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Implications of EU Governance Reforms

Rationale and Practical Application

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Implications of EU Governance Reforms: Rationale and Practical Application

Abstract

We consider the real life implementation of some key elements of the new economic governance framework for the euro area. The main findings are the following.

The Country Specific Recommendations issued in the context of the European Semester seem to be too little 'specific' to constrain governments in general and even less creditor governments, who so far have been able to ignore them.

We argue that the Excessive Imbalances Procedure should be based much more on forward looking variables and on deviations from the euro area average instead of absolute thresholds.

The emphasis on cyclically adjusted balances in the reformed Stability and Growth Pact, as well as the Fiscal Compact (formally the TSCG) will face serious problems of implementation given the uncertainties surrounding the estimates of the cyclical component and the frequent revisions this component is subject to.

Finally we show that the rationale for fiscal policy coordination, namely spill-over effects from national actions to the rest of the euro area, change nature in different economic circumstances. During a financial crisis much more coordination is desirable than during normal times. This implies that the set of ambitious rules for economic policy coordination created under the impression of the euro crisis might not be appropriate for different circumstances.

Key words: EU governance, policy coordination, macroeconomic imbalances, spillovers, structural balance

JEL: E02, E60

EU:n hallinnon uudistusten vaikutukset: perustelut ja soveltaminen käytäntöön

Tiivistelmä

Tarkastelemme joidenkin euroalueen uusien hallintorakenteiden elementtien soveltamista käytäntöön. Päätulokset ovat seuraavat.

Eurooppalaisen ohjausjakson yhteydessä luodut maakohtaiset suositukset eivät näytä olevan tarpeeksi "tarkkoja" rajoittamaan hallitusten, ja erityisesti velkojamaiden hallitusten, toimintaa.

Väitämme, että liiallisten alijäämien menettelyn pitäisi perustua enemmän eteenpäin katsoviin muuttujiin ja poikkeamiin euroalueen keskiarvosta kuin absoluuttisiin viitearvoihin.

Uudistetun kasvu- ja vakaussopimuksen (kuten myös finanssipoliittisen sopimuksen, TSCG) huomio suhdannekorjattuihin tasapainoihin kohtaa vaikeita toimeenpanovaikeuksia – ottaen huomioon suhdannekomponenttiin liittyvät epävarmuudet ja useat tarkistukset sen alaerissä.

Lopuksi me osoitamme, että perustelu finanssipoliittiselle koordinaatiolle, nimittäin kansallisten toimien sivuvaikutukset muuhun euroalueeseen, on erilainen erilaisissa taloudellisissa tilanteissa. Finanssikriisin oloissa tarvitaan enemmän koordinaatiota kuin normaaliaikoina. Tämä merkitsee sitä, että eurokriisin aikana luodut kunnianhimoiset talouspolitiikan koordinaation säännöt eivät välttämättä sovellu toisenlaisiin olosuhteisiin.

Asiasanat: EU:n hallinto, politiikan koordinaatio, makrotaloudelliset epätasapainot, rakenteellinen tasapaino

JEL: E02, E60

1 Introduction

Financial and economic crises usually cause large losses in countries' income and welfare but they also create momentum for reforms which otherwise would be deemed politically infeasible. The Euro area crisis is certainly a good example in this respect. In the wake of the crisis, and under the pressure of financial markets, European institutions and national governments hastened to introduce changes aiming, on the one hand, to manage the crisis and, on the other hand, to set a new system of governance which would prevent other crises from reoccurring.

Under the hypothesis that a full fiscal and political union (as complement to the monetary union) would not materialize soon, the strategy has been guided by the objective to strengthen economic governance at the European level to ensure that policies are sound *ex-ante* in the different countries and coherent among member states. As the crisis showed that the Stability and Growth Pact (SGP) had failed to deliver fiscal discipline and large macroeconomic imbalances had built up within the monetary union eroding competitiveness of some Member State (MS) and abating their economic growth prospects, the focus of the reforms has been on how to improve the SGP and complement it with the macroeconomic imbalances procedure (MIP) and a more effective enforcement mechanism.

It is worth noting that since changes have been triggered in response to the euro area (not EU) crisis, they have resulted in a very complex system of economic governance with different layers legislation consisting essentially of three main elements, 1) the so-called six-pack, 2) the two-pack and 3) the Treaty on Stability, Coordination and Governance (TSCG). These three packages contain a series of new norms and mechanisms. Taken together there are substantial overlaps of competences at EU and euro area level, which are often difficult to disentangle.

1. The six-pack derives its name from the fact that it contains five regulations and one directive which build on the EU treaties, specifically Art. 121(1)[1] of the TFEU, and introduce the macroeconomic surveillance mechanism as well as the new SGP. They set the framework of the European Semester for Economic Policy Coordination. The European Semester is the cycle of economic and fiscal policy coordination which combines such changes. As the name already indicates it is set as one half of the year cycle in which national economic policy plans are analysed and evaluated by the European institutions resulting in Country Specific Recommendations (CSR) which are then supposed to be implemented at the national level during the second semester.

2. The two-pack is the set of two regulations building on the legislation included in the six-pack and which aim at strengthening the legal basis of the European semester particularly for the euro area countries and those in severe economic and budgetary difficulties.

3. The TSCG introduces a commitment to incorporate the so-called debt-break into national constitutions for the MS of the Monetary Union and other EU MS which opted to adhere to this Treaty.

[1] "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council" and furthermore "The Council shall, on a recommendation from the Commission, formulate a draft for the broad guidelines of the economic policies of the Member States".

All three elements have the common objective to strengthen economic policy coordination and fiscal discipline, particularly for the Euro Area, either by increasing the intrusion of European Commission into the budgetary powers of the national governments or by ensuring that MS commit themselves in the strongest manner, i.e. written in the national constitutional law (like in the case of TSCG). As of today, the hypotheses that these two approaches are complementary, overlapping or competing remain all untested.

This summary description of the new framework of European economic governance gives a sense of its complexity; for this reason in this paper we do not aim at making a complete or exhaustive assessment of it in all its dimensions. Rather we will put emphasis on assessing some key aspects of the European Semester, namely the macroeconomic imbalances procedure (MIP) and the country specific recommendations (CSRs), and of the new TSCG, as well as the overall philosophy and guiding principles behind the idea of fiscal coordination.

Against this background the rest of this note is organized as follows. The next section provides a detailed description of how the European semester architecture is drawn, considers its enforcement mechanisms and highlights the strength and weaknesses of this process. Section 3 and 4 address two specific components on the new system of governance, the MIP and CSRs and attempt to assess their effectiveness. Section 5 looks at some features of the TSCG and considers the uncertainty surrounding the concept of structural deficit. Section 6 reflects on the overall philosophy behind fiscal policy coordination and its ultimate justification, namely cross country spill-over effects and illustrates how the case for coordination changes with economic circumstances. The last section draws some conclusions.

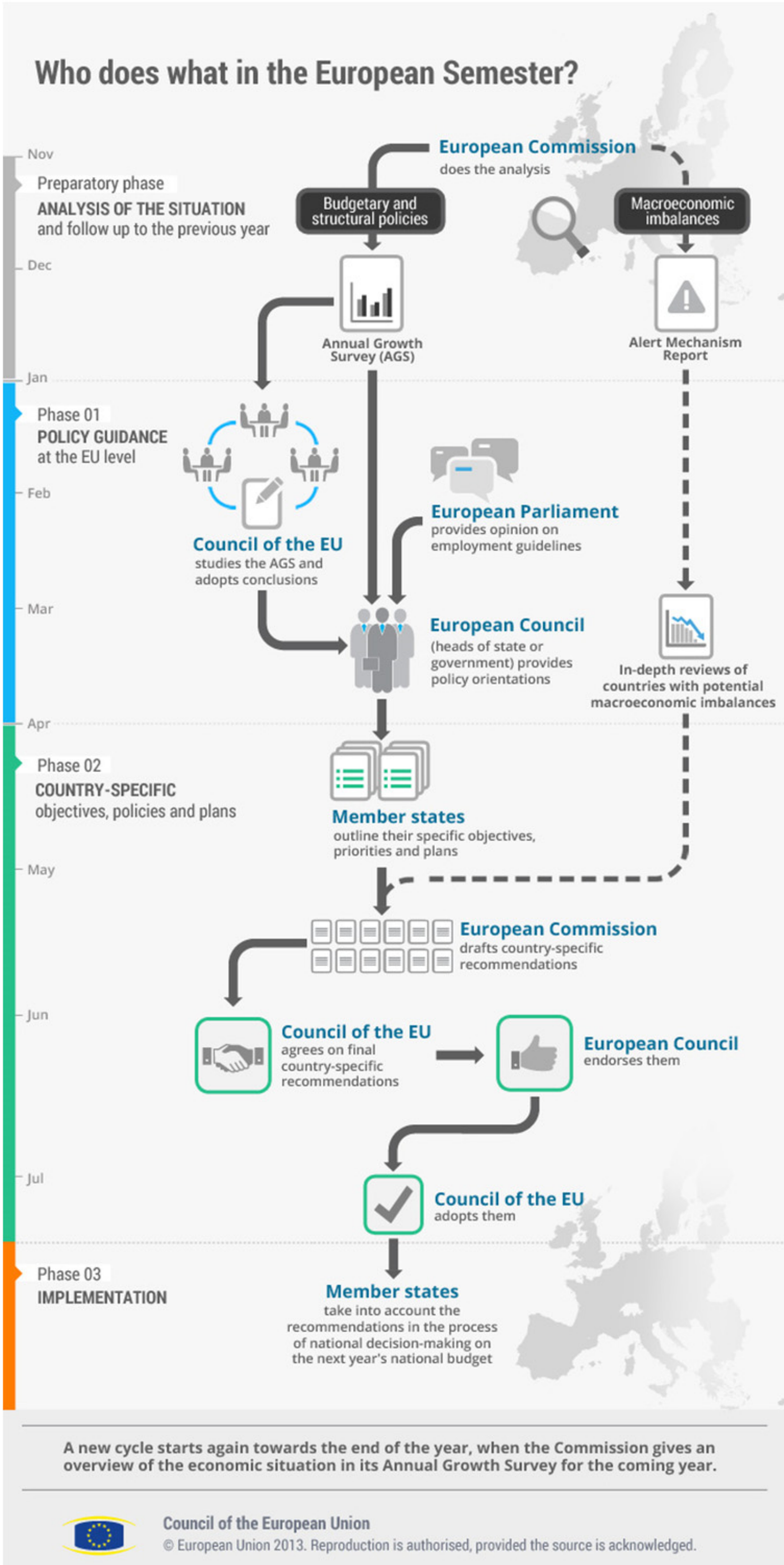
2 European semester: the cycle of economic and fiscal policy coordination within the EU

The full cycle of the European Semester (See Figure 1) starts in December with the European Commission's publication of the *Annual Growth Survey* (AGS) and the *Alert Mechanism Report* (AMR). The AGS provides the foundation for the entire cycle concerning potential budgetary measures and reform agendas. The AGS provides also growth forecasts; but its core are the policy goals on which policy recommendations and then the action of the MS during the ensuing cycle should focus. The overall aim of the semester is to: ensure sound public finances, foster economic growth and prevent excessive macroeconomic imbalances in the EU

The AGS of 2014 provide a good illustration of the main issues (which were about the same as during the preceding years). It states that the EU and its Member States should pursue – and in some cases reinforce – their focus on making progress in the following five priorities:

- Pursuing differentiated, growth-friendly fiscal consolidation
- Restoring normal lending to the economy
- Promoting growth and competitiveness for today and tomorrow
- Tackling unemployment and the social consequences of the crisis
- Modernising public administration

Figure 1 The European Semester cycle



Source: Council of the European Union.

The pursuit of these targets filters into the *Stability and Convergence Programs* (SCP) and *National Reform Programs* (NRP), which are to be published by each Member State in April. However beforehand, the AGS are assessed by the Council of ministers and adopted for the European Council to be converted into policy orientations for the MS. This process should precede the making of national plans with the specific purpose of influencing national policy making in its initial stage.

The impact of the general policy goal and recommendations resulting from the AGS can only be limited. Some of these recommendations are timeless (modernising public administration, promoting growth and competitiveness). These are in principle goals which should be pursued continuously. Other recommendations (growth friendly fiscal consolidation) provide little specific guidance to policy making unless one specifies concretely how a fiscal consolidation could be made more growth friendly.

Given the tight timing required it is also clear the neither the Council nor the European Council will be able to undertake more than a broad political evaluation of the overall philosophy behind the AGS. In practice it would anyway be difficult to maintain the time table of either of the two were to express a substantial disagreement with the AGS as proposed by the Commission.

During the same period (i.e. in parallel to the AGS) the AMR analyses macroeconomic trends to signal current and potential macro imbalances.[2] MS, which are considered to be at risk of imbalances posing a threat to Union, receive in April an "in-depth report'. The imbalances are identified on the basis of a scoreboard entailing a series of 11 quantitative indicators (supplemented by some others which serve as background and complements). Either a threshold or a range of 'normality' is attached to each of them to identify deviations which can lead to excessive imbalances.

In May, together with the updated estimations under the Commission's spring economic forecast, the European Commission's combines the findings in the in-depth report (MIP arm) and the MS reform and budget plans submitted under the NRP and SCP and drafts *Country Specific Recommendations* (CSRs).[3] These are once again picked up by the Council and subsequently adopted by the European Council. This ends, broadly speaking, the European Semester in mid-year. The second half of the year is then supposed to be used by MS action taking into account the CSRs in their national decision process when formulating (national) policies including the following year's budget. The Commission closely scrutinizes their implementation throughout the rest of the year.

As illustrated above the European semester involves the action of different European actors with rather specific tasks and a very unbalanced weight of the different European institutions in the process: The European Commission plays a key role by providing background information for the assessment of the counties' economic situation and policies at the start of the cycle and then by drafting the country specific recommendations while the European Council has the key role to first provide policy orientation and then adopt the final recommendations.

[2] As it will be explained in the next section, not all measures/sanctions applied to euro area countries are applied to other EU, non-EMU MS.

[3] An exception to this is applied to the 'program Countries' i.e. Cyprus, Greece, Ireland and Portugal, which do not receive and CSRs as they are already under close surveillance of the ECB, IMF and European Commission.

By contrast the European Parliament has only the very marginal role to express an opinion before policy orientations are formulated in the early stage of the cycle. Meetings between the European Parliament and national parliaments can take place both in the pre-spring council (of the ECON, EMPL & BUDG committees) and the ECON meetings in September, but the aim is only to discuss national policies on the basis of the AGS. The European Parliament can publish an own initiative report besides on the opinion on employment guidelines, but neither the Council nor the Commission are accountable to the European Parliament. They merely have to ensure that the EP's opinion is acknowledged.

The centrality of the Commission in the European Semester is natural given its executive role. There can be little doubt that in terms of staff and technical competences, the European Commission is best placed for the surveillance of national economic conditions and policies. Moreover its status of body who voices the collective European interest, above national interests, should ensure that such a process is carried out in effective fashion. However monitoring and assessing may be less objective and more complicated than one would expect. Even the quantitative indicators, like those included in the MIP, are seldom as clear-cut as they might seem at first glance, especially under adverse economic conditions. It would thus seem to appropriate for the Commission to present as early as practicable to the EP its general philosophy and approach in measuring imbalances.

Two crucial issues arise in the context of the MIP. The first relates to the concept of 'normality', which defines ranges and thresholds but for which there is neither theoretical nor empirical economic foundations. In the end they are subject to judgement. One example of the importance of a judgemental component is given by asymmetric range imposed on current account imbalances[4] and which has feed a very large debate during the 2013/4 cycle. The second issue is about what kind of action a government can undertake to affect matters falling outside the fields of budgetary and reforms policies. While it must be acknowledged that the MIP represents the clearest attempt to learn from the mistakes made before the crisis and the information it collects is relevant as it could work as warning mechanism, it remains the fact that, in most cases, governments do not control the mechanisms behind macro imbalances which are mainly driven by market forces. What policies can do is to affect behaviour through incentives, which means that their influence on the final target is only indirect and with a lag.

Lastly, if we assume the framework is monitoring the correct indicators and imposing the appropriate policies to bring the MS back on course, the question remains about what tools the European Institutions have to ensure compliance. The next section tries to answer this question.

2.1 The enforcement of the rules

As described above, the European Semester is organized along two arms: the preventive arm and the corrective arm. In the case of the budget section the preventive arm consists of the medium-term budgetary objectives (MTOs) under the SGP.

[4] A current account deficit larger than -4% (of GDP) is considered excessive imbalance just as a current account surplus of more than 6% (of GDP), the range is hence asymmetric and with an upper bound more leniently set. This is relevant in the current debate as the German current account is just below 6%. If the range were symmetric, Germany would be in position of excessive imbalance, but in reality there is theory neither for 4% nor for 6%.

Stability and Convergence Programs shall contain MTOs representing a budgetary position that safeguards against the risk of breaching the 3% of GDP threshold and ensures the long-term sustainability of public finances as well as the adjustment path towards the MTO (the year-by-year target effort until it is achieved) and the expected path of the debt ratio.[5]

As an example of how this mechanism works it is interesting to look at Italy. In the Italian SCP 2013[6], the maximum limit to growth in the spending aggregate is set according to whether the MTO targets are achieved or not. More specifically in the period 2014–2016 the benchmark is equal to -1.1 per cent a year if the MTO is not achieved and 0.0 per cent if the MTO is achieved. Moreover, the first assessment by the Commission and the European Council of Italy's compliance with the debt rule will be made in 2015, namely at the end of the three-year transition period after the excessive deficit procedure was closed. For that date the debt benchmark, set at 122.2% of GDP, has been obtained on the series of the planned debt observed during the 2012–2014 period. In the document such ratio is lower than the ratio planned by the Government equal to 125.5, thereby signaling a possible a non-compliance with the debt criteria. This implies that unless further measures are designed and implemented the corrective arm may be triggered.

Under the MIP the preventive arm consists in the respect of the thresholds and ranges foreseen in the scoreboard. The counsel on how to achieve the MTOs as well as macroeconomic rebalancing measures are delivered within the CSRs each year thereby provide ex ante guidance to the MS to prevent the engagement of the corrective arm[7].

The corrective arm is triggered once the Commission has determined (and the Council has not overridden that judgment by a qualified majority) that proposed preventive measures have not been implemented and the budget deficit or macroeconomic imbalance persists. An Excessive Deficits Procedure (EDP)[8] and an Excessive Imbalance Procedure (EIP) can then be launched. As consequence the MS concerned is obliged to produce a short-medium term plan to bring the budget/economy back onto a sustainable path. If the intended budgetary corrections are deemed by the Commission to be non-credible it can ask the concerned MS to draft a new budgetary plan. If the excessive deficits persist the European Commission can opt to file a recommendation to the Council to impose a non-interest-bearing deposit (0.2% of GDP). Note that this sanction is only applicable to EA MS. The deposits may not exceed 0.5% of GDP and after two consecutive years of neglected correction of the EDP (confirmed by the Council) the deposit is converted into a fine. A similar approach is used for the EIP, though the interest bearing deposit is capped at 0.1% of GDP.

A reversed qualified majority voting procedure, from which the MS concerned is excluded, was introduced in 2010 in order to facilitate the adoption of the Commission's recommendations. Under this framework a recommendation is deemed adopted unless the Council votes with qualified majority against it. This was meant to rule out the *quid pro quo* approach (I vote to save you if you vote to save me) which was observed during the 2004 SGP violation of German and France.

5 http://ec.europa.eu/economy_finance/economic_governance/sgp/preventive_arm/index_en.htm

6 See http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2013/01_programme/it_2013-04-23_sp_en.pdf

7 The legal basis is anchored in Article 121(4) TFEU and concerning the SGP in Article 126 TFEU. Interestingly, for the EA Member States even a failure to comply with the MTOs (determined by the Council) will result in an interest bearing deposit of 0.2% of GDP.

8 See TFEU Protocol on the excessive deficit procedure.

Neither a fine nor the interest bearing deposit has been made use of so far and it will be interesting to see how the Council will decide should a large country be on the verge of receiving a fine.

2.2 Strength and weaknesses of the process

The two previous sections have illustrated the complex architecture of the European semester. This is still a young procedure and it certainly is too early to make an overall assessment about its effectiveness and impact on national policy-making. Yet, the first three cycles do provide a hint of what has worked well and which expectations were not fulfilled thus far.

While on the one hand the effort to improve surveillance and coordination within the EU must be acknowledged, the process seems to suffer some limitations.

The first one is about the lack of democratic legitimacy of decisions. The new system of governance is featured by low input legitimacy with executive powers at EU level gaining strength and the ground lost by national parliaments not being offset by a parallel increase in the power of the European Parliament. This aspect tends to spill over into the issue of lack of ownership of policies and structural reforms which are perceived by countries as imposed by Brussels (European Commission).

Another limitation relates to the assessment of the implementation of CSRs by national governments. While in the case of specific quantitative targets, the assessment should be simply based on the outcome (that is indeed the task of the EDP and the MIP), in the case of reforms or medium term objectives the evaluation seems to be based more on the effort made rather than on the results obtained. In facts, the short experience suggests that even in the case of numerical targets the assessment is not always based on outcome. The extension offered to Spain and France to achieve their budgetary targets is an example in this direction. This may not necessarily mean that such an approach is wrong, but it shows that judgement plays a key role and as such it can be influenced, thought the Commission is supposed to act as '*supra partes*' institution. Until now the sanctions foreseen in case targets are not met have never been triggered and the resort to judgement or unobservable variables has always played a crucial role.

As it will be shown in section 4, in practice there seems to be an asymmetric evaluation of the CSRs: Strong countries tend to ignore the recommendation and no action is taken against them. Similarly weaker countries sometimes tend to be too proactive without being able to deliver.

3 The Macroeconomic Imbalance Procedure in action: the case of surplus countries

In the framework of the new system of governance the Macroeconomic Imbalance Procedure aims at detecting, preventing and possibly correcting macroeconomic imbalances that would jeopardize the functioning of the EU and euro area economies. In order to do this the MIP identifies trends that could lead to 'booms and busts' and helps countries in deciding the appropriate policy reactions to mitigate and manage these risks.

A crucial tool for this purpose is the MIP scoreboard – a set of early warning indicators intended to screen internal and external macroeconomic imbalances in the Member States. The scoreboard acts as a first step in a broader process seeking to disentangle the existence and seriousness of macroeconomic imbalances in the Member States. In this process, the scoreboard is used in combination with additional indicators and all available information to ensure a non-mechanical interpretation based on sound economic judgment.[9]

Originally the process was mainly designed to prevent the emergence of imbalances like the large and persistent current account deficits that occurred in Spain, Portugal and Ireland and resulted in the accumulation of large external debt as the consequence of domestic booms in real estate. For these countries the EIP comes too late and market mechanisms more than rules have triggered the absorption of the current account deficits. For this reason the attention has now shifted towards the application of the EIP to surplus countries.

3.1 Identifying current account imbalances

Within the alert mechanism, the current account is only one among 11 different indicators which should be taken into account. In reality it is, however, a key indicator because it shows the combined effect of many different forces (the strength of domestic demand and the competitive position of exporters, to mention only two). But within this mechanism, a current account surplus is also viewed as a source of concern. Two questions arise in this context: why and how an 'excessive' surplus should lead to problems for the euro area as a whole. To answer these questions we look closely at the case of the German surplus.

The 2012 Alert Mechanism Report signalled an excessive current account surplus for the Netherlands and Luxembourg, while Germany had remained marginally below the 6% threshold (using over a 3-year average). In the 2013 document[10] Germany, along with the Netherlands and Luxembourg, was singled out as a euro-area country with a surplus above the upper threshold.

One single figure, which is set in arbitrary fashion, cannot possibly tell the full story, and this is acknowledged by the fact that the Commission's report called for an 'in-depth analysis'. But the large debate about the German surplus requires an understanding of whether it constitutes an imbalance that threatens the stability of the euro area and how its relevance should be measured.

A first key point is about the definition of excessive current account imbalance.

In the context of the Regulation specifying the MIP, the Commission defines an imbalance (applied to the several indicators of the scoreboard) as follows:

[9] In 2014 the European Commission suggested changes to some of the auxiliary indicators, including additional indicators that contribute to complement and qualify the reading of the scoreboard. Ultimately this has the objective to better understand the social dimension of risks implied by imbalances and help to identify policy measures to correct imbalances.

[10] See the 2014 report of 13 November 2013 (http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm).

> *"Any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole."*[11]

Since the Regulation refers to a trend and the MIP system and its scoreboard are engineered as a preventive tool, it would make sense that the indicator were forward, not backward, looking. This is especially important if one considers that in the specific case of the 2013/14 exercise. For Germany, the forward-looking average (2012–14) still triggered the indicator, for the Netherlands, the trend is towards ever-higher current account surpluses, a priori justifying an early warning and, none of the deficit countries has an imbalance any longer (see the Table 1). On a forward-looking basis one would have found by end 2013 that even the largest crisis countries – Italy and Spain – were moving from a deficit to a surplus position, while Portugal was getting close to balance in its current account.

Table 1 Current account balance as % of GDP, 3-year backward (2010–12) and forward (2012–14) average

	Backward 2010–12	*Forward 2012–14*
Germany	**6.6**	**6.9**
Ireland	2.3	4.4
Greece	**-9.9**	-3.2
Spain	-3.2	0.9
France	-2.1	-1.8
Italy	-2.4	0.5
Cyprus	**-6.7**	-3.1
Netherlands	**6.7**	**9.1**
Portugal	**-6.5**	0.0

Source: Own calculations based on AMECO data.

Forecasts of current account balances are of course subject to uncertainty, especially in the current fragile state of the global economy and a small forecasted deficit could turn into a rebalancing throughout the next semester, or vice-versa. However, even past current account data have been revised, for example in the Fall Economic Forecasts of 2013 corrected Germany's surplus from formerly 6.1% (on a 3-year average, i.e. 2010–2012) to 6.6%. Secondly, a similar uncertainty exists for the excessive deficit procedure whose starting point is the budget, i.e. spending and tax plans for the next fiscal year. These plans are also subject to considerably uncertainty. Thirdly, what should matter for the EIP is not so much the level of the current account balance, but its expected change over time. It is clear that any sanctions should be imposed only if the realised values later confirm the forecasts.

In (political) reality the German current account surplus remains the one variable most scrutinized. The 2013 exercise found that it at a level just above the MIP threshold (based on 2010–12 data); leading the Commission to launch an 'in depth review'. The outcome of this in depth review was published in early 2014. It found that Germany had indeed an imbalance, but not

[11] See Regulation (EU) No 1176/2011 of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

an excessive one. This finding[12] leads to the central question of when an imbalance is to be considered 'excessive' or harmful.

3.1.1 When is an imbalance harmful? Negative spill-over effects

Intervention by the EU under the Excessive Imbalance Procedure (EIP) can be justified if there are external effects. This is recognised in the official regulation:

> *"When assessing macroeconomic imbalances, account should be taken of their severity and their potential negative economic and financial spill-over effects which aggravate the vulnerability of the Union economy and are a threat to the smooth functioning of the economic and monetary union."*[13]

Furthermore the European Commission when explaining the rational for current account imbalances states:

> *The surveillance under the MIP covers both current account surpluses and deficits which, from an economic point of view, pose different types of policy challenges. In particular, unlike current account deficits, large and sustained current account surpluses do not raise the same concerns about the sustainability of external debt and financing capacities, concerns that can affect the smooth functioning of the euro area (which is a key criterion for triggering the corrective arm of the MIP).*[14]

Unfortunately, one cannot find a description of the negative spill-over effects resulting from a current account surplus in any official document. The two possible criteria for finding external effects are a) vulnerability of the EU economy and b) threat to the smooth functioning of the economic and monetary union. It is difficult to argue on either account, however, that a high surplus in one country per se constitutes a threat which must be dealt with.

The term 'smooth functioning' of the euro area must be interpreted widely in order to consider a surplus an imbalance that is harmful to the others. With reference to the current context, one could argue that a demand deficiency in Germany has a negative impact on (or does not help to provide relief to) the rest of the euro area, much of which is in a deep recession. Hence, the argument is valid in a specific environment characterized by an area-wide demand shortfall or a liquidity trap. This aspect deserves further investigation.

First, if demand spill-over manifests itself in the current accounts of euro area partners, one should look at the correlation of current account balances within the euro area. There was a strong negative correlation concerning the current account balance between aggregated Germany and the Netherlands vis-à-vis the rest of the euro area until 2009 (close to -90%). But this relationship changed totally after the financial crisis with the correlation turning strongly positive (2010–14). This suggests that, up until the crisis, a higher German surplus meant

[12] For the Netherlands, the Commission also did not find that its current account surplus constitutes an 'imbalance' worthy of corrective policy prescription. Given that the German surplus is lower than that of the Netherlands (and that the other indicators are of a similar order of magnitude), it would have been difficult for the Commission to find that Germany's surplus constitutes an imbalance worthy of the sanction, but not that of the Netherlands.

[13] Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances, paragraph 17.

[14] See "The scoreboard for the surveillance of macroeconomic imbalances", European Economy, Occasional papers 2012, p. 6.

a larger deficit for the rest of euro area, but this linkage is no longer valid today, i.e. at least *ex post*. Needless to say, correlation does not mean causation. At any rate experience has shown that the continuing large German surplus did not impede the adjustment in the deficit countries after the start of the euro crisis, although it might have made it more difficult.

Second, the size of the direct and indirect demand spill-over effects on the deficit countries is likely to be small, as documented in a study of surplus economies undertaken by the Commission (DG ECFIN).[15] Even a sizeable reduction in the German surplus would lead only to a small change in the external accounts of the peripheral euro-area countries. Moreover, in considering the external effects of stronger (domestic) demand in Germany and the Netherlands, one should look at the potential effect on employment where unemployment is very high. But this is unlikely to be appreciable.

All this suggests that if demand spill-over effects are the main reason to label the German external surplus an 'imbalance', it does not really matter whether this surplus has arisen because of higher investment incomes or a higher trade surplus. From a pure demand-management viewpoint, the key consideration would be that part of any increase in the German income would spill over into higher external demand and that about 40% of it would go towards goods produced in other euro-area countries.

This consideration has significant impact on the choice of the threshold for surpluses to be labelled imbalances given that this spill-over effect is independent of the size of surplus (as a % of GDP or otherwise). Indeed no economic justification is given here for the number that was adopted under the 'intelligent symmetry' as illustrated in the following text:

> "*The upper value of the threshold is set at +6%. The upper quartile of the distribution of the three-year backward average of current account balances corresponds to +2%. To this an additional 4% margin has been added in line with the "intelligent symmetry" approach to current account balances. This allows tackling both current account surpluses and deficits but recognizes that the urgency for policy intervention is clearly greater in the case of current account deficits. It also reflects the fact that the risk of negative spill-over effects of current account deficits is more prevalent than for current account surpluses due to sustainability considerations.*"[16]

Whether or not a large surplus is in the interest of Germany is irrelevant for the issue at hand. The purpose of the EIP is not to force countries to do what is best for them, but to protect the rest of the euro area from the fall-out of national policy mistakes.

It is interesting to note that the Commission found in its 2014 in-depth review that Italy was in an excessive imbalance position although the current account of the country was inside the threshold. The assessment was made on the basis of weak external competitiveness "rooted in the long standing misalignment between wages and productivity, a high labour tax wedge, an unfavourable export product structure and a high share of small firms which find it difficult to compete internationally"[17]

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[15] European Commission (DG ECFIN) (2012), "Current account surpluses in the EU", European Economy, September (http://ec.europa.eu/economy_finance/publications/european_economy/2012/current-account-surpluses_en.htm).

[16] http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp92_en.pdf

[17] http://ec.europa.eu/economy_finance/economic_governance/documents/2014-03-05_in-depth_reviews_communication_en.pdf, p. 16

3.2 Imbalances within euro area? Absolute or relative indicators?

Starting from the assumption that the EIP should prevent imbalances within the EA, it is questionable to use absolute indicators to set up thresholds. If all euro-area countries have exactly the same external imbalance, the potential for disruptions that threaten the 'smooth' functioning of the EMU should be much smaller. Moreover, in this case, the recommendation to act on the external imbalance of the Union should go to the EMU authorities.

For example, if all countries have a large deficit, a sudden stop to capital inflows would affect all of them at the same time. But given that the euro exchange rate is flexible, the shock would play out quite differently than a sudden stop inside the euro area. Furthermore, if most euro-area countries run external surpluses, a particularly large surplus in any one country should not be regarded necessarily as an 'imbalance'.

Table 2 shows that it makes a big difference whether one looks at the indicators *per se*, or their values relative to the euro area.

Table 2 Current account balance as % of GDP, average 2012–14

	Absolute	*Difference with EA average**
Germany	6.9	4.4
Ireland	4.4	1.9
Greece	-3.2	-5.7
Spain	0.9	-1.6
France	-1.8	-4.2
Italy	0.5	-2.0
Cyprus	-3.1	-5.6
Netherlands	9.1	6.6
Portugal	0.0	-2.5

* Difference with extra EA17 Current Account Balance as % of EA17 GDP.
Source: Authors' own calculations based on AMECO data.

In the case of Germany, the difference between its current account position and the euro-area average remains comfortably below the threshold of 6%. Hence, under the hypothesis that deviations from the euro-area average are the right measure to assess imbalances, it would be mistaken to consider Germany as having violated a threshold. The Netherlands would still exhibit a current account surplus above the threshold, although it would not be far from the upper bound.

Looking at the deviations from the euro-area average would also lead to a different view of the remaining deficit countries. Greece, Cyprus and in particular France would trigger the threshold. The French deficit remains modest in absolute terms, but it is now far away from the euro area average.

It is clear that from a global perspective, the absolute surpluses/deficits matter and it is thus understandable that from the point of the view of the IMF or the US authorities, the German surplus remains a key issue. By contrast given that the purpose of the EIP is to signal emerging intra-euro-area imbalances, it is more appropriate to look at the deviations of national external deficits/ surpluses relative to the euro-area average.

The case for using relative indicators is even stronger for the indicator based on the market shares of exports. In principle for any individual country a fall in the share of its exports in the global market is a sign of a loss of competitiveness. However, given the rise of China and other emerging economies, it is unavoidable that mature economies as those of the euro area lose global market shares. This implies that, on the one hand, it is not surprising that the market share indicator for virtually all euro area countries shows a warning signal, but on the other hand, for this same reason this indicator worthless. To restore its meaning, the indicator should measure the difference between the evolution of national market shares and the euro area overall.

3.3 Can policies correct current account imbalances?

Even abstracting from measurement issues illustrated in the previous section, a finding that a surplus needs to be sanctioned is rendered unlikely by the difficulties that arise in terms of measures required to 'correct' the surplus – in such a way that the rest of the euro area benefits.

In a Keynesian perspective a stronger domestic demand in a surplus country (today Germany and the Netherlands) would benefit the rest of the euro area mired in high unemployment.

This leads to the eternal question of what could the German authorities be asked to do to strengthen domestic demand.

The Commission may find it difficult to argue that a fiscal expansion would be appropriate as this would require Germany to violate EU rules (e.g. the Fiscal Compact, see below) and its own constitution. Higher public investment in Germany seems appropriate given its current low level, but it would have to be financed by taxes, thus strictly limiting the impact on demand. It thus seems difficult to imagine any measure by which the German government (or that of any surplus country) could directly increase domestic demand.

It has often been argued that service-sector reform could unlock more growth in Germany. This seems very likely. But would it contribute to lowering the German surplus? The answer is very uncertain since reform of the service sector would increase supply, but it is not a certainty that it would also increase demand and more than supply. Service-sector reforms that increase productivity improve, *ceteris paribus*, competitiveness. One would have to hope that wages would increase by at least the same amount and that consumption would increase more than proportionally (than the increase in productivity). But this is not a foregone conclusion. Service-sector reforms are recommended for deficit countries with the opposite intended effect: to improve the external balance. It is difficult to understand why the same reforms should reduce the deficit in one case and reduce the surplus in another.

The only measure that would in all likelihood have an impact on the German surplus is the introduction of a (high) minimum wage. This seems the surest way to increase demand in the short run. Germany adopted this measure in 2014, but without real consultation and the in-depth review of the Commission had not dared to recommend such a measure.

The 2013/4 application of the EIP thus shows that two issues remain unresolved. First, it is not always clear what the spill-over effects of specific structural reform measures reforms will be. The other one is how to ensure that countries actually follow the recommendations addressed to them (and what to do if they do something totally different). The latter issue is addressed in the following section.

4 The country specific recommendations in action

The European Semester cycle closes in early July with the endorsement of the country-specific recommendations (CSRs) by the European Council. Member State governments are then expected to implement such recommendations into budgetary decisions, structural reforms and employment policies. The recommendations are formulated on the basis of specific challenges previously identified by the Commission in the framework of the annual growth survey (budget and structural challenges) as well as within the macroeconomic imbalances procedure and after hearings of the European Parliament opinion.

Two stages are therefore crucial in this process: first, the identification of the main challenges within the framework of the EU policy instruments, which include fiscal issues (falling under the spectrum of activity of the 'traditional' SGP), macroeconomic imbalances (falling under the new excessive imbalance procedure, EIP) and major overarching economic objectives, including growth and financial stability. Second, the identification of the challenges has then to result in policy recommendations which should be as concrete and measurable as possible.

In 2013/4 there were sets of formal CSRs for each Member State (except the four programme countries Cyprus, Greece, Ireland and Portugal) and for the euro area as a whole, each of which covered a whole array of fiscal and structural measures.

CSRs contain two quite different sets of recommendations: the policy recommendations regarding fiscal policy are usually precise and contain numbered targets. However, many other policy recommendations are quite vague and effectively constitute exhortations to the government to adopt a certain general policy direction without giving any precise target to be achieved. This leaves lots of room for disagreement on what the recommendations actually mean and leads to vague suggestions that might be addressed in a superficial and artificial way by any country. Examples of the latter include recommendations like "better coordination of different levels of government" or "a more efficient implementation of planned reforms". Generalities like these are not meaningful since one might well ask which country would not benefit from them.

On the structural reforms front the key is thus the interpretation and enforcement. This is unavoidable, given that in some areas targets cannot be quantified and it is not clear how best to reach them. Box 1 and Box 2 provide two, admittedly extreme, examples for this, the one of Germany and the one of Italy.

Overall the recommendations dispensed in the context of the European Semester contain many very useful elements, but two key shortcomings exist.

The first is related to the current economic situation: the adjustment after a credit boom is always painful and comprises difficult policy choices and possible trade-off between different policy goals. One such policy dilemma is that of the need to reduce debt ratios and at the same time lower domestic prices and wages. Some debt deflation effect is inevitable after the 'debt inflation' enjoyed by some countries until 2008. Hence, this is not a problem that can be 'solved' easily. We propose that one should not look only at headline debt-to-GDP ratios, but also at the value this ratio would have at the prices that would make the country competitive again (See Gros and Alcidi, 2013).

A second shortcoming of the CSRs is that their structural parts are often too vague to allow one to judge implementation. The politically and financially strong countries tend to ignore them. The politically and financially weaker countries usually respond to recommendations on

Box 1
Do CSRs affect domestic policy? the case of Germany

One example of how a government deals with a generic recommendation to "further stimulating competition in the services sector" is provided by the case of Germany.

Germany's national reform plan of 2013* (which is supposed to incorporate the CSRs) contains a response to the recommendations of the previous CSRs. Below we consider the parts relative to competition in the services sector:

> *"70. The domestic services market harbours great potential for growth, especially in the area of services based on network infrastructure. For this reason, the Federal Government is further considering the elimination of excessive constraints. Essential and appropriate regulations that serve, for example, to safeguard a level of training, actively provide consumer protection or ensure freedom to exercise a profession independently, are to be retained."*

This statement at the surface just states the obvious: excessive constraints are to be eliminated but 'useful' regulation to be retained. Implicitly it is saying, however, that Germany has little intention of enacting reform in this sector. This become clearer if one reads the following paragraph:

> *"71. The internal market for services cannot be strengthened through legal regulations alone. Improving "soft" factors is also important: such as building trust among consumers in services providers from other member states."*

Similar to the point above, this also states a truism. But the real message is that German consumers will in any case not buy services from other countries because they do not trust them.

The most interesting part of the German government's response is contained in the following paragraph:

> *"72. Competition has become more intense in the services sector over the last few years.........According to the laws on chimney sweeping, regulation of fees is to be limited to the few remaining government tasks performed by authorised district chimney sweeps."*

It is interesting that in the summary evaluation of the Commission this liberalisation of chimney sweepers is judged as 'limited progress' with service sector liberalisation.

All in all it seems that the recommendation to "further stimulate competition" in the German services sector has not had much of an impact on German policy-making.**

* The plan presented in early 2013, refers to reforms implemented over the past year (see http://ec.europa.eu/europe2020/pdf/nd/nrp2013_germany_en.pdf).

** In defence of Germany, one needs to keep in mind that the CSR are addressed to the national government, but that in Germany services sector liberalisation would require the consent of the lower echelons of government as well.

Box 2
Do CSRs affect domestic policy? the case of Italy

In Italy the situation is not much better: in 2013 key recommendations contained in the CSR were:

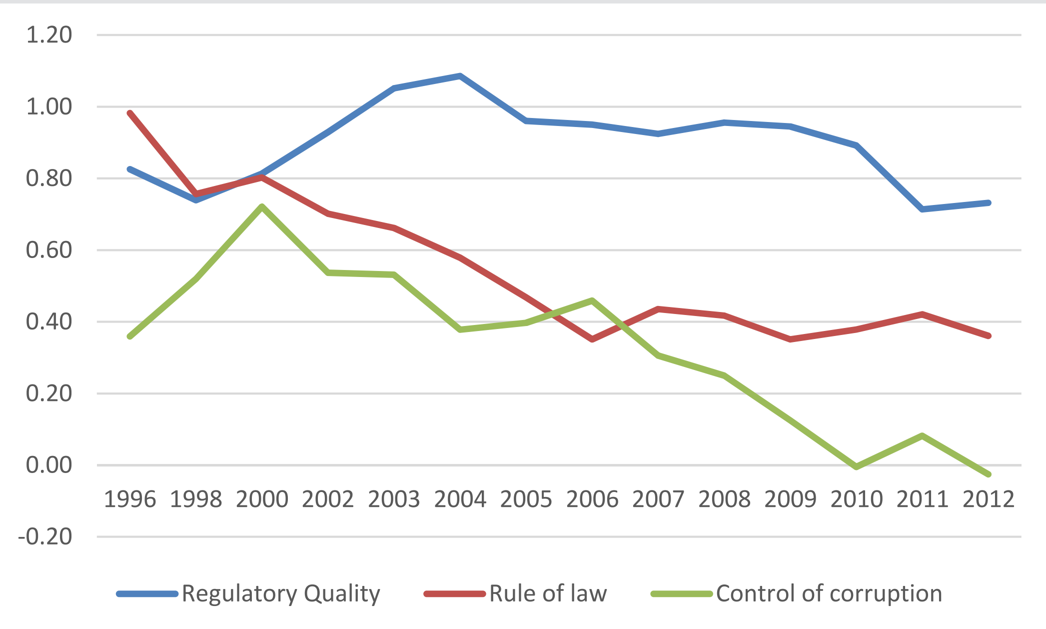
1) Keep taxes on wealth: "shift tax burden away from capital and labour to property...

While this recommendation was clear the Italian government proceed to abolish the real estate tax (IMU) introduced by the former Monti government. This step was taken without consultation with the Commission. Other, somewhat similar taxes were then introduced for 2014, but it is not clear whether they will have the same effect..

2) Improve the judicial system: "Reduce the duration of case handling and the high level of litigation in civil justice... Strengthen the legal framework for the repression of corruption"

This is an evergreen, which every government in the past has promised to address. But the results so far have had the opposite effect. The scarce available statistics on the length of civil and criminal court procedures do not show any improvement over the last decade. Moreover, the most widely followed indicators of corruption have actually deteriorated over the last decade (see also Gros (2011) on this issue). Fighting tax evasion constitutes another evergreen which all Italian governments have vowed to address – but on which little progress has been achieved.

Figure 2 Italy: Selected governance indicators



Source: World Bank, Worldwide Governance indicators.
Note: Indicators range from approximately -2.5 (weak) to 2.5 (strong) governance performance.

This simple observation that indicators of the quality of governance have deteriorated in Italy despite official government efforts to the contrary raises a key issue for the parts of the CSR that aim at structural reforms: should compliance with the CSR be judged based on the actual outcome (as in the SGP) or on the efforts of the government concerned?

structural policies with many measures, but it is often difficult to say whether these measures will achieve the intended result. One important case where policy activism has gone hand in hand with deteriorating results is that of Italy, where the professed fight against corruption and administrative inefficiencies does not seem to have delivered any results over the last decade.

There have of course been also instances where the CSRs have resulted in identifiable reforms (Belgium, France?), but in many cases the process seems to have become more important than the results. Therefore more emphasis should be put on assessing implementation of the annual recommendations.

5 Fiscal compact

The TSCG was signed in March 2012 by 25 of the 27 EU member states[18] and by December 2012 ratified by 12 euro area Member States, a sufficient condition for the treaty to enter into force on 1 January 2013.[19]

The treaty contains two main provisions: first, the annual structural balance of the general government of each signatory country must respect its specific medium-term objective as defined in the SGP with a lower limit of a 'structural deficit' of 0.5% of GDP and ensure rapid convergence towards it in case of deviation (Art. 3); second, in the case of failure of a contracting party to comply with the recommendations, a procedure may be launched with the Court of Justice of the European Union (CJEU), which can impose a sanction not exceeding 0.1% of its GDP.

The TSCG stipulates that MS have to incorporate the provision on the budgetary discipline and the automatic correction mechanism into their national legal systems, preferably at constitutional level within the year following the entry into force, i.e. 1 January 2014. Many countries have already done this. But how these national constraints and the debt rule will be applied is still not known.

What is certainly known is that the concept to 'structural budget', which is central in this framework, is at best uncertain. It is not observable and, as it will be shown in the next section, calculations are subject to revisions over time, also of substantial magnitude. In practice this may limit considerably the stiffness and certainty of this simple rule.

The TSCG has a significant overlap with the new SGP and the subsequent extensions for euro area MS via the six-pack and the two-pack; fiscal discipline is the common denominator but specific targets are different (nominal deficit in the case of the SGP and structural deficit in the case of TSCG), correction mechanisms triggered under different circumstances, sanctions are different and actors involved are also different. In this last respect while under the SGP the European Commission plays a dominant role, in the case of TSGC its role is limited; national countries have first of all to respect their own (constitutional) rules and in case

[18] The United Kingdom and the Czech Republic have opted not sign the treaty which is not mandatory for EU countries as it is not part of the EU treaties.

[19] The Treaty is legally binding as international agreement (result of an intergovernmental initiative). According to Art. 16, its substance will be incorporated into the existing EU treaties within five years from the entry into force.

of infringement of certain rules the matter can end before the CJEU. This last point recalls to us of the key difference between country specific recommendations issued in the framework of the European semester, whose implementation is assessed by the Commission the enforcement power in case of non-compliance remain limited and the case of non-compliance with the national, constitutional, law under the TSGC and the possibility for the case to be brought before the CJEU.

5.1 Structural balance: an uncertain indicator

As explained in the previous section the structural balance is the crucial indicator for the fiscal compact. The structural deficit is defined as the actual deficit adjusted for the impact of the economic cycle and any once off special measures. In practice the latter are of limited importance in most years. We thus concentrate on the cyclical adjustment.

This approach has an economic rationale: there is widespread consensus among economists that the adjustment of fiscal balances for the output cycle is crucial for assessing fiscal sustainability and that headline numbers (nominal targets) can be misleading. In practice other temporary factors such as commodity shocks housing stocks, and other asset price cycles as well as output composition and absorption effects may also affect fiscal balances, concealing the underlying fiscal position. Correcting for a broad set of transitory factors provide with a more accurate measurement of the underlying fiscal position.

However, the problem is that there is no single universally agreed method for adjusting fiscal balances. An appropriate adjustment needs to take several country-specific factors into consideration, to estimating revenue and expenditure elasticities, measuring the output gap and deviations from the "normal" asset or commodity price level. For example, a cyclical upswing based on higher exports yields much less revenues, than one based on domestic demand given that exports are exempted from VAT. Moreover, as forcefully argued by Borio and Piti (2013), the financial cycle can exert a more profound and longer term influence on the economy than the shorter cycles, which are supposedly captured by the cyclically adjusted balances.

The fact that no unique definition of the cyclical adjustment exists implies that a certain degree of uncertainty cannot be removed and there is room for different estimates and possibly disputes. This problem has become particularly acute in the present circumstance of low inflation and widespread unemployment since the estimate of the cyclical position is based in turn on an estimate of the 'non accelerating wage natural rate of unemployment' (NAWRU). This is a non-observable variable very difficult to estimate in practice and different estimates might yield quite different results depending on the econometric and other methods used. Moreover, the NAWRU becomes particularly difficult to estimate when wage inflation hits the zero bound since wage flexibility is limited downwards and there are few observations available to estimate the degree of this downwards rigidity.

In facts, another degree of uncertainty is introduced by the fact that the structural balance has to be estimated ex-ante for the formulation of appropriate policies in order to keep it under the threshold of the 0.5%. This implies that the uncertainty associated with the measurement of the structural component of GDP is combined with the uncertainty of the future, i.e. forecasts about future GDP and budgetary items. Table 4 shows for the case of Italy, as example, how estimates of the structural balance are subject to corrections over time. Of course the two errors could either offset or magnify each other.

The table suggests that revisions can be quite significant. First of all the budgets submitted in spring are almost systematically over-optimistic (as shown by the positive values in the last two rows). Moreover, subsequent revisions, mainly to the cyclical component brought the overshot to more than 1% of GDP (see last row). It is difficult to envisage how the TSCG would have worked under these circumstances. If the 2013 and 2014 data were subject to revisions of similar size (e.g. because new estimates of the NAWRU, which leads to different estimates of the cyclical component) Italy would immediately have problems under the TSCG.

Table 3 Italy: Structural balance as % of GDP, real time data with revision for yearly values of the time series

						Ref point						
Vintage	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*
2004 Spring	**-1.9**	**-2.6**	**-3.6**									
2004 Autumn	-1.9	-2.4	-2.6	-3.4								
2005 Spring	**-2.6**	**-2.4**	**-2.9**	**-4.0**								
2005 Autumn	-3.0	-3.0	-3.5	-3.6	-4.0							
2006 Spring	**-3.4**	**-3.3**	**-3.4**	**-3.4**	**-3.8**							
2006 Autumn	-3.5	-3.3	-3.4	-4.1	-2.4	-2.5						
2007 Spring	**-3.4**	**-3.2**	**-3.4**	**-3.8**	**-1.6**	**-1.8**						
2007 Autumn	-3.4	-3.3	-3.4	-3.9	-1.9	-1.9	-1.8					
2008 Spring	**-3.4**	**-3.5**	**-3.9**	**-3.2**	**-1.7**	**-1.8**	**-1.6**					
2008 Autumn	-3.3	-3.6	-4.2	-3.5	-1.8	-2.3	-1.9	-1.2				
2009 Spring	**-3.4**	**-3.8**	**-4.6**	**-4.3**	**-2.8**	**-3.2**	**-2.6**	**-2.7**				
2009 Autumn	-3.4	-3.7	-4.5	-4.3	-2.9	-3.4	-3.5	-3.7	-3.8			
2010 Spring	**-3.5**	**-3.7**	**-4.6**	**-4.4**	**-3.0**	**-3.3**	**-3.3**	**-3.6**	**-3.7**			
2010 Autumn	na	-3.7	-4.6	-4.4	-3.0	-3.3	-3.5	-3.7	-3.5	-3.3		
2011 Spring	**na**	**-3.9**	**-4.7**	**-4.5**	**-3.0**	**-3.2**	**-3.2**	**-2.9**	**-2.6**	**-2.2**		
2011 Autumn	na	-3.8	-4.7	-4.4	-3.0	-3.2	-3.4	-3.3	-2.8	-1.3	-0.4	
2012 Spring		**-3.7**	**-4.7**	**-4.4**	**-3.0**	**-3.3**	**-3.3**	**-3.4**	**-2.9**	**-0.6**	**0.1**	
2012 Autumn		-3.9	-4.9	-4.5	-3.1	-3.5	-3.6	-3.5	-3.0	-1.3	-0.4	-0.9
2013 Spring		**-4.0**	**-5.0**	**-4.7**	**-3.3**	**-3.6**	**-3.5**	**-3.5**	**-2.9**	**-1.3**	**-0.7**	**-0.7**
2013 Autumn		-4.0	-5.0	-4.8	-3.4	-3.7	-3.5	-3.5	-3.0	-1.3	-0.6	-0.7
Difference Spring estimate of the year and spring estimate of following year		-0.2	0.5	0.4	0.1	1.4	0.7	-0.7	0.3	0.7		
Difference Spring estimate of the year and newest estimate		1.4	2.1	1.4	1.8	1.9	0.9	-0.1	0.4	0.0	-0.1	

Note: Data in light blure are half-finalized, data in dark blue are estimates.
Source: European Commission services.

6 Fiscal policy coordination in a monetary union and spillover effects

The key objective of the new framework of European governance has been to tighten budgetary coordination, essentially with the aim of keeping deficits low and reduce debt levels.

There is little disagreement among economists that in general in the long run it is better to limit deficits and to keep debt levels low. However, this general long term goal should not necessarily be pursued under all circumstances. Moreover, there might be circumstances where spill-over effects become less important, thus lessening the need for coordination.

Should policy always aim at lower deficits? There has been an intense debate among economists and policy makers about the merits of what is called 'austerity'. To a large extent this debate is no longer relevant since most countries have undertaken the large fiscal adjustments. However, the question of whether deficits should be further reduced now that financial market tensions have abated remains. De Grauwe (2014) has framed this question by making the distinction between supply and demand shocks. He argues that during the 1970s and 1980s Europe's economy was hit by supply shocks coming from the sharp swings in energy prices. The expansionary policies (demand policies) chosen by some countries were not the appro-

Box 3
Fiscal, Monetary and Political Union

It is widely assumed that a common currency makes it desirable to have also a common fiscal policy and a political union. Indeed in September 2012 the four presidents of the EU (presidents of the European Commission, European Council, Euro Group and the European Central Bank) stated that the Banking Union, which constitutes the key step to break the link between governments and banks, should also be seen as a very specific form of fiscal union and further integration in this sense should be desirable. This would also imply the need for a political union.

This argument has three dimensions which deserve to be taken into consideration.

First, despite the official talk of the presidents it seems that, at the moment, the political appeal for a fiscal and political union is at best very limited.

Second, the rationale for moving towards a fiscal and political union is mainly driven by the fact that in reality we do not have experience of well-functioning monetary unions which are not fiscal and political unions. Most monetary unions have a quite substantial common budget and are true federations; this is notably the case of the US which is certainly considered a benchmark for the future united states of Europe. The main reason why the existence of a large federal budget is seen as an important requirement for the well-functioning of the union is that it provides a shock absorber. But this has been disputed, for instance Gros 2013a and Gros 2013b shows that the US federal budget has only marginal effects as shock absorber.

Third, strengthening fiscal coordination should ensure that national policies are consistent within the monetary union and the monitoring system should ensure this but tighter cooperation should not necessarily entail higher correlation in fiscal policies.

Indeed fiscal policy can also be a source of shocks. There are a variety of reasons why fiscal policy could be destabilizing: policy makers do not have full control over the outcome, at times the effect of a certain measure (e.g. a tax reform) is quite different from what is anticipated; or the economic forecasts underlying fiscal policy might turn out to be wrong.

priate response and resulted in high inflation and the accumulation of large debt levels. By contrast the euro area today is not confronted with a supply, but a (negative) demand shock. This would imply that an expansionary fiscal policy might be the appropriate policy reaction to high unemployment. This argument is reinforced by the fact that the effectiveness of monetary policy is diminished by policy interest rates which are already zero. This argument implies that the long term goal of stable public finances might conflict at times with other more short to medium run goals, namely to stabilize demand. Such a conflict is not foreseen in the Stability Pact or the TSCG.

More in general one can argue that the need for policy coordination (and the need to impose limits on the degree of freedom for national fiscal policy) depends on the economic and financial market regime of the moment.

Table 4 considers the possible spillover effect of an increase in the fiscal deficit in one country on other countries of the monetary union, under different circumstances. In particular distinguishing 'normal times', times the monetary policy is ineffective and lastly times of crisis

During normal times, when financial market stability is not in danger (first row) the level of the debt does not play an important role. There is no spill-over even if (or perhaps more correctly particularly if) financial markets do price a premium for a higher debt level. Countries with a higher debt level would then face higher debt service costs, but that would not be a problem for the others or the stability of the entire financial system of the euro area. One of the aims of the Banking Union is to achieve such a situation with financing difficulties of any one member country remaining a problem of that country without negative spill-over effects to the rest of the euro area (see for instance Gros (2013a).

Under these circumstances the spill-over effects of national fiscal policy could be of either sign as argued more formally in Belke and Gros (2009). The basic economic reasoning is straightforward: a fiscal expansion in any one country leads to an increase in domestic demand, which increases imports from the rest of the euro area. However, this increase in demand will also induce the monetary authorities to tighten its policy stance, which has a negative impact on all countries. This implies that the impact of an expansionary fiscal policy in Germany on other countries, say Portugal or the Netherlands, depends on the strength of the trade linkages and the degree to which monetary policy effects demand locally. In the illustrative case chosen here one could argue that for Portugal, whose trade linkages with Germany are rather small the negative impact from a tightening by the ECB could outweigh the increase in exports. For

Table 4 Spillover effects in a monetary union

	Relevant variables	
State of economy & financial markets	***Debt (stock)***	***Fiscal deficit***
Normal times	Not material?	Sign uncertain
Zero interest rate (policy rate)	Not material?	Positive
Crisis times: High risk premia	Very strong negative	Strong negative

The differences among the cells are briefly motivated here.
Source: own elaboration.

the Netherlands the result might be the opposite given the very intense trade relationship this country has with Germany. The rationale for an explicit ex ante coordination of fiscal policy for demand management purposes is thus rather weak during 'normal' times.

The argument changes when one considers a 'liquidity' trap situation (second row). In this case a fiscal expansion should have an unambiguously positive impact on the other countries because the ECB would not increase rates in response to an increase in demand in Germany. This simple application of standard demand management models (which are embodied in almost all of the macroeconomic models used by the Commission, major central banks worldwide and the international financial institutions in general) can thus provide a rationale for ex ante fiscal policy coordination (but not with the restrictive bias embodied in the euro area's governance framework).

During a financial crisis the nature of the spill-over changes radically. When financial markets are no longer functioning properly the difficulties of any one country can impact all the others as it was shown with the case of Greece in 2009/10. Under these circumstances a negative fiscal shock in any one country can have a very large negative impact on other countries because it can lead to a malfunctioning of financial markets throughout the entire area. Moreover, the size of the public debt matters greatly during a financial crisis. The higher the debt the stronger the negative impact of high risk premia and the larger the potential burden on the other countries if they have to support the country in financial difficulties.

This cursory consideration of the likely spill-over effects of national fiscal policy strongly suggest that the nature of these spill-overs changes nature (sign and size) with the regime under which the economy of the euro area works. From a strictly economic point of view this implies that the rationale for policy coordination changes radically from regime to regime.

During normal times the case for explicit ex ante coordination is weak as long as the general thrust of policy is not towards the accumulation of unsustainable debt levels.

During a financial crisis, by contrast, the case of fiscal policy coordination is very strong.

The most difficult case is that of a liquidity trap when short term demand considerations suggest a rationale for policy coordination with an expansionary bias. However, this raises the problem of the long term consistency of policy because a long period of expansionary fiscal policy might well lead to an accumulation of debt which later precipitates a financial crisis.

The general conclusion is that: one size does not fit all. The appropriate regime for economic policy coordination must be adapted to different economic circumstances. The new regime for economic policy coordination for the euro area was created under the impression of the euro crisis. Not all of its element will remain appropriate once more normal times return.

The difficulties in establishing the sign and size of spill-overs are of course even greater in the case of structural reforms, such as labour market policies or measures to foster competition in product markets. In these areas there is already often wide disagreement about the benefits of concrete measures. For example, it is often argued that making it possible to renew temporary contracts might actually have negative long term effect because it leads to less investment in firm specific human capital. In the area of product market regulation the impact of reforms depends often more on their application on the ground than the text of the law or regulation which has been communicated in the context of the European Semester. These additional difficulties are likely to make the coordination of structural reforms a formal exercise with little concrete impact on actual economic performance.

7 Conclusion

The new framework for economic policy coordination in the euro area is very ambitious and suggests that economic policy is tightly coordinated among member countries. However, reality is different. We show that the Country Specific Recommendations issued in the context of the European Semester are often not very specific and frequently not implemented. We also show that a core indicator of the Fiscal Compact (namely the structural balance) is very difficult to measure and subject to large ex post revisions; making a concrete application of the limit on the structural deficit of 0.5 % of GDP difficult in practice. We also argue that the spill-overs from national fiscal policy, which should constitute the main rationale for fiscal policy coordination are likely to change sign and size under different economic and financial market conditions.

The difficulty in establishing the sign and size of spill-overs is of course even greater in the case of structural reforms and are likely to make the coordination of structural reforms a formal exercise with little concrete impact on actual economic performance.

We have not discussed the more general objection that it may be difficult to believe that Brussels always knows better (than national governments) how to achieve a certain target. At the academic level there is large debate how to reach growth friendly consolidation (see the debate between Alesina (2010, proposing to cut expenditure) versus Krugman who proposes to increase deficits to maintain growth.

All in all there is clear danger than an overreach in the attempt to coordinate too much and too tightly leads to an excessive attention to procedural issues, at the expense of the substantive results to be achieved.

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