	Macroeconomic Imbalance Procedure (MIP)		
	No imbalance	Preventive arm	Corrective arm (EIP)
No imbalance			
Preventive arm			
Corrective arm (EDP)			

EDP: Excessive Deficit Procedure (fiscal); EIP: Excessive Imbalance Procedure (macro).

More symmetry between the MIP and the SGP would help fighting the "deflation bias" of the euro area, since countries with a current account surplus would feel the same pressure to adjust as those with a fiscal deficit. At the same time, "double imbalance" countries would be considered putting more systemic risk on the euro area than "simple imbalance" ones.

3.3 Independent authorities and boards

One major innovation suggested by the report of the Five Presidents[19] is to construct a shared diagnosis of the situation of the euro area as a whole before entering into a country-by-country analysis. The shared diagnosis would be constructed based on the Commission's Annual Growth Survey, itself being fed by four independent reports: (i) the annual report of the future European Fiscal Board (EFB), (ii) a joint employment and social report, (iii) the annual report of the European Systemic Risk Board, and (iv) the annual report of the future System of Competitiveness Authorities or Boards (SCB[20]). At this stage, the objective should be to clarify the main positive and negative risks faced by the euro area: inflation or deflation? A banking crisis in one Member state? A severe correction of house prices? A divergence of

[18] For instance, a country with excess external deficit but a fiscal surplus could increase its fiscal surplus to reduce its external deficit.
[19] Juncker et al. (2015).
[20] Here we use the term employed by the European Commission in its communication of 21 October 2015.

unit labour costs? A fiscal risk? Social unrest in relation with unemployment? The ranking of CSRs should subsequently account for the ranking of these euro-wide risks.

It has sometimes been argued that the EFB and the SCB would be useful to better enforce fiscal and wage adjustment in individual Member states. Such interpretation pre-supposes that the main problem lies in insufficient control. We have argued above that the semester itself suffers from several imperfections that may explain the lack of national ownership. **In order to raise national awareness on imbalances, it would be more promising to reinforce the aggregate leg of the European Semester.** The EFB would contribute by providing an independent assessment of the aggregate fiscal stance, and possibly by making suggestions on the application of further “flexibilities” to the SGP: temporary floors or caps on fiscal adjustment, or even a temporary suspension of the SGP (in “severe circumstances”). These recommendations would be delivered to the Commission that would incorporate them in its own process. The EFB would also be heard by the European parliament. This would not preclude the EFB from having a key role in coordinating the national fiscal councils, especially in a technical sense (methodology to assess potential growth and fiscal adjustment). Far from weakening the Commission, it would reinforce its role since it would raise the importance of the integrated approach, as opposed to the country-by-country one.

Similarly, if the SCB consists in raising the pressure on Member states to adjust their wage costs downwards, it will duplicate the MIP and end up with a detrimental race-to-the bottom. It should be reminded here that lowering nominal unit labour costs simultaneously in all euro area countries will not raise the competitiveness of any of the Member states since sooner or later the euro will appreciate.[21] It will just make it more difficult for the ECB to reach its inflation objective. The mandate of the SCB should rather be to foster a *convergence* of unit labour costs across euro area countries. This involves looking at ULCs either relative to the euro area average, or in real terms (see Appendix 1).

[21] In the long term, the real effective exchange rate of the currency of an advanced area is constant (relative version of purchasing power parity, see Rogoff, 1996).

4. CONCLUSIONS

In June 2015, the European Parliament published a severe assessment on European economic governance, and made a number of suggestions (see European Parliament, Rapporteur Bérès, P., 2015c). Concerning the European semester, the report argued that it should be "streamlined and reinforced", and that it should "better articulate the fiscal and the macroeconomic frameworks" in order to increase "focus, effectiveness and ownership".

The Five-president report, and the Communication of the Commission on 21 October 2015, contain important building blocks of such reinforcement: a reorganisation of the semester in two consecutive stages, the first one being devoted to the euro area as a whole; plenary debates in the European Parliament on the Annual Growth Survey; more systematic interactions between Commissioners and national parliaments and social partners; the creation of an advisory European Fiscal Board and of a system of National of Competitiveness Boards; a more explicit and consistent MIP process; a simplification of the SGP.

These new elements will strengthen the euro area leg of the European Semester and help raising the consistency between the diagnosis and recommendations at the two levels (euro area, and country level). But they fail to streamline the MIP, and the deflationary bias of macroeconomic policies remains. Therefore, we propose to complement these reforms through a better delimitation of the MIP, more symmetry with the SGP, and an equal treatment of all EU countries vis-à-vis the "Integrated Guidelines" of the Europe 2020 process.

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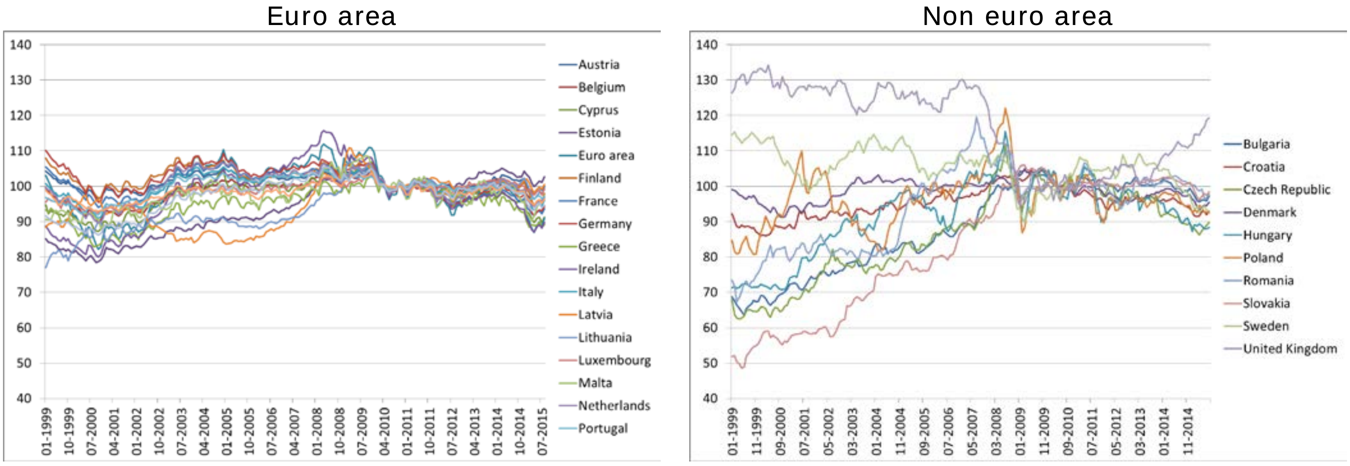
ANNEX 1: STREAMLINING THE SCOREBOARD OF THE MIP

Among the 11 main indicators of the scoreboard, three do not convey accurate information.

The first one is the **change in export market shares**. Due to the rise of new players in the global economy, export market shares of advanced economies have been on a declining trend since the 1990s. Then, the observed fall in market shares of a given EU country basically depends on its GDP per capita. In 2015, only Central and Eastern European countries did not post a fall of more than 6% (over 5 years) of their market shares.

The second misleading indicator is the **Real Effective Exchange Rate** (REER). Figure A1 shows the evolution of the REER for euro area and non-euro area countries, from 1999 to 2014 and with the same scale. For euro area countries, the REER closely follows that of the euro area as a whole, especially in recent times where inflation differentials are minimal (hence the evolution of the REER mainly depends on the evolution of the euro). Since a given Member state cannot be held responsible for an appreciation (or depreciation) of the euro, imposing a 5% threshold on such variation (over 3 years) does not really make sense. At least, REERs should be calculated against EU (or even euro area) partner countries rather than against the whole world.

Figure A1: Real effective exchange rate, Jan 1999-Aug. 2015
(2010=100)



Source: Bank of International Settlements.

Finally, imposing a fixed threshold to the **increase in nominal unit labour costs** (ULCs) does not make sense. If all countries cut their ULCs, this will result in a downward price pressure. Since the real effective exchange rates are stable over the long term in advanced economies (see Rogoff, 1996), this means that the nominal exchange rate will appreciate to make up for the price decrease. The result will be deflation without improved cost competitiveness. Alternatively, in case of a resumption of inflation in the euro area, all nominal ULCs would rise, with no automatic impact on cost competitiveness.

Within the euro area, nominal ULCs should always be compared to the euro area average, since intra-euro area exchange rates cannot adjust. For non-euro countries, nominal ULCs may be meaningful but the threshold should depend on world inflation. For all countries, an appropriate indicator is the real ULC that deflates nominal ULCs by the GDP deflator. Indeed, CSRs refer to real ULCs when they require wages to evolve in line with productivity.

It is sometimes argued that the imperfection of the scoreboard has little detrimental implication since it is not used mechanically in the in-depth analysis of the Commission. However this is additional motivation for streamlining the scoreboard, in order to free the economists of the Commission from devoting time to painfully calculate useless indicators.

ANNEX 2: THE LOOSE LINK BETWEEN IN-DEPTH REVIEWS AND CSRs

Here we sum up CSRs according to the classification of the European Commission (2015c), which counts several times a recommendation that covers different areas. Table B1 shows the average number of recommendations in three broad areas, for the different stages of the MIP. Stage 4-5 countries do not appear to receive more CSRs on labour market and education issues, whereas they do receive more recommendations on public finances and the welfare system. In fact, those countries receiving the highest number of CSRs under the labour market and education heading are those at stage 3. The detailed classification is given in Figure B1.

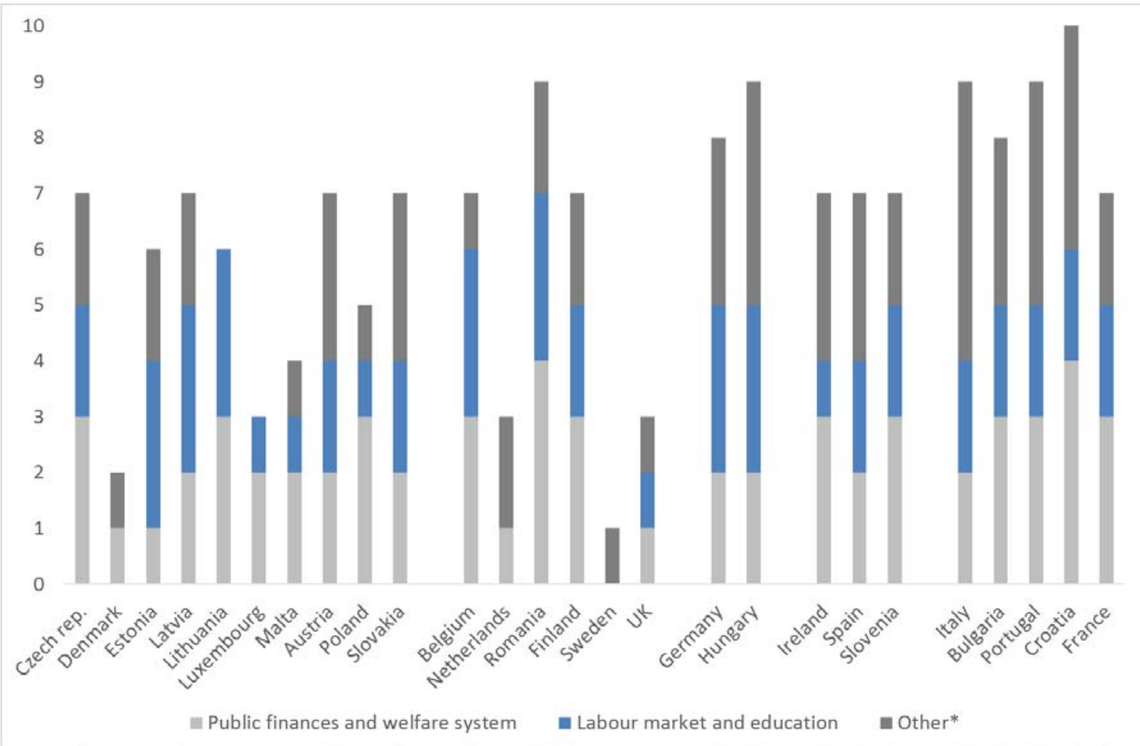
Table B1: **Average number of recommendations in three different areas**

	Public finances and welfare system	Labour market and education	Other*
Stage 1	2.1	1.8	1.5
Stage 2	2.0	1.5	1.5
Stage 3	2.0	3.0	3.5
Stage 4	2.7	1.7	2.7
Stage 5	3.0	2.0	3.6

* Financial sector, product and service markets, social inclusion, administration.

Source: European Commission (2015c), Annex 1.

Figure B1. **Number of recommendations in three different areas**



* Financial sector, product and service markets, social inclusion, administration.

Source: European Commission (2015c), Annex 1.

Европейски парламент Parlamento Europeo Evropský parlament Europa-Parlamentet Europäisches Parlament Euroopa Parlament Ευρωπαϊκό Κοινοβούλιο European Parliament Parlement européen Parlaimint na hEorpa Europski parlament Parlamento europeo Eiropas Parlaments Europos Parlamentas Európai Parlament Parlament Ewropew Europees Parlement Parlament Europejski Parlamento Europeu Parlamentul European Európsky parlament Evropski parlament Euroopan parlamentti Europaparlamentet

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