DIRECTORATE GENERAL FOR INTERNAL POLICIES
ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)

EUROPEAN PARLIAMENT

IN-DEPTH REVIEW

Fiscal and macro-structural challenges and policy recommendations for the Euro Area and its Member States under the 2014 Semestre Cycle

Author: Professor Dr. Peter Bofinger

Briefing on the request of the
Economic and Monetary Affairs Committee

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Briefing submitted in advance of the Economic Dialogue
with the President of the Eurogroup in ECON on 4 September 2014

Abstract

The European Semester is an extremely important tool for economic policy coordination. In the absence of an integrated fiscal policy a monetary union requires a coordination mechanism to avoid negative spill-overs and to achieve an appropriate aggregate fiscal policy stance. In its present form, the focus of the Country Specific Recommendations (CSRs) is on the surveillance of fiscal policy consolidation and of structural reforms. A genuine coordination of national policies is virtually absent. There is also no systematic analysis of challenges for the main macroeconomic targets. The 2014 CSRs neglect the fact that target of price stability is not met and that there is a serious risk of deflation and economic stagnation. There is no systematic analysis whether the aggregate fiscal policy stance of the Euro Area is adequate. In the area of wage setting, the CSRs propose asymmetric wage reductions for many Member States which would increase deflationary tendencies. Therefore, the President of the Eurogroup should prepare a coordinated programme for public investments that could be implemented rapidly if the deflationary tendencies become manifest. In addition, (s)he should monitor wage relevant structural policies to avoid competitive (real) devaluations and encourage stronger wage increases in countries with a very high current account surplus.

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DISCLAIMER

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LIST OF ABBREVIATIONS

CSR(s)	Country Specific Recommendation(s)
ECB	European Central Bank
IMF	International Monetary Fund
MIP	Macroeconomic Imbalance Procedure
OECD	Organisation for Economic Cooperation and Development
OMT	Outright Monetary Transactions
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union

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EXECUTIVE SUMMARY

The European Semester is an extremely important tool for economic policy coordination. In the Euro Area, the need for coordination derives from the fact that there is **no fiscal policy integration** so that the single monetary policy is confronted with 18 independent national fiscal policies. Without a community budget that is available for macroeconomic stabilization, the aggregate fiscal policy stance that is required for internal balance can only be achieved by policy coordination. In addition there is a risk that national wage policies create negative externalities with a negative impact on internal balance.

In its present form, the Country Specific Recommendations (CSRs) lack **a systematic framework** for policy coordination. First, there is no comprehensive assessment of the challenges for macroeconomic targets. Second, the decisive issue of the aggregate fiscal policy stance is not addressed explicitly. Third, there is no discussion of whether individual countries could adjust their fiscal policies in order to generate a better, i.e. more symmetric, outcome for the whole system. Fourth, there is no awareness of potential negative spill-over effects from wage-related national structural reforms. The need of a symmetric adjustment process in the Euro Area is not reflected in the CSRs. Instead, the main focus of the CSRs is on the **surveillance** of a one-dimensional fiscal policy consolidation and of "one-size-fits-all" structural reforms. While these are important issues, the lack of a systematic approach is a severe flaw of the CSRs and the whole European Semester.

In the current CSRs, the violation of the target of price stability and the risks of deflation and economic stagnation are not discussed. As the ECB has reached the limits of its room for manoeuvre, a **less restrictive fiscal policy stance** could be warranted to counter these risks. For many years, the underlying fiscal deficit of the Euro Area has been much lower than the deficits in the United States, the United Kingdom and Japan. A natural candidate for more fiscal expansion is Germany, but the CSRs for Germany do not ask for a stronger stimulus. In the area of **wage setting**, the CSRs propose asymmetric wage reductions (mainly by lowering social security contributions) for Member States independently of their external balance position. There is no explicit recommendation for higher wage increases in countries with very high current account surpluses. Instead of coordinating wage developments to prevent competitive internal devaluations the CSRs foster deflationary tendencies.

As far as the **implementation of the CSRs** is concerned, the Commission is relatively satisfied with those which are related to the Stability and Growth Pact (SGP). This can partly be related to the fact that since 2013 the Commission has adopted a much more flexible approach in the application of the SGP. The Commission sees less progress in the implementation of the CSRs which concern the MIP. From an outside perspective this assessment is difficult to evaluate. The problem here is not so much the implementation but the asymmetry that is created by the CSRs.

In order to avoid deflation, the **President of the Eurogroup** should prepare the outline of a coordinated programme for public investments in the Member States as soon as possible. It should be implemented rapidly if the deflationary tendencies become manifest. A deflation can be regarded as an "exceptional circumstance" that warrants temporarily higher fiscal deficits. In addition, a monitoring of wage relevant structural reforms is required to avoid competitive devaluations within the Euro Area. For a better democratic accountability of the whole European Semester, the European Parliament should establish an independent **Council of Economic Experts**. It should produce an annual report on the Euro Area with policy recommendations for the Euro Area Member States. This would help the European Parliament to formulate its opinions on the European Semester.

INTRODUCTION

This Briefing Paper discusses the CSRs that were adopted by the Council of the European Union in July 2014. The focus is on the coordination of economic policies. Coordination requirements in the Euro Area are very high due to the co-existence of an integrated monetary policy with 18 independent national fiscal policies. After a short discussion of an analytical framework for policy coordination, the paper discusses whether the CSRs have identified the most serious fiscal and macro-structural challenges. It is argued that the CSRs do not pay sufficient attention to the very low inflation rate in the Euro Area and the associated risks of deflation and economic stagnation. This leads to the decisive question of the required aggregate fiscal policy stance, especially in a situation where the ECB has reached the limits of its room for manoeuvre. In the CSRs, this cornerstone for fiscal policy coordination is not addressed analytically. There is also no discussion whether a more symmetric adjustment within the Euro Area could be achieved by a more expansionary fiscal policy in countries with historically high current account surpluses. The Paper identifies national wage developments as a second important area where coordination at the European level is required in order to avoid negative spill-over effects. Although this topic is especially important in an environment of "lowflation", the CSRs do not even consider a need for policy coordination in this area. Instead they propose a "one-size-fits-all" approach of wage reductions, mainly by lowering social security contributions. Thus, the CSRs for Germany – instead of asking for stronger wage increases – propose an internal devaluation.

Due to space limitations, the paper can only give a short survey of the implementation of the CSRs concerning the SGP and the MIP. While the implementation of the CSRs which are related to the SGP is very satisfactory, there is relative little progress in the area of the CSRs which are related to the MIP. But the main problem with these CSRs is not their implementation but their formulation.

Within this short paper, the agenda of the new President of the Euro Group cannot be discussed in too much detail. Given the serious risk of deflation, the focus should be on measures that could be implemented without delay if the inflation rate falls further. Therefore, the President should develop a comprehensive program for public investment in the Member States that could be activated if needed. In addition, an intensive monitoring of wage relevant structural reforms should be implemented to avoid competitive (real) devaluations in the Euro Area.

For a better democratic legitimacy, the CSRs have to become more transparent. Their wording is often coded and the recommendations are not presented with numerical targets. For a better assessment of the CSRs, the paper presents the institutional innovation of an independent Council of Economic Experts. This Council should present an annual report on the Euro Area with a specific focus on the challenges to internal balance and the coordination requirements between the Member States. The Council should be appointed by the European Parliament.

1. THE COUNTRY SPECIFIC RECOMMENDATIONS AND THE EUROPEAN SEMESTER

The European Semester is an extremely important tool for economic policy coordination. In the Euro Area, the specific need for coordination derives from the fact that there is no fiscal policy integration so that the single monetary policy is confronted with 18 independent national fiscal policies. This coordination requirement is based on the Treaty (see Articles 120 and 121) and is explicitly referred to in EU Regulation 1175/2011 which provides the legal basis for the European Semester (see Article 2-a).

1.1 An analytical framework for policy coordination within the Euro Area

The general need for policy coordination within the European Union and above all the European Monetary Union is widely accepted. But in the last few years there has been relatively little academic and political discussion of its objectives and its implementation. As a consequence, the European Semester so far lacks a clear analytical framework.

A very useful exposition of the **rationale of macroeconomic policy coordination** between the Member States of EMU can be found already in the Delors Report (1989, p. 19):

"(…) the fact that the centrally managed Community budget is likely to remain a very small part of total public sector spending and that much of this budget will not be available for cyclical adjustments will mean that the task of setting a Community-wide fiscal policy stance will have to be performed through the coordination of national budgetary policies. Without such coordination it would be impossible for the Community as a whole to establish a fiscal/monetary policy mix appropriate for the preservation of internal balance (…). Moreover, strong divergences in wage levels and developments, not justified by different trends in productivity, would produce economic tensions and pressures for monetary expansion."

According to this analysis, policy coordination within in a Monetary Union is a **multi-level process** which involves the single monetary policy, national fiscal policies and national wage setting mechanisms with the aim of preserving internal balance:

- First, a comprehensive assessment of **challenges for main targets of internal balance** is required.
- Second, the **appropriate fiscal/monetary policy mix** for the whole currency area has to be determined.
- Third, the required Community-wide fiscal policy stance has to be performed through the **coordination of national budgetary policies**.
- Fourth, in addition to fiscal policy coordination, some **coordination of wage developments** is required to avoid tensions with the single monetary policy.

The focus of the CSRs is completely different. Although the Commission explicitly stresses "the interdependence of the economies of our Member States" (European Commission 2014a, p. 2) and the "cross-cutting elements identified collectively" (European Commission 2014a, p. 4) a systemic approach is difficult to identify. In addition, a systematic analysis of the main macroeconomic targets is missing.

1.2 Very low inflation as the main challenge for the Euro Area

This leads to the question of **main fiscal and macro-structural challenges** for the Euro Area and its Member States. The 2014 CSRs provide above all a very upbeat picture of the economic situation of the Euro Area. The important issue of potential challenges is addressed in a rather general and cursory way:

"The main challenge now relates to the strengthening of the real economy – growth and jobs – over time." (European Commission 2014a, p. 6).

Nevertheless, the 2014 CSRs correctly address **important challenges** with which the Euro Area is confronted, above all the "deleveraging of the high levels of public and private debt (…); further stabilizing the financial sector to facilitate a pick-up in credit flows to the real economy; pursuing policy measures to strengthen sources of jobs and growth; reinforcing the conditions to promote private investment (...); improving skills and helping people back into employment as well as social cohesion." (European Commission 2014a, p. 6)

But as the 2014 CSRs do not systematically analyse the **targets of internal** balance they do not realize that in addition to high unemployment and low growth another important macroeconomic target is violated: with a current HICP inflation rate of 0.4 % in July 2014 the ECB's inflation target of "below, but close to 2%" is clearly not met. In addition, there is a not negligible risk that the "**lowflation**" turns into deflation. This challenge is not also addressed in the 2014 CSRs. It is mentioned in the In-Depth-Review (European Commission 2014b) and in the Country Note for the Euro Area (European

Commission 2014c). However, this is not reflected in the CSRs for the Euro Area (European Commission 2014d and Council of the European Union (2014)).

The failure of the CSRs to identify and to deal with the most serious macroeconomic challenge of the Euro Area becomes obvious if one compares them with most recent **IMF Report** on "Euro Area Policies" (International Monetary Fund 2014a) which was published only some weeks later. In this report, the downside risks are explicitly addressed, especially the risk of deflation. In the medium term, the IMF even sees "high risk of stagnation" for the Euro Area.

For the Euro Area, the challenge of very low inflation is especially frightening as the European Central Bank has now more or less reached the **zero lower-bound of its interest rate policy**. Of course, the ECB has so far not made use of Quantitative Easing. But the example of Japan shows that this instrument is not a very reliable deflation therapy.

A period of very low inflation, or even deflation, together with low growth or even stagnation would be an economic disaster for the Euro Area. It would become almost impossible to bring the high unemployment rates back to an acceptable level. It would also make it very difficult to cope with the problem of high private and public debt in many Member States. Irving Fisher (1933) emphasized the dangers that are associated with "**debt-deflation**":

"When over-indebtedness stands alone, that is, does not lead to a fall of prices, in other words, when its tendency to do so is counteracted by inflationary forces (whether by accident or design), the resulting "cycle" will be far milder and far more regular. Likewise, when a deflation occurs from other than debt causes and without any great volume of debt, the resulting evils are much less. It is the combination of both—the debt disease coming first, then precipitating the dollar disease—which works the greatest havoc. The two diseases act and react on each other."

In contrast to this assessment, a reader of the Commission Staff Document for the Euro Area might even come to the conclusion that a deflation provides a positive contribution to the adjustment process:

"(…) stronger real wage adjustment leads to a smoother reaction of employment and, consequently, of real output, while a faster adjustment in prices allows for an also faster adjustment in the real interest rate towards the equilibrium level." (Commission 2014b, p. 9)

All in all, one can conclude that the 2014 CSRs, including the ones for the Euro Area as a whole, completely neglect the problem of low inflation and the risk of deflation which currently can be regarded as the most serious macro-structural challenge for the Euro Area. In the same vein, the 2014 CSRs do not address the fundamental problem of the **asymmetry of the adjustment process** within the Euro Area. The same applies to the In-Depth-Review (European Commission 2014b) 150 final) which is even more surprising given its focus on macroeconomic imbalances. The problem of asymmetric adjustment is only mentioned in the Commission Staff Document for the Euro Area (p.4):

"(…) rebalancing in the euro area is ongoing, but has been asymmetric and there has not been progress in adjustment of current account surpluses." (European Commission 2014d).

In fact, the very low inflation can be regarded as the result of this asymmetry. So far the whole adjustment process has been achieved by wage moderation and severe consolidation in the deficit countries. The surplus countries, above all Germany, did not provide an active contribution to the required rebalancing of the Euro Area.

1.3 What is the appropriate aggregate fiscal policy stance for the Euro Area?

For a coordination of fiscal policies in the Euro area, the **appropriate aggregate fiscal policy** stance is of central importance. The statements in the 2004 CSRs on the aggregate fiscal policy stance are very vague and dominated by a one-dimensional focus on "growth-friendly" consolidation. This applies also to the In-Depth-Review (European Commission 2014b) although this report mentions at least "the responsibility" of the Euro Area Member States "for the aggregate policy stance in the euro area to ensure the good functioning of the euro area and to increase growth and employment. (p. 8)"

In the Commission Staff Document for the Euro Area one can find the following statement:

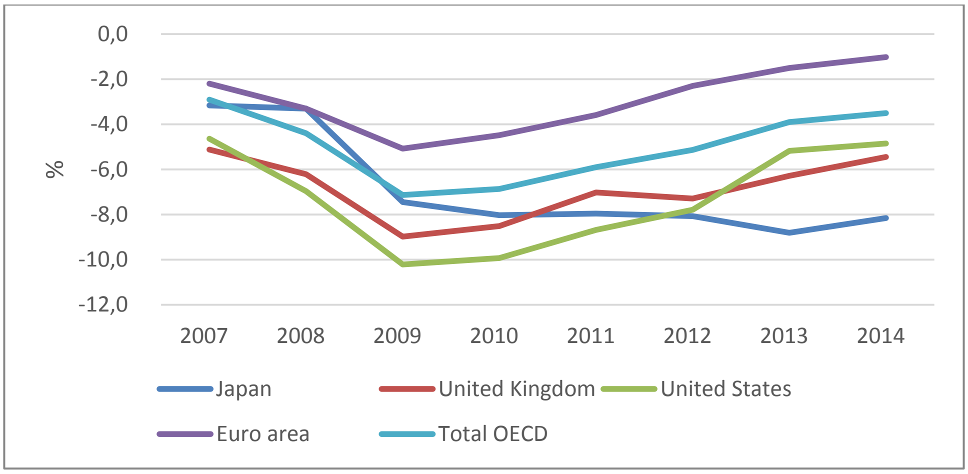
"With that, both the debt and deficit projections for the euro area are considerably more positive than for other major economies including the United States and Japan." (Commission 2014d, p. 11)

This all seems to imply that the Commission regards the current fiscal stance of the Euro Area as adequate. But such statements are far from sufficient for a comprehensive analysis of the aggregate fiscal policy stance which is required for the Euro Area. This serious deficit of the whole coordination process was already criticized by Darvas and Vihriälä (2013, p. 6):

"The concept of the aggregate fiscal stance of the euro area is largely an empty concept."

Under current macroeconomic conditions, especially given the risk of deflation and the very limited room for further monetary stimulation, it is far from obvious that the aggregate fiscal deficit of the Euro Area is not too low. This is at least indicated by a simple comparison of the Euro Area with **other major currency areas**. As Graph 1 shows, since the outbreak of the crisis the underlying fiscal balance of the Euro Area (which is adjusted for the cycle and for one-offs) has been much more restrictive than the balance of Japan, the United Kingdom, the United States and the average of OECD countries. The same applies to the non-adjusted fiscal balance.

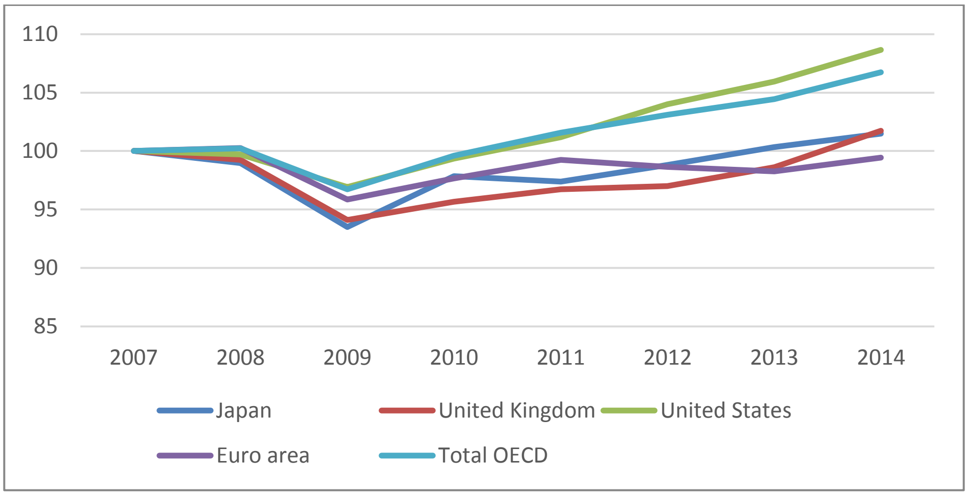
Graph 1: Underlying fiscal balances of major currency areas



Source: OECD, Economic Outlook 95, Annex Tables

It is not obvious that the relatively low deficit of the Euro Area can be regarded as a positive factor for growth and employment. Since 2007, the **growth performance** and the employment performance of the Euro Area have been lagging behind than the performance of the three other major currency areas and the average of the OECD (Graph 2).

Graph 2: Real GDP developments since 2007 (2007=100)

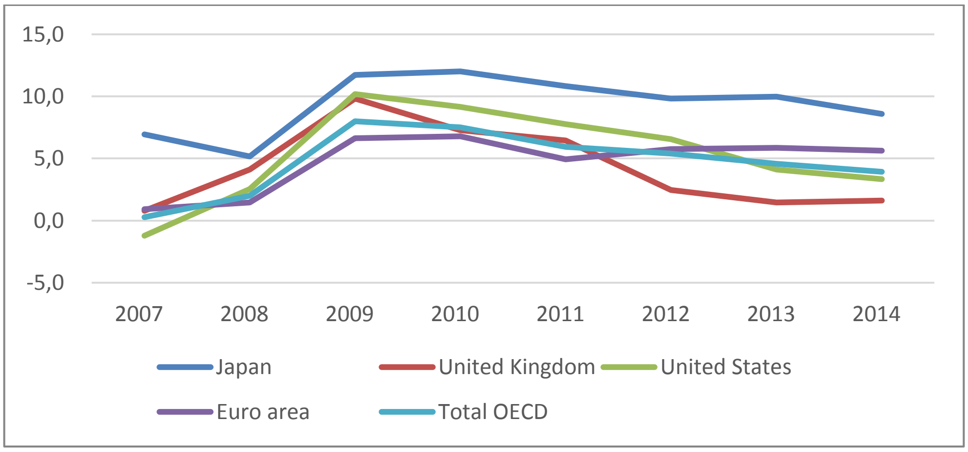


Source: OECD, Economic Outlook 95, Annex Tables

The need for a strong fiscal stimulus after a severe financial crisis can be explained with the phenomenon of private sector **deleveraging** which is shortly addressed in the 2014 CSRs. In the In-Depth-Review (European Commission 2014b) and in the Commission Staff Document for the Euro Area (European Commission 2014d) "deleveraging pressures" are intensively discussed. Deleveraging means that the private sector tries to reduces its debt level. This can only be achieved if economic agents are able to generate financial surpluses over many years. In other words, they have to spend less than they earn. But sustained financial surpluses of the private sector are only possible if the public sector is willing to incur the corresponding deficits.

In the Euro Area, as in the other major currency areas, the deleveraging is reflected in a strong **increase of the financial balances of the private sector (Chart 3)**. However, in contrast to the three other major currency areas this was not matched by a corresponding deficit of the public sector. As a consequence the Euro Area has experienced a strong increase of its current account surplus since 2007. In the other major currency areas the current account has remained constant (United States) or it has even deteriorated (United Kingdom and Japan).

Graph 3: Private financial balances in % of GDP



Source: OECD, Economic Outlook 95, Annex Tables. The financial balances of the private sector are calculated as the difference of the current account balance and the fiscal balance

As the Commission seems to be satisfied with the aggregate fiscal stance of the Euro Area, the 2014 CSRs do not make specific recommendations for an explicit **differentiation of national fiscal policies** and a corresponding adjustment of national fiscal plans to ensure a better fiscal stance. In this respect, the 2014 CSRs for the Euro Area are even less specific than the 2013 CSRs[1]:

- CSR 2 (2013): "Ensure that the Eurogroup monitors and coordinates fiscal policies of the euro area Member States and the aggregate fiscal stance for the euro area as a whole to ensure a growth friendly and differentiated fiscal policy."

- CSR 2 (2014): ""Coordinate fiscal policies of the euro area Member States (...) to ensure a coherent and growth friendly fiscal stance across the euro area."

Accordingly, the CSRs for the two Euro Area Member States with the highest current surplus in 2014, the Netherlands (8.9 % of GDP) and Germany (7.9 % of GDP) do not envisage an extra fiscal stimulus to support a more symmetric fiscal adjustment.

- CSR 1 for **Germany** at least entails a recommendation for more public investment: "Pursue growth friendly fiscal policy and preserve a sound fiscal position, ensuring that the medium-term budgetary objective continues to be adhered throughout the period covered by the Stability Programme (…). In particular, use the available scope for increased and more efficient public investment in infrastructure, education and research." But it does not make a concrete proposal for the size of the additional investment.

- CSR 1 for **Netherlands** even asks for a more restrictive fiscal policy: "(...) reinforce the budgetary measures for 2014 in the light of the emerging gap of 0.5 % of GDP based on the Commission services 2014 spring forecast (…). In 2015, significantly strengthen the budgetary strategy to ensure reaching the medium-term objective (…)."

A different and more specific approach can be found in the "Selected Issues" of the most recent **IMF Report** on "Euro Area Policies" (International Monetary Fund 2014b). It presents a "'desired' rebalancing scenario with further progress on structural reforms and higher investment in larger creditor countries". It recommends an increase in public investment in Germany of slightly below ½ % of GDP in the years 2014 and 2015. For the Netherlands, an annual increase of ¼ % is recommended. The calculations of the IMF show "remarkable benefits": real GDP in 2019 would be 3 ½ percent higher in 2019 compared to the baseline. (International Monetary Fund 2014b, p. 80)

1.4 Deflationary risks from competitive internal devaluations

In an environment with very low inflation and deflationary risks, wage developments should be monitored very carefully. Above all, an asymmetric wage adjustment should be avoided. This insight can be found in the 2014 Commission Staff Working Document for the Euro Area:

"A more symmetric adjustment in the euro area would make the overall adjustment smoother and less costly and also moderate the overall euro area surplus." (European Commission 2014d, p. 7)

However, the 2014 CSRs do not attempt to call for more symmetry in the adjustment process. Instead they recommend outright wage moderation or "structural reforms" which induce wage moderation as a way to improve the competiveness of Member States:

[1] In the following the concrete Country Specific Recommendations 2013 and 2014 and the assessments of the Commission of the 2013 recommendations are quoted from the Synopsis presented Economic Governance Support Unit (2014).

“To support job creation, a number of countries have taken steps aimed at decentralising their wage setting system and easing the adaptation of wage conditions to the economic environment (e.g, France, Italy, Portugal and Spain).” (European Commission 2014a, p. 14)

The same applies to the In-Depth-Review which explicitly recommends internal devaluations:

“The euro area is going through a rebalancing process which is well advanced, but not yet complete. For a number of Member States, this means regaining competitiveness via an internal devaluation, i.e. wage moderation, productivity gains and reduction of other production costs relative to trading partners.” (European Commission 2014b, p. 7)

CSRs that call for explicitly or implicitly for **wage reductions** can be found for the following countries:

- Belgium (CSR 5): “Restore competiveness by continuing the reform of the wage setting system, including wage indexation, (…) to ensure that wage evolutions reflect productivity developments at sectoral and/or company levels.”
- Spain (CSR 3): “Promote real wage developments consistent with the objective of creating jobs.”
- France (CSR 2): “Ensure that the labor cost reduction resulting from the ‘credit d’impôt compétitivité employ’ is sustained. Take action to further lower employer social security contributions (…). Further reduce the cost of labour in a budget neutral way (…).”
- Italy (CSR 5): “Evaluate by the end of 2014 the impact of the labour market and wage setting reforms on job creation, dismissals’ procedures, labour market duality and cost competiveness, and assess the need for additional action.”
- Portugal (CSR 2): “Maintain minimum wage developments consistent with the objectives of promoting employment and competiveness. Ensure a wage setting system that promotes the alignment of wages and productivity at sectoral and/or firm level. Explore (…) the possibility of mutually agreed-level temporary suspension of collective agreements.”

A symmetric adjustment within the euro area would require a compensation of the negative impact of these wage reductions by stronger wage increases in the **countries with a high or a very high current account surplus**. But the CSRs for these countries are almost identical with those for countries with a low surplus.

- For Germany, CSR 2 (2013) had recommended wage increases at least in a very indirect way: “Sustain conditions that enable wage growth to support domestic demand.” But even this sentence has been omitted in the CSR 2 (2014): “Improve conditions that further support domestic demand inter alia by reducing high taxes and social security contributions, especially for low-wage earners.”
- CSR 4 for the Netherlands recommends: “(…) allow for more differentiated wage increases by making full use of the institutional framework.”
- CSR 3 for Luxembourg suggests: “Speed up the adoption of structural measures (…) to reform the wage setting system including wage indexation with a view to improving the responsiveness of wages to productivity developments (…).”
- CSR 3 for Austria: “Reduce the high tax wedge on labour for low income earners by shifting taxation to sources less detrimental to growth (…).”

Thus, although the need for a symmetric wage adjustment is obvious, especially in the current “lowflation” environment, the CSRs follow a **one-fits-all approach** for all Member States, even for those with abnormally high current surpluses. This is a second very serious flaw of the CSR approach and the whole European Semester.

From the perspective of an individual country, it is always attractive to improve its competitiveness by an internal devaluation. The very need for coordination arises from the **negative externalities of competitive devaluations**. The problem of “competitive disinflation” is explicitly addressed in the

Commission Staff Working Document on the Euro Area (European Commission 2014d, p. 5) Therefore, it is even more than surprising that the European Semester, which is designed as an institution for coordination, calls for wage developments that would foster competitive devaluations.

Above all, such recommendations **prevent the required rebalancing** within the euro area. For example, if France is able to reduce its social security contributions in a painful political process and the CSRs recommend the same for Germany, the relative competitiveness of France remains unchanged.

One could argue that competitive devaluations within EMU still open the possibility of improved **competitiveness vis-à-vis third countries**. This requires that the nominal exchange rate of the euro does not react to the lower inflation rate of the Euro Area which results from the cost reductions of lower social security contributions and/or lower wage increases or reductions. But according to the **purchasing-power-parity theory** of exchange rates, a lower inflation rate of the Euro Area would be compensated at least in the medium-term by an appreciation of the Euro vis-à-vis third countries. The example of Japan in the period from 2007 to 2012 with a very low inflation rate and at the same time a strong appreciation of the yen shows that this is a very real risk.

In sum, one could conclude that the CSRs in the area of wage setting mechanisms are even worse than no coordination at all. On the one hand, they fail to recommend (at least temporarily) **higher wage increases in countries with very high surpluses.** Higher wage increases in Germany are nowadays even endorsed by the Deutsche Bundesbank and by the Chief economist of the ECB. On the other hand, the CSRs recommend the strategy of internal devaluation even for surplus countries, which would annihilate the adjustment efforts by countries with serious labour market problems. In the specific environment of ”lowinflation” such a one-sided approach increases the risk of deflation for the whole currency area.

2. ARE THE PROVISIONS OF THE STABILITY AND GROWTH PACT, THE MACROECONOMIC IMBALANCE PROCEDURE, AND THE ENHANCED BUDGETARY SURVEILLANCE WELL IMPLEMENTED BY THE EURO GROUP AND ITS MEMBER STATES?

Due to the limited space of this Briefing Paper, these complex questions can only be addressed in a very general way. According to the Survey provided by Economic Governance Support Unit (2014) of the assessment of CSR 2013 based on COM staff documents almost all Member States have been implementing the CSRs concerning the **Stability and Growth Pact (SGP)** in a satisfactory manner. Of the 23 Member States for which an assessment of implementation of CSR 2013 concerning the SGP was made, only 3 countries were given the category “limited progress”. The category “no progress” was not applied.

To some extent, this positive assessment can be related to the fact that since 2013 the Commission has been willing to provide the Member States more time for fiscal consolidation. The **more flexible consolidation approach** is especially obvious in the case of Spain. In 2013, the deficit was still 7.1% which is the second highest value of all Member States. For 2014, a deficit of 5.6 % is expected and for 2015 the forecast is still 6.1 %. A correction of the excessive deficit is required only by 2016. Portugal and Ireland which also had high deficits in 2013 must correct their excessive deficit by 2015.
Together with the supportive monetary policy of the ECB, above all the announcement of the Outright Monetary Transactions (OMT) in September 2012, this more flexible approach to fiscal policy in Member States with high deficits can be regarded as an important explanation for the end of the recession in 2013.

As far as the implementation of the 2013 CSRs which refer to **macro-economic imbalances** is concerned, the Commission comes to a much less positive assessment. For more than 50 % of the 45 CSRs which were especially directed to macro-economic imbalances, “little progress” or even “no progress” is recorded. Only two of the 2013 CSRs were classified in the categories “substantial progress” or "full progress". As these recommendations are mainly of a microeconomic nature, an independent assessment of their implementation is very difficult from an outside perspective. Above all, the main problem with these recommendations is not their implementation but the lack of a systemic approach in their formulation.

As far as the **Enhanced Budgetary Surveillance Procedure** is concerned, it suffers from the same shortcomings as the whole European Semester. According to Regulation (EU) No 473/2013 this exercise should provide for an "for enhanced monitoring of budgetary policies in the euro area and for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the SGP and the European Semester for economic policy coordination." (Article 1). However, without a clearly specified target for the aggregate fiscal stance, the whole procedure is limited to a mere **surveillance** of consolidation programs within the framework of the SGP. This becomes again obvious in the case of Germany where no attempt is made to call for a somewhat more expansionary fiscal stance. The only statement to the fiscal policy in Germany is the following:

"Overall, based on the 2013 Autumn Forecast, the Commission is of the opinion that the Draft Budgetary Plan of Germany submitted on 15 October 2013 is compliant with the rules of the SGP." (European Commission 2013, p.2).

3. WHAT ARE THE MAIN REMAINING CHALLENGES FOR IMPLEMENTING THE ON-GOING FINANCIAL ASSISTANCE PROGRAMMES AND THE POST-PROGRAMME SURVEILLANCE?

A comprehensive assessment of these complex issues goes beyond the scope of this short Briefing Paper. Therefore, only one major challenge will be addressed. It concerns the financial assistance programme for **Greece**. This programme seems extremely unrealistic. This concerns above all the underlying growth projections until 2019 which can be found in the IMF's Fifth Review for Greece from June 2014 (International Monetary Fund 2014c). A comparison with the IMF forecasts for other problem countries of the Euro Area shows that in the period 2016 to 2019 the average real GDP growth forecast for Greece is 3.5 % per annum which by far exceeds the growth forecasts for the other problem countries (Table 1). In addition, for this period, a primary surplus of more than 4 % is projected. Again, this is much more ambitious target than the projected primary surpluses for the four other problem countries. Compared with a primary surplus of 1.5 % in 2014 this would require major additional consolidation efforts, above all in 2014 and 2015. Additional expenditure cuts or higher taxes would threaten the weak improvement of the Greek economy which is taking place right now.

Table 1: Real GDP Growth Projections for Problem Countries of the Euro Area

	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**Average 2016-19**
Cyprus	-4.2	0.4	1.6	2.0	2.2	2.1	2.0
Greece	0.6	2.9	3.7	3.5	3.3	3.6	3.5
Irland	1.7	2.4	2.5	2.5	2.5	2.5	2.5
Portugal	1.2	1.5	1.7	1.8	1.8	1.8	1.8
Spain	1.2	1.6	1.7	1.8	1.9	2.0	1.9

Source: International Monetary Fund, Staff Reports

4. HOW SHOULD THE PRESIDENT OF THE EUROGROUP FACILITATE THE COLLECTIVE AND INDIVIDUAL ACTIONS BY EURO AREA MEMBER STATES IN ORDER TO ADDRESS THE ABOVE MENTIONED POLICY CHANGES AND TO INCREASE THE DEMOCRATIC ACCOUNTABILITY AT BOTH EU AND NATIONAL LEVELS? WHAT ELSE SHOULD S(HE) DO TO SUPPORT/FACILITATE THE SMOOTH

FUNCTIONING OF THE EURO AREA? WHAT SHOULD BE THE PRIORITIES IN THIS REGARD FOR THE NEXT 6 MONTHS?

4.1 A pre-emptive strategy against deflation

As mentioned in the previous sections, the most serious challenge for the Euro Area is a period of very low inflation and even deflation coupled with very low growth or even stagnation. The fact that the most recent inflation forecasts for 2014 and 2015 and beyond do not indicate such a development is not very reassuring. The experience of the year 2013 shows that **inflation forecasts are very unreliable**, even on a year-to-year basis. For instance, in March 2013 the forecast of the ECB Staff for the HICP in 2014 was 1.3 %, the Survey of Professional Forecasters predicted 1.8 %.

Therefore, the President of the Eurogroup should intensively monitor the development of inflation in the Euro Area. On the one hand, he should encourage stronger wage increases in the surplus countries, one the other hand he should limit wage-related structural reforms to avoid competitive real devaluations. If the HICP inflation rate declines further, the ECB's room for manoeuvre is very limited. Therefore, a **strong coordinated response by fiscal policy** would be needed to avert an outright deflation in the Euro Area.

For that purpose, a **comprehensive public investment program** for the Euro Area would be required. As it takes time to develop and to implement such a program, the President should ask all Euro Area Member States to prepare the outlines of such a program immediately. Special attention should be given to investments in education and investments that improve European networks in energy, transportation and research. The contribution of each Member State to the aggregate fiscal stance should be differentiated according to the sustainability of its fiscal policy. A similar approach has been suggested by the International Monetary Fund in its Report on "Euro Area Policies":

"If inflation remained subdued after the monetary policy arsenal has been exhausted, the escape clauses of fiscal rules could be activated." (International Monetary Fund 2014a, p. 21).

There is no doubt that a deflation in the euro area can be qualified as an "**exceptional circumstance**", i.e. as a "case of an unusual event outside the control of the Contracting Party concerned which has a major impact on the financial position of the general government". Thus, temporarily higher deficits would be compatible with the Treaty on Stability, Coordination and Governance in the Economic Monetary Union ("fiscal compact") as well as with the Stability and Growth Pact.

4.2 How to increase democratic accountability

The accountability of the whole process of the European Semester suffers from an unclear wording, a lack of numeric targets and from CSRs that are not comprehensive.

- The recommendations are **not transparent** as they are presented in a very vague form without numerical targets and often a coded language used. This applies for instance to the CSR 2 for Germany which recommends more public and private investment without quantifying the required amount. The CSR in the area of wage policy do not explicitly mention the need for real or nominal wage reductions. Instead they use a coded language: (…) decentralizing their wage setting systems and easing the adaptation of wage conditions to the economic environment." (European Commission 2014a, p. 14)
- The recommendations are **incomprehensive**. For instance, they recommend reductions in social security contributions without discussing the implications of this recommendation. Do the CSR envisage a lower social protection in a period where millions of people are confronted with unemployment and where retirement benefits have already been seriously reduced? In some cases the CSR recommend the shifting of the tax burden from labour to other sources. But in this case they do not discuss the impact of this shift on the **income distribution**. A higher share of capital in national

income together with higher value added taxes could weaken the aggregate demand in the Euro Area and thus aggravate the deflationary tendencies. The lack of comprehensiveness also concerns some very general statements: "More generally, progress still can be made to reduce the overall tax burden problem." (European Commission 2014a, p. 9). Is this a recommendation for all countries implying a reduced role of the state in the economy, especially in a situation where many countries have not yet reached their medium-term budgetary objective?

An institutional innovation to improve the democratic accountability of the European Semester would be the establishment of an **Independent Council of Economic Experts**. Such a council which could be designed according to the model of the German Council of Economic Experts should have the task to present an annual report on the Euro Area by the end of May. This report should analyse the main challenges to the Euro Area and identify the required policy response at the aggregate level. On this basis the Council of Economic Experts should develop its own country specific recommendations for the Euro Area Member States.

Thus, when the Commission comes out with its CSRs, it would be possible for the European citizens to compare it with the recommendations of the independent council. When adopting the CSRs, the Council of the EU should take into account the report made by the Council of Economic Experts. Based on this report the European Parliament could formulate its opinion on the CSRs.

The Council of Economic Experts should be appointed by the **European Parliament** for a five year term according to the election period of the Parliament. It should be independent. In line with the German example, it should have five members. In order to guarantee a broad representation of the relevant groups the ETUC and the Federation of European Employers Association should each have the possibility to propose one member.

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ЕВРОПЕЙСКИ ПАРЛАМЕНТ PARLAMENTO EUROPEO EVROPSKÝ PARLAMENT EUROPA-PARLAMENTET
EUROPÄISCHES PARLAMENT EUROOPA PARLAMENT ΕΥΡΩΠΑΪΚΟ ΚΟΙΝΟΒΟΥΛΙΟ EUROPEAN PARLIAMENT
PARLEMENT EUROPÉEN PARLAIMINT NA hEORPA EUROPSKI PARLAMENT PARLAMENTO EUROPEO
EIROPAS PARLAMENTS EUROPOS PARLAMENTAS EURÓPAI PARLAMENT IL-PARLAMENT EWROPEW
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Abstract

The European Semester is an extremely important tool for economic policy coordination. In the absence of an integrated fiscal policy a monetary union requires a coordination mechanism to avoid negative spill-overs and to achieve an appropriate aggregate fiscal policy stance. In its present form, the focus of the Country Specific Recommendations (CSRs) is on the surveillance of fiscal policy consolidation and of structural reforms. A genuine coordination of national policies is virtually absent. There is also no systematic analysis of challenges for the main macroeconomic targets. The 2014 CSRs neglect the fact that target of price stability is not met and that there is a serious risk of deflation and economic stagnation. There is no systematic analysis whether the aggregate fiscal policy stance of the Euro Area is adequate. In the area of wage setting, the CSRs propose asymmetric wage reductions for many Member States which would increase deflationary tendencies. Therefore, the President of the Eurogroup should prepare a coordinated programme for public investments that could be implemented rapidly if the deflationary tendencies become manifest. In addition, (s)he should monitor wage relevant structural policies to avoid competitive (real) devaluations and encourage stronger wage increases in countries with a very high current account surplus.

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