



European economic policy

A profile of the coordination mechanisms

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Economic policy coordination in the EU and the eurozone has changed over the last two years. It now consists of three pillars. (1) The Integrated Guidelines ensure coordination via an extensive reporting system that encompasses guidelines for economic and employment policies. These objectives are complemented by the Euro Plus Pact, a political agreement reached between 23 EU member states. (2) Fiscal policy coordination is conducted via the Stability and Growth Pact. The Fiscal Compact strengthens fiscal policy coordination between 25 EU member states. (3) The newly introduced macroeconomic surveillance is a target-based mechanism underpinned by sanctions.

Since 2011 the European Semester has established a timetable for all the governance mechanisms. This makes sense as governance mechanisms and reporting for the three pillars are conducted separately, whereas they share some objectives.

The European legal framework requires that all economic policy measures continue to be initiated at member-state level. Economic policy coordination can therefore at best act as a means of assessing the effectiveness of national economic policy – it cannot launch concrete country-specific measures but can only be a reactive instrument via the assessment of national policy.

There are still loopholes, exemptions and wide discretionary powers. If these are also utilised in future, the coordination mechanisms run the risk of squandering their currently good prospects of gaining new credibility.

Economic policy coordination can result in conflicting objectives and time inconsistencies, if it is conducted via indicators and threshold values. Indicators are subject to a variety of influences and thus to measurement and forecast errors. A supplementary, case-based assessment is to be recommended.

At the same time, the selection of indicators is always the result of previous developments and is therefore backward-looking. In addition, the reliability of growth forecasts is questionable. Last but not least, it is unclear whether the potential benefits of economic policy coordination based on reporting and indicators will be outweighed by the new challenges – such as new uncertainties in the financial markets, political risks or an increasingly pragmatic monetary policy.

It is not so much the rule book itself, but rather how it is actually applied which can make economic policy coordination more effective and imbue it with a new reputation. The pressure of the capital markets will remain a key driver of reform in this regard. The three pillars of economic policy coordination can, however, channel this pressure in constructive ways via the European Semester and fill it with substance.



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Three new elements: Economic Sixpack,
Euro Plus Pact and Fiscal Compact

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The *Economic Sixpack* (Economic Governance Package) contains a total of six legislative acts (five regulations and one directive) that entered into force in November 2011. Among other things these legislative acts (1) speed up the excessive deficit procedure (EDP), (2) increase the probability of sanctions being imposed on EMU countries, and (3) provide for macroeconomic surveillance using a set of indicators (scoreboard) and an Excessive Imbalance Procedure, including sanctions.

The Fiscal Compact was signed by the EU member states – minus the UK and the Czech Republic – in March 2012. Besides confirming the already existing rules contained in the *Economic Sixpack* it provides for (1) national debt brakes in EMU countries, preferably anchored in the country's constitution (2) a quasi-automatic launch of an EDP against EMU countries and (3) the possibility for individual member states to sue others if they fail to implement debt brakes. The plaintiffs would be those three countries that occupy the EU presidency in the space of eighteen months ("triple presidency"). The Fiscal Compact is subordinate to EU law, since it is an arrangement under international law.

The Euro Plus Pact is a politically but not legally binding agreement between the EMU countries plus Denmark, Latvia, Lithuania, Poland, Bulgaria and Romania. Member states determine their own measures for achieving the four goals of the Pact. These four goals are: 1. Fostering competitiveness, 2. Fostering employment, 3. Improving the sustainability of public finances, 4. Strengthening financial stability.

Economic policy coordination in the EU and the eurozone has changed over the last two years. The *Economic Governance Package* (*Economic Sixpack*) is a legislative package that reformed and supplemented the existing rules. The *Euro Plus Pact* and the *Fiscal Compact* were supplementary new governance instruments.

Following these reforms economic policy coordination is conducted via three pillars:

- Economic policy is coordinated via the Europe 2020 growth strategy and the Integrated Guidelines. The main governance instrument is extensive reporting. This pillar does not include any sanctions.
- Fiscal policy coordination has a preventive component and a corrective component in the form of the excessive deficit procedure. Following the latest reforms they are both underpinned by sanctions.
- The macroeconomic surveillance element introduced by the latest reforms also contains a preventive component and a corrective component. The latter is underpinned by sanctions.

These most recent changes give rise to three questions that are to be investigated in this Research Briefing:

1. What is the structure of economic policy coordination following the latest reforms?
2. Are there contradictions between the procedures?
3. How should the effectiveness of the reformed framework be rated?

1. Economic policy coordination outlined

The foundations of the governance mechanisms differ in their legal force: all three pillars are based on EU primary law and thus the European treaties. They are augmented by secondary EU law – for example via regulations. They are supplemented via the Fiscal Compact, which is an arrangement under international law that is subordinate to EU law. The Euro Plus Pact in turn is a politically but not legally binding agreement.

Pillar 1: Integrated Guidelines and Europe 2020

The first pillar of economic policy coordination concerns the general economic policy of the EU-27. It is not underpinned by sanctions, but is based on extensive reporting by the member states and recommendations from the Council of Ministers together with the economics and finance ministers (Ecofin) and the Commission. It is implemented via the *Integrated Guidelines for Growth and Jobs* that apply to all 27 EU member states and operationalise the five headline targets of the *Europe 2020* strategy¹ in two sets of goals: the *Broad Economic Policy Guidelines* and the *Employment Guidelines*. They are the basis of the National Reform Programmes (NRPs) of the member states.

¹ The Europe 2020 growth strategy is a political agreement reached in March 2010. As the successor to the Lisbon Agenda, its objective is "smart, sustainable and inclusive growth. Closer coordination of economic policy is intended to help "a high level of employment, productivity and social cohesion" to be attained. This is to be achieved by pursuing the following five quantified headline targets: (1) raising the employment rate for those aged 20-64 to 75% (2) raising combined public and private R&D investment to 3% of GDP (3) reducing greenhouse gas emissions by 20% compared to 1990 levels; (4) reducing school drop-out rates to less than 10%, and (5) increasing the share of 30-34-year-olds having completed tertiary or equivalent education to at least 40%. (5) Reducing the number of people suffering from or at risk of poverty and social exclusion by at least 20 million. See Conclusions, European Council, June 17, 2010.



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The Integrated Guidelines in detail

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As the element for guiding economic policy coordination the Integrated Guidelines comprise the Broad Economic Policy Guidelines and the Employment Guidelines.

Broad Economic Policy Guidelines

- 1) Ensuring the quality and the sustainability of public finances.
- 2) Addressing macroeconomic imbalances.
- 3) Reducing imbalances in the euro area.
- 4) Optimising support for research, development and innovation, strengthening the knowledge triangle and unleashing the potential of the digital economy.
- 5) Improving resource efficiency and reducing greenhouse gases.

6) Improving the business and consumer environment and modernising the industrial base.

Employment Guidelines:

- 7) Increasing labour market participation and reducing structural unemployment.
- 8) Developing a skilled workforce responding to labour market needs, promoting job quality and lifelong learning.
- 9) Improving the performance of education and training systems at all levels and increasing participation in tertiary education.
- 10) Promoting social inclusion and combating poverty.

The Euro Plus Pact in detail

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The Pact contains a list of goals (fostering competitiveness and employment, long-term sustainability of public finances, strengthening financial stability), under which an assessment framework and a package of measures are subsumed.

One example is the fostering of competitiveness.

- Assessment framework: development of pay and productivity as well as the need for adjustment of competitiveness.
- Package of measures: monitoring of wage-setting procedures and indexation mechanisms, ensuring that public-sector settlements provide a benchmark for the private sector.

The necessary measures are determined by the member states themselves and are set out in the NRPs which are presented in spring as part of the European Semester. The NRPs thus also include a package of measures for the Euro Plus Pact. In the German NRP these measures are addressed in a dedicated chapter.

Coordination takes place in four stages within the European Semester (see below):

- *The Integrated Guidelines* are formulated by the European Council on the recommendation of the Commission and based on the conclusion of the Council of Ministers (Ecofin) – and are then approved by Ecofin (in *March*).²
- Based on the *Integrated Guidelines* the member states submit *National Reform Programmes* in which they themselves set their national goals – after all, their starting points do differ (NRPs in *April*).
- In accordance with the guidelines the Commission evaluates the National Reform Programmes and drafts a vote for Ecofin and the European Council (*early in June*).
- The European Council then issues recommendations based on Ecofin's assessments of the NRPs (endorsement, *mid-June*).

The **Euro Plus Pact**, which has also been adopted by the non-EMU states Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania, has strengthened economic policy coordination since March 2011. The objectives are to boost the competitiveness of all the participating countries in order to minimise long-term macroeconomic imbalances and achieve growth and convergence. Coordination is carried out via the reporting of the NRPs. The Euro Plus Pact measures are thus also reviewed annually.

However, three of these goals – (1) competitiveness, (2) employment and (3) sustainability of public finances – overlap with three of the ten *Integrated Guidelines for Growth and Employment*

Pillar 2: Fiscal policy coordination (Stability and Growth Pact)

Fiscal policy coordination consists of two elements – the preventive arm of the stability and growth pact and the corrective arm (excessive deficit procedure). Here, too, policy surveillance is conducted via extensive reporting – however, fiscal policy coordination is underpinned by sanctions at least for the euro-area countries.

Preventive arm: Fiscal policy surveillance

The EU-27 states submit annual programmes; in the case of euro-area countries they are called Stability Programmes and for the non-EMU countries they are called Convergence Programmes (SCPs). They describe a country's medium-term planning – factoring in the impact of demographic change – to achieve or secure a fiscal medium-term objective (MTO). The MTO refers to the structural budgetary balance and varies – depending on the assumed trend growth and debt level – between a surplus of 1% and a deficit of 1% (relative to GDP). As a rule a structural deficit of 0.5% (GDP) is allowed. For countries whose public debt is higher than the 60% of GDP threshold, they must still reduce the debt overhang annually by 1/20.³

The coordination process is scheduled as follows: countries submit their stability or convergence programmes (in *April*). The Commission evaluates these programmes and Ecofin issues guidance on them (in *June*). If the plans in the programmes of the EMU countries do not tally with the opinions of the Commission, there may be the threat of sanctions (see box). Sanctions have only been an element of the preventive arm of the Stability and Growth pact since the latest reform resulting from the *Economic Governance Package*.

² Hearing: European Parliament, Economic and Social Affairs Committee, Committee of the Regions, Employment Committee.

³ See section 3 below regarding the restrictions concerning this rule.



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Sanctions in the preventive arm of the SGP 4

- (1) The Commission can issue an early warning and recommendations for remedies to Ecofin.
- (2) Within one month, Ecofin can recommend concrete remedies to the member state concerned. Deadline for implementation: 5 months at most (3 months in particularly severe cases).
- (3) The Commission constantly assesses whether remedies are being implemented.
- (4) If the Commission concludes that the measures have been inadequately implemented, it can propose sanctions within 20 days (0.2% BIP).
- (5) The Commission's recommendation is deemed to be confirmed by Ecofin, if the latter (euro-area countries voting only) does not reject it by a qualified majority within 10 days.
 - (a) Standard procedure: sanctions within 6 months (5+1).
 - (b) Fast-track procedure: in particularly serious cases with strong deviations sanctions can be imposed within 4 months (3+1).

See German Finance Ministry (2011). Monthly Report, April.

Sanctions in the corrective arm of the SGP 5

- (1) If Ecofin is of the opinion that according to the terms of the treaty the deficit is excessive or debt reduction is insufficient it can recommend corrective measures to the member states concerned and set them a deadline for implementation.
- (2) At this stage of the procedure there is already the possibility of euro-area countries being subjected to financial sanctions (non-interest-bearing deposit of up to 0.2% of GDP which can be turned into a fine in the case of continued non-compliance).
- (3) If recommendations are not complied with, then the next steps in the procedure are launched within the deadline set. These include the possibility of further sanctions.

See German Finance Ministry (2011) Monthly Report, April.

A new element of the Fiscal Compact is that within one year of its entering into force the contracting parties must write debt brakes into their national legislation. There is an indirect threat of sanctions as the contracting parties can be sued in the European Court of Justice (ECJ) if they do not implement debt brakes. According to a Protocol to the Fiscal Compact the plaintiffs are the three countries that have occupied the EU presidency in the last eighteen months ("triple presidency"). The Fiscal Compact also confirms the MTO of 0.5% (GDP) for countries with a public debt to GDP ratio above 60%.

Corrective arm: Excessive Deficit Procedure

As the corrective arm of the Stability and Growth Pact the Excessive Deficit Procedure is launched if a country's general government deficit exceeds 3% of GDP or if it is established that public debt is being insufficiently reduced towards the 60% of GDP threshold. Upon recommendation from the Commission, Ecofin requires a qualified majority (55% of votes representing at least 65% of population) to launch an excessive deficit procedure.⁴ Once the EDP is launched, further steps in the procedure will be implemented via the "reverse majority principle" quasi-automatically: if the Commission proposes the next step in the procedure, that step can only be prevented by a qualified majority of the Ecofin voting against it.

Two elements are new in the Fiscal Compact:

- Firstly, the excessive deficit procedure will already be launched quasi-automatically. In order to avoid contravening primary EU law the euro-area member states have pledged to gear their voting behaviour in Ecofin to the opinion of the Commission and to invariably confirm this opinion. The reason for this is that the excessive deficit procedure – as defined in primary law – does not allow the quasi-automatic launching of the procedure. The self-imposed contractual obligation to invariably support the position of the Commission is therefore a sleight of hand to enable the quasi-automatic launching of the procedure after all. Whether this sleight of hand would be declared lawful by the ECJ, if a country in acute difficulties were to file suit against the automatic launching, remains to be seen.
- Secondly, euro-area countries under the EDP present *budgetary and economic partnership programmes* in which they describe the structural reforms that have to be initiated and implemented in order to effectively and permanently correct their excessive deficits. The content and form of these programmes will probably be established in a regulation in the upcoming months – they could look like the economic policy memoranda that were concluded within the euro-area bailout packages.⁵ The article in the Fiscal Compact makes no mention of whether they have a binding character: since it is an element of the EDP but the EDP is defined in primary European law (TFEU) and no reference to the programmes is made there, then they can hardly be legally binding. The implementation of the programmes and the annual budgetary plans will, however, be monitored by the Commission and Ecofin. Dates and schedules have not yet been determined.

Pillar 3: Macroeconomic surveillance

The third element of economic governance aims to prevent macroeconomic imbalances. Two regulations adopted in November 2011⁶ provide for

⁴ The Fiscal Compact also allows for a quasi-automatic launching of the excessive deficit procedure. See below.

⁵ As stated by Chancellor Merkel at a press conference following the European Council on December 9.

⁶ COM 2010/525 and COM 2010/527.



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Sanctions for non-EMU countries, too?

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Also following the latest reform of the excessive deficit procedure under the *Economic Governance Package* sanctions can only be imposed on EMU countries. For non-EMU countries the procedure ends prior to the sanctions level.

However, the amendment of a relevant regulation concerning the Structural and Cohesion Fund (Art. 4, EC 1084/2006) enables the freezing of the resources from the funds for all EU member states, if there is non-compliance with these recommendations from the Commission. A sleight of hand that also allows sanctions to be imposed on non-EMU states.

In February, Ecofin was therefore able to threaten Hungary with freezing of the resources from the Structural and Cohesion Funds if it continued its non-compliance with the Commission's economic policy recommendations.

Macroeconomic scoreboard: Indicators and thresholds

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The scoreboard differentiates between internal and external imbalances which are each allocated five indicators.

External imbalances:

1. 3-year average current account balance (% of GDP): -4/+6%
2. Net external assets (% GDP): -35%
3. Percentage change (in 3 years) in real effective exchange rate. (HICP deflator): $\pm 5\%$ & $\pm 11\%^*$
4. Percentage change (in 5 years) in export market share: -6%
5. Percentage change (in 3 years) nom. Unit labour costs: +9% & +12%*

Internal imbalances:

1. Percentage change in deflated house prices: +6% yoy
2. Private borrowing (% GDP): 15%
3. Private-sector debt (% GDP): 160%
4. Public-sector debt (% GDP): 60%
5. Average unemployment rate (3 years): 10%

*Threshold for non-EMU member states

**Conceptual overlap with the debt criterion of the Stability and Growth Pact.

Source: European Commission

macroeconomic surveillance – with a preventive arm and a corrective arm, as is the case with fiscal surveillance.

Preventive arm: Macroeconomic surveillance along a set of indicators

An indicator-based warning mechanism will be set up to facilitate the early identification and surveillance of imbalances. To this end the Commission will publish an annual report (*Alert Mechanism Report*) containing an economic and financial evaluation based on a macroeconomic *scoreboard*.⁷ It comprises a set of macroeconomic indicators whose values are compared with previously defined thresholds.

- In its annual report the Commission names those member states which may be affected by or at risk of developing imbalances. Ecofin examines this report and includes its overall assessment thereof in its conclusions.
- If thresholds have been breached, then the Commission performs a more detailed analysis. In doing so, it also takes into consideration other Ecofin recommendations, NRP and SCP targets as well as warnings and recommendations issued by the European Systemic Risk Board (ESRB). If the Commission concludes that the situation is unproblematic, then no further steps are taken. The macroeconomic situation then continues to be monitored in the following year's *Alert Mechanism Report*.

Corrective arm: Excessive Imbalance Procedure

If in its analysis the Commission comes to the conclusion that excessive imbalances are developing in a member state, it informs the European Parliament, Ecofin and the Eurogroup. The Council can then make recommendations to the member state (Art. 121 (2) TFEU).

As with the Excessive Deficit Procedure (EDP), Ecofin can decide that an excessive imbalance exists in a euro-area member state – and publish its recommendations accordingly. The member state concerned must then draw up a corrective action plan which the Council then evaluates within two months. This corrective action plan corresponds with the “*budgetary and economic partnership programmes*” that are required under the corrective arm of the SGP since its was reformed by the Fiscal Compact.

- Persistent non-compliance with the recommendations can lead to the imposition of a fine of up to 0.1% of GDP. If Ecofin deems that the measures have been implemented properly, it can terminate the procedure.
- Under the corrective arm, too, member states subject to an excessive imbalance procedure must fulfil reporting and surveillance obligations. Since no such procedure has been conducted to date it is unclear how much substantive overlap there is with the coordination of general economic policy.

The analysis carried out by the Commission and Ecofin focuses on measures that have actually been implemented, not however on the actual readings attained by indicators as these are also influenced by external effects, for example exchange rate developments or the collapse of the global economy.

The three pillars of economic policy coordination in the EU and the euro area are highly complex and cannot be grasped immediately. This gives rise to two more questions that we aim to address in the following two sections.

⁷ The legal basis for the macroeconomic surveillance is thus the same as for the NRPs und SCPs, namely Art. 121 TFEU. Whether the reporting on macroeconomic imbalances is part of the NRPs or SCPs has not yet been definitively clarified.



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An example of coordination

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To throw more light on the mechanisms mentioned we shall examine an EMU state with a high budget deficit and a high unemployment rate.

The coordination of general economic policy would

- under the Employment Guidelines make the country adopt measures in its NRP to reduce the high unemployment (Guidelines 7-10). (in April).
- under the Broad Economic Policy Guidelines make the country adopt measures in its NRP to secure the sustainability of public finances (guideline 1). As in every other euro-area country the specimen country also makes a statement regarding the attainment of the objectives of the Euro Plus Pact (in April). If the Commission, Ecofin and the European Council were to come to the conclusion that the country has not made sufficient progress in solving these problems, more detailed recommendations would then be issued in July. No sanctions can be imposed, however.

The coordination of fiscal policy would

- under the preventive arm of the SGP criticise the high budget deficit. In the case of repeated failure to achieve the medium-term objective (MTO) Ecofin can impose sanctions upon recommendation of the Commission. The basis for the evaluation is the stability programme (convergence programme for non-EMU countries). (in July)
- under the corrective arm of the SGP automatically launch an excessive deficit procedure if the deficit threshold (3% of GDP) is breached. (Coordination takes place outside the European Semester.) Under a budgetary and economic partnership programme the country would have to document which measures it adopts to reduce (1) deficits and (2) its high unemployment rate (outside the European Semester).

The surveillance of macroeconomic imbalances would

- in the preventive arm signal a problem if unemployment were to breach the threshold reading for the scoreboard. Closer analysis by the Commission would incorporate the measures announced in the SCPs and NRPs. If these measures are sufficient, then the launching of an ...
- ... excessive imbalance procedure in the corrective arm is unconceivable for the time being. (Coordination takes place outside the European Semester.)

2. Do the processes contain contradictions?

A close look at the individual processes and the reporting shows that there is some overlap between the requirements and targets for the various instruments of economic policy coordination. This is the case for instance with the Integrated Guidelines and the Euro Plus Pact – and possibly also with the *budgetary and economic partnership programmes*, which are planned for budget offenders as part of the Fiscal Compact, but which have not yet been sufficiently specified.

Despite the overlaps there is a consistency of objectives: the respective objectives are congruent and do not contradict one another. One example of this “*overlap of consistent objectives*” is for instance the target debt ratio of 60% (of GDP), that is cited in both the Stability and Growth Pact and in the macroeconomic surveillance and is subject to sanctions.

The instruments of reporting are, however, applied separately – even though the reports have referred to each other up until now. The German stability programme for instance refers in many places to the German national reform programme – and vice-versa. Our above-mentioned example of excessive debt illustrates this:

- In the two preventive arms of the fiscal and macroeconomic surveillance the failure to remain within the debt threshold (60% of GDP) would be addressed and evaluated separately, but a large part of the analysis for the macroeconomic surveillance then probably refers to the evaluation made under the Stability and Growth Pact.⁸
- If the corrective components were to be applied, it is obvious that no excessive imbalance procedure would be initiated under macroeconomic surveillance, if the debt level criterion were the only problematic area. In this case the correction would occur via the corrective arm of the fiscal surveillance of the Stability and Growth Pact.

Accordingly, despite shared goals there is strict separation at the instrument level.

Regardless of targets, objectives and instruments the processes of coordination in the European Semester have been harmonised – a big step forward which ensures that the differing reports are published within a common timetable and thus also refer to data and statistics from comparable periods.

The European Semester ensures that all those elements of economic policy surveillance conducted annually are synchronised in a common process. This is described as “multilateral surveillance”, which comprises all the reporting from the first pillar and the preventive arms of the second and third pillars. The synchronisation of the processes does not, however, mean that their elements and objectives are combined. They are still drawn up and pursued separately. Since the corrective elements of economic governance (i.e. excessive deficit procedure and excessive imbalance procedure) are always initiated solely on an *ad hoc* basis, they are not formally included in the European Semester.

The timetable for the Semester harmonises the voting by different combinations of member states – for example, of the EU-23 under the Euro Plus Pact (which occurs within the NRP round as the objectives of the Euro Plus Pact are addressed under the NRPs), but also of the EU-25 under the Fiscal Compact (occurs within the SCP round as the objectives of the Fiscal Compact are

⁸ The first cycle of macroeconomic surveillance has not yet been concluded – 2012 is the first year. A final evaluation cannot therefore be made. That reference is made to other instruments is to be expected, however, as a look at the preventive arm of the fiscal surveillance and its references to the Euro Plus Pact and National Reform Programmes shows: stability programmes (non-EMU member states: convergence programmes) are limited only to improving the long-term budget situation. Nevertheless, they contain cross-references to the NRPs and the Euro Plus Pact. The latter comprises as an objective also the sustainability of public finances.



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The European Semester in detail

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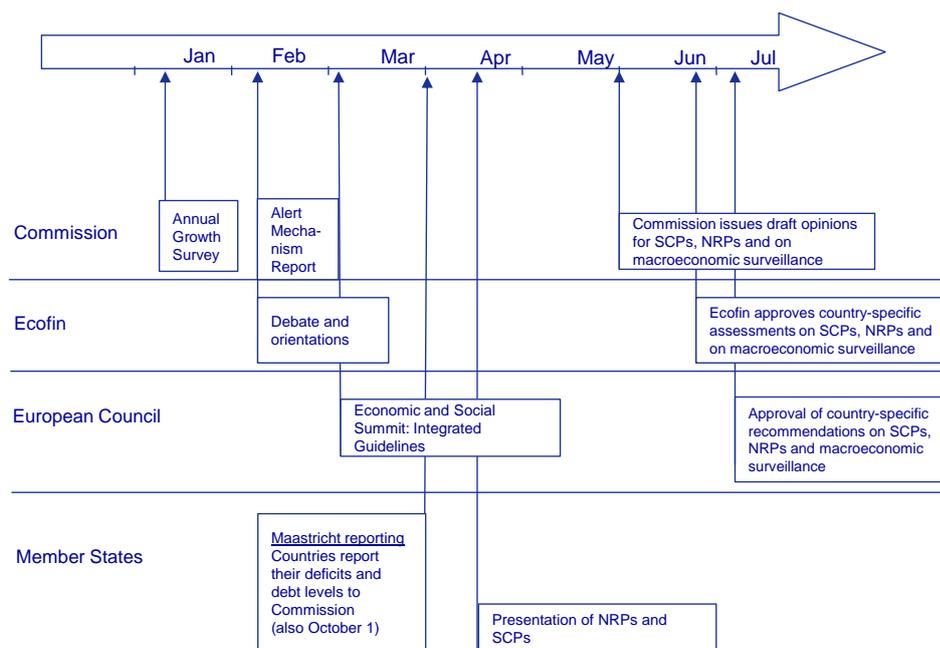
The European Semester is based on an annual coordination process lasting several months with fixed calendar deadlines.

- In January the European Commission publishes its Annual Growth Survey. This report analyses the economic outlook for the whole of the EU. It describes the economic and fiscal policy challenges facing the member states and issues policy recommendations. These recommendations and economic policy priorities are however abstract and are not aimed at individual member states (so-called horizontal recommendations).
- February continues to see publication of the Alert Mechanism Report as a part of the macroeconomic surveillance.
- Based on these reports the European Council sets general trans-national economic policy priorities for all member states in March. Recommendations for budget policy (stability and convergence programmes) and economic policy (national reform programmes) are derived from these priorities.
- In April, member states submit to the Commission their medium-term budgetary plans (SCPs) and economic strategies (NRPs) along the lines of these target recommendations.
- At the beginning of June the Commission evaluates the programmes of these member states and proposes how Ecofin should vote on them. This means that in June Ecofin issues its assessments of the SCPs and NRPs.
- In July, the European Council provides country-specific policy advice on general economic policy and budget policy. The Commission's reports in the following year assess how well these recommendations have been implemented.

addressed under the stability and convergence programmes of fiscal policy coordination). These votes are held during a single meeting of Ecofin.

While the processes of economic policy coordination in the euro area formally operate separately (and have fixed deadlines within the European Semester), there is some overlap between their substantive objectives.

The European Semester: Annual coordination process



Source: European Commission

3. Assessment and outlook: Are the procedures effective?

Economic policy coordination is not an end in itself. It can only be justified from a regulatory point of view if it can reduce and prevent macroeconomic imbalances. In Europe this objective is subject to *de facto* and *de jure* limitations.

- Firstly, the macroeconomic situations and competitiveness of European countries are still very diverse.
- Secondly, the current European legal system permits only member states to carry out economic policy action themselves. The European Union currently has no powers to take such action. Targets from Brussels may at most be formulated along a common target corridor for all EU member states, but not issued on a country-specific basis. That is why there are always common guidelines and targets – that can only be made specific once the member state has delivered some input.

These two limitations allow the conclusion to be drawn that economic policy coordination in a European context can be true to its objective primarily if countries

- continue to have the freedom to conduct economic policy independently using a country-specific *policy mix*,
- and this *policy mix* moves within a regulatory target corridor that provides the framework for their activities.



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Discretionary scope and exceptions:
Three examples

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- As part of the fiscal surveillance conducted via the reformed SGP and the Fiscal Compact the 1/20 rule applies to euro-area countries to reduce public-sector debt starting in 2014 – a fact that has not been made sufficiently transparent.
- The case of Spain shows that even following the extensive reform of the Stability and Growth Pact countries that repeatedly and culpably fail to comply with the consolidation targets set by the Commission and Ecofin do not face sanctions. The meeting of economics and finance ministers in March decided that the EDP for Spain – despite missing the consolidation target by a clear margin – is to be suspended and that a final assessment should not be made until next year. The considerations may certainly be justified in the light of the economic risks on the Iberian peninsula. Nevertheless, it is the case that the Commission and Ecofin continue to make full use of their discretionary powers.
- The situation is also similar for macroeconomic surveillance in the third pillar. An excessive imbalance procedure against a member state is subject to a double discretionary filter of the Commission and Ecofin: only if both come to the conclusion that a macroeconomic imbalance not only exists but that it is also harmful will an excessive imbalance procedure be initiated. Given the multi-faceted reasons for macroeconomic imbalances such prudence may certainly be appropriate – whether the coordination, however, is sufficiently effective is somewhat doubtful.

Does the reformed system of rules for economic policy coordination fulfil these requirements?

First of all, at this juncture it is difficult to make a conclusive assessment of the current framework of economic governance. The European Semester is only going through its second cycle, macroeconomic surveillance and the Euro Plus Pact are in their first cycle and the ratification process for the Fiscal Compact has not yet been completed.

Conventional coordination mechanisms – pillars 1 and 2, as they existed up until the euro crisis – failed to deliver the hoped-for success in the past: sanctions simply did not exist (pillar 1) or were highly unlikely to be imposed (pillar 2). On top of this there was an always strong discretionary component for Ecofin and multiple reforms were made to the rules and regulations.

With the start of the “euro crisis” the pressure from the capital markets as the provider of financing also increased at the same time (from about January 2010). This occurred some six months before a reform of the framework was initiated and corresponding signals were sent to national policymakers (from around July 2010).

This means that if we want to make a retrospective assessment of the success of economic policy coordination it is difficult to conduct this assessment without looking at the corrective action of markets or stripping out this factor. A final assessment cannot therefore be made of the mechanisms at this point, but at best of certain segments. All the same, the three pillars of economic policy coordination certainly can be criticised with respect to the above-mentioned two requirements.

Firstly, target corridors are now binding and mostly underpinned by sanctions – concrete lists of measures can at the same time, however, only be formulated as policy goals and cannot be enforced by the EU. Under current European law it is carved in stone: the European Treaties simply do not bestow the European institutions with the power they would require for greater rights of intervention. With regard to expedient coordination this remains a shortcoming that results in economic policy coordination always only being able to follow national policy via an iterative process of constant *ex post* monitoring of success, but not being able to take the lead. It remains to be seen to what degree this will change within the economic and budgetary partnership programmes that the Fiscal Compact stipulates for the excessive deficit procedure in future – these formats have not yet been sufficiently defined.

A second area for criticism is that despite extensive improvements in the rigour of sanctions the coordination arrangements still provide numerous loopholes and huge scope for discretion to be applied (see box). If these are also exploited in future, coordination runs the risk of squandering its currently good prospects of gaining new credibility.

A third topic that can be criticised is that the indicator-based fiscal and macroeconomic surveillance can result in conflicting objectives and time inconsistencies. Although indicators are assessed separately, they are linked.

- An example: in order to reduce unemployment not only is deregulation of the labour market necessary, but also comprehensive training measures. The latter require a large amount of public funding in most cases. Since growth effects and lower unemployment do not materialise immediately the public-sector deficit expands as a result – at least in the short term. This shows that indicators illustrate developments that are closely linked and suggests a supplementary case-based assessment should be made. A static indicator-driven analysis alone would result in sanctions on account of the high unemployment (under macroeconomic surveillance) and the large budget deficit.



The benefit of a strictly indicator-based approach is questionable in cases where a highly dynamic situation arises due to existing adjustment processes and potential impacts on the economy and growth. If, however, the analysis is also conducted on a case-specific basis, this limits the originally intended benefit of an indicator-based approach – namely of transparent, common target values that apply to all and prompt all to take action.

It would be possible to codify exceptions to indicator-based surveillance – in a similar way to that with the Stability and Growth Pact in its *Code of Conduct* which allows crediting for the additional burdens that arise from pension reforms. Nevertheless, the macroeconomic conditions in member states differ widely due to historical path dependencies: some countries have larger public debt, others are particularly successful in export markets thanks to their economic structure. Seeking to capture all these circumstances by making explicit exemptions would call into question the clarity of the indicator-based approach.

With regard to indicator-based surveillance there are three more limitations:

- Indicator-based control tends to be backward-looking, as the selection of indicators is based solely on past developments.
- Furthermore, there are doubts about the reliability of growth projections on which the European Commission's assessment is based (Annual Growth Survey). Comparisons show that the European Commission's growth forecasts cannot always guarantee to be spot on.
- There is also the question of whether economic policy in future may face new challenges that overtax the capabilities of economic policy coordination based on reporting and indicators. Some conceivable challenges include new uncertainties in the financial markets, political risks, and reactions on the part of consumers and investors to increasingly pragmatic monetary policy.

These limitations indicate that it is not so much the rule book itself, but rather how it is actually applied that can render economic policy coordination more effective and imbue it with a new reputation.

A strict application of the new rule book can be ensured via rigorous pressure from the capital markets. They will also drive reforms in the future. Nevertheless, the three pillars of economic policy coordination can channel this pressure in constructive ways via the European Semester and fill it with substance. Nothing more, but also nothing less.

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