BRUEGEL POLICY CONTRIBUTION

ISSUE 2013/12
SEPTEMBER 2013

DOES THE EUROPE SEMESTER DELIVE THE RIGHT POLICY ADVICE?

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Highlights

- The July 2013 European Council recommendations to the euro area recognise number of fiscal and macrostructural challenges, but do not fully exploit the optio made possible by the European economic governance framework. There are pa cular problems with the Council's suggestions for the euro area as whole, which not (or not adequately) reflected by the country-specific recommendations. A maj drawback is that the Council recommendations do not give sufficient importance symmetric intra-euro area adjustments. Reference to the euro area's 'aggrega fiscal stance' is empty rhetoric. Insufficient attention is paid to demand manage ment. The most comprehensive recommendations are made on structural refor
- The July/August 2013 Article IV IMF recommendations on macroeconomic polic could also have been more ambitious, but they correspond better to the econom situation of the euro area than the Council's recommendations.
- The President of the Eurogroup should continue discussions on the completion the economic governance framework, including completion of the banking unio and the setting-up of a euro-area institution responsible for managing the eu area's aggregate fiscal stance.

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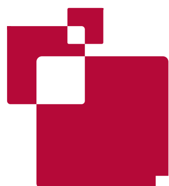

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DOES THE EUROPEAN SEMESTER DELIVER THE RIGHT POLICY ADVICE?

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1 INTRODUCTION

The European Semester, a yearly cycle of economic policy coordination inaugurated in 2011, lies at the heart of the European Union's new economic governance framework. It starts with the setting of the main priorities by the European Commission in the 'Annual Growth Survey', followed by the submission and assessment of EU member state National Reform Programmes and Stability and Convergence Programmes. It concludes with country-specific recommendations and recommendations for the euro area as a whole.

EU member states are expected to implement the recommendations. The two main EU surveillance procedures, the Excessive Deficit Procedure (EDP) and the Macroeconomic Imbalances Procedure (MIP), are integrated into the European Semester, and non-compliance with the Council recommendations may trigger procedural steps, including sanctions.

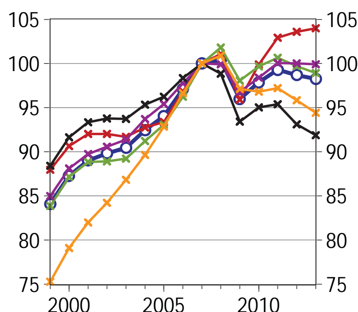
The third European Semester was concluded by the Council recommendations on 9 July 2013. In this Briefing Paper, we assess the main fiscal and macro-structural challenges and recommendations for the euro area and its member states. Given the space constraints of this briefing paper, we focus on the main challenges for the euro area and therefore we cannot assess the recommendations for all 17 euro-area member states.[1] Instead, in addition to recommendations for the euro area as a whole, we assess the recommendations for the euro area's five largest economies: France, Germany, Italy, the Netherlands and Spain. These five countries account for 83 percent of euro-area GDP, meaning that they represent well the diversity of the euro area.

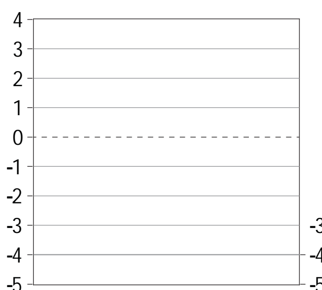
We first characterise the main economic, fiscal and financial conditions in the euro area to present the situation against which the recommendations should be assessed. This is followed by the summary and our assessment of the main recommendations for the euro area as a whole and for the five countries. For comparison, we also report the International Monetary Fund's recommendations in the framework of the Article IV consultations for all five countries and the euro area. Finally, we summarise our conclusions.

2 ECONOMIC AND FISCAL DEVELOPMENTS IN THE EURO AREA

The figures in this section highlight the main economic and fiscal developments in the euro area, which provide the basis for assessing the Council's and the IMF's recommendations in the next section.

1. See a summary of the 2012 and 2013 recommendations and the European Commission's assessment of the implementation of the 2012 recommendations in European Parliament (2013). An independent assessment of the first two rounds of the European Semester can be found in Hallerberg, Marzinotto and Wolff (2012a,b).





In 2012, euro-area GDP fell by 0.6 percent. It is expected to continue to fall in 2013, despite the recent positive quarterly growth rate in 2013Q2. The output gap is forecast to widen from -1.2 percent of GDP in 2011 to -2.9 percent in 2013. There is also a growth deceleration in Germany and a forecast widening of the output gap to -1.0 percent in 2013, though arguably, Germany is in the best economic condition among the countries we consider. In the Netherlands, the output gap is expected to widen to -3.6 percent, and to even more in Spain and Italy. The unemplo

The EU's fiscal strategy was based on the conviction that fiscal austerity is needed to restore trust, to limit increases in debt and thereby to lay the foundations for sustainable growth. Undoubtedly, low public debt has great benefits. But premature fiscal consolidation at the euro-area level has side effects, and the need for fiscal consolidation at the country-level varies.

The public-debt-to-GDP ratio is indeed high and rising in Italy and in Spain, and therefore there was no alternative to fiscal consolidation in highly indebted countries (the only but question was its pace). However, debt levels are lower in Germany and the Netherlands and no one questions their sustainability. From 2010 to 2013, Germany consolidated its primary structural balance by about 3 percent of GDP and the Netherlands by about 2 percent of GDP. These two countries have strong policy regimes and more expansive fiscal policies better aligned to their negative output gaps, and the needs of the euro area would have not led to concerns about debt sustainability. As a comparison, the US and Japan continue to borrow at low interest rates despite their much higher public debts and deficits. Therefore, the issue is not a return to 'failed old debt-making policies' in highly indebted countries, but to ensure fiscal stabilisation at the euro-area level as long as private demand is weak.

Buti and Carnot (2013) challenge some criticisms of the EU's fiscal strategy and essentially conclude that fiscal consolidation was necessary in southern Europe, a conclusion that we agree with. But they are silent on developments of the aggregate fiscal stance of the euro area, which was strongly influenced by the major fiscal consolida-

tion in Germany and other euro-area member states with strong fiscal fundamentals during the past few years. They only note that the fiscal stance of Germany is now broadly neutral: again, this assessment does not consider the implication of the German fiscal stance for the aggregate euro-area fiscal stance at a time when the cyclical position of the euro area is very weak.

The premature aggregate euro-area fiscal consolidation is hindering the deleveraging of the private sector and rendering it more difficult for southern euro-area member states to implement their necessary fiscal consolidation. It is also making more difficult the reduction in intra-euro area current-account imbalances and pushing the euro area to a current account surplus. This last effect can worsen global imbalances[2].

BOX 1: ACADEMIC FINDINGS ON FISCAL STABILISATION, INCLUDING IN A MONET

Is fiscal policy needed to stabilise output? If the central bank is not constrained by the zero lo bound on nominal interest rates, the classical models suggest no role for fiscal policy in stabi tion (Mankiw and Weinzierl, 2011). Mankiw and Weinzierl argued further that even if the zero-b is binding, the central bank can stabilise aggregate demand by committing to future expansio policy. Krugman (1998) made the same point by arguing that with policy rates at zero, the ce bank faces the dilemma of “promising credibly to be irresponsible”. If that fails, Mankiw and Weinzierl, and Krugman, agree that expansionary fiscal policy can increase output, although the fo note that welfare gains are larger if the fiscal reaction consists of tax changes rather than incre public spending. In practice, central banks do not seem to offset fiscal policy changes comple all the time. Notably Auerbach and Gorodnichenko (2012) found that fiscal policy has signific effects on output, particularly in recessions.

The textbook role for fiscal policy in a multi-country monetary union is to counteract national sho Ferrero (2009) argued that countries should respond to idiosyncratic shocks by varying distor taxation and government debt. Gali and Monacelli (2008) concluded that when the central ban gets aggregate price stability, national fiscal policy to smooth idiosyncratic shocks is desirable from the viewpoint of the individual country and the entire monetary union. Nevertheless, in current situation, countries that could most use fiscal policy flexibility do not have, or are at ris losing, market access. Therefore an important question is whether fiscal expansion in countries fiscal space would have positive spillover effects and could be used as an (imperfect) substit Hebous and Zimmermann (2013) found that the effect on output of a currency union-wide fi shock is greater for most countries than the effect of a similarly sized national shock. As the f costs of an aggregate shock are considerably smaller for each single country than the costs of p domestic expansion, this favours coordination of fiscal policies. However, the impact on partic countries depends on their openness and trade links. For instance, Cwik and Wieland (2011) a that the spillover effects are quantitatively small.

It is not realistic though to expect first-best coordination of fiscal policies decided by 17 euro- national parliaments. Therefore, there is on-going discussion about the need for a European fi fiscal authority (Darvas, 2012b; Wolff, 2012). Proponents of this argue that it would i

2. Darvas (2010) warne that premature fisca consolidation at the euro area level would likely lea to these four side effects

We therefore conclude that the overall euro-area fiscal stance, significant consolidation from 2011 to 2013, was inconsistent with the sizeable dete-rioration of the cyclical position. Lack of an author-ity responsible for the aggregate fiscal stance has therefore been a major handicap for the euro area (Darvas 2012b, Wolff 2012).

In addition to fiscal consolidation, another concern has been the adjustment of external imbalances. There has been significant progress on this. The previous current-account deficits of Spain and Italy are expected to turn to surpluses, and Spain's intra-euro real affective exchange rate has depre-ciated significantly (though Italy's has not)[3].

However, while Spain's export performance is indeed impressive (Italy's less so), it needs to be further improved and sustained. Also, it is not easy to determine the parts played by improved com-petitiveness and the collapse of domestic demand in the improvement of the trade balance[4]. Spain has a close to minus 90 percent of GDP net inter-national investment position (NIIP), which is largely comprised of debt and is much larger than the 35 percent threshold in the Macroeconomic Imbalance Procedure (MIP). Therefore, Spain's trade balance should shift to a sizeable surplus in order to ensure external debt sustainability. Italy does not have a large negative NIIP, but its exports have long been losing market share and its eco-nomic growth was low even before the crisis. Real exchange rate depreciation could foster the devel-opment of the tradable sector, which in turn could improve overall economic growth as a larger share of the economy would face international competi-tion-fostering productivity growth. Therefore, major adjustments still lie ahead. Since euro-area member states do not have a stand-alone cur-rency, intra-euro adjustment is necessary (though not sufficient).

Finally, the weak state of domestic banking sys-tems in southern Europe constrains access to credit. The Non-performing loans continued to increase in Italy and Spain in 2012. Domestic problems are accentuated by the simultaneous de-nationalisation of banking systems. Foreign banks have significantly reduced their exposure to southern Europe and have therefore withdrawn a major source of bank funding (Figure 4 on the next page). Although cross-border intermediation has also decreased in stronger countries, this is less of a problem for them because they received a massive private capital inflow which also pushed down interest rates. Furthermore, the nature of the reduction of bank exposure to Ger-many and the Netherlands was more related to the Lehman Brothers crash, and exposure broadly stabilised soon after.

Based on these observations, we highlight five major challenges for the euro area:

- Aligning the aggregate fiscal stance of the euro area with the aggregate economic situation;
- Stimulating private investment conomic situation;
- Stimulating private investment conomic situation;
- Stimulating privat.0255 Tw [(fisc)8(al stance, signifi(fisc)8(al stance, si

3. We note that in Spain, the major reason for the fall in ULC was massive layoffs (Darvas, 2012a), with adverse social consequences.

4. Using a simple account-ing identity, it is possible to calculate the roles played by exports and imports in the improvement of the trade balance. For example, in the case of Spain, imports contributed by about two-thirds when con-stant-price data is used. But there were major changes in the terms of trade and current-price data suggests that exports had a two-third role. Beyond the accounting identity relating exports and imports to the trade balance, the impact of domestic demand collapse on both imports and exports are not known. For example, Esteves and Rua (2013) argue that there is a strong negative relationship between exports and domestic demand in a recession. Therefore, there is much controversy about the roles played by improved competitiveness and the collapse of domes-tic demand in the improve-ment of the trade balance.

specific recommendations.

- Reducing unemployment in the harder-hit countries by either creating jobs in those countries, or helping intra-EU mobility;
- Fostering the symmetric adjustment of intra-euro price/wage divergences and external imbalances;
- Fully reversing financial fragmentation.

3 THE JULY 2013 COUNCIL RECOMMENDATIONS

We now turn to the July 2013 Council recommendations, which are summarised in Table 1.

When assessing the Council recommendations, one has to bear in mind that they are required to comply with the euro area's new economic and fiscal governance framework. For example, even if a case can be made for a more active fiscal policy at the euro-area level, the revised Stability and Growth Pact and the Fiscal Compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) set limits on structural deficits[5] Also, monetary policy is the responsibility of the independent European Central Bank and therefore the Council should not give recommendations that are related to the authority of the ECB. The recommendations therefore have to be assessed within the remits of the fiscal framework, while the governance framework itself has to be assessed separately (which is beyond the scope of this briefing paper).

We make the following observations:

1 A number of euro-area recommendations are not (or not properly) reflected in country-

approved by national parliaments, and national parliamentarians primarily consider their own countries, and not the euro area as a whole, when setting fiscal policy. Only the establishment of a euro-area fiscal institution responsible for managing the euro area's fiscal stance (financed ideally from direct tax revenues) would be able to achieve an adequate aggregate fiscal stance (Darvas, 2012b, Wolff, 2012).

3 Certain principles are not applied equally. As laid out in the document for the euro area, member states with "significant and potentially rising risk premia should limit deviations from the nominal balance targets even

TABLE 1: SUMMARY OF JULY 2013 MAIN RECOMMENDATIONS ADOPTED BY THE COUN

	Euro area	Germany	The Netherlands	France	Italy	Spain
Fiscal policy	Aggregate fiscal stance the euro area should en growth-friendly and diffe entiated fiscal policy; Allow automatic stabilisers function along adjustment	Preserve sound fiscal po tion	Correct excessive deficit 2014 and achieve MTO 2015	Correct excessive deficit 2015 and achieve MTO 2016	Deficit below 3% in 2013; Achieve MTO by 2014	Correct excessive deficit by 2016 and achieve MTO by 2018
Demand managemen	Coordinate aggregate fis stance; Address employment cri	Promote wage growth by reducing high taxes and social security contributio	Protect growth-sensitive public expenditure.	Growth friendly consolid tion and tax reform.	Growth-friendly fiscal co solidation; Upgrade infrastructure.	Reduce government arrears
Labour market	Coordinate and monitor national reforms; Tackle the social conse- quences of the crisis an rising unemployment, in line with the Compact fo Growth and Jobs and th Youth Guarantee.	Raise the educational achievement of disadva taged people; Improve incentives to w for second-earners and skilled; Integrate long-term unemployed.	Increase labour market ticipation by reducing ta disincentives on labour reforming employment p tection legislation.	Unemployment benefit system reform; Increase labour market ticipation (focus on olde workers); Promote apprenticeship	Increase labour market ticipation; Improve incentives to w for second-earners and skilled; Better targeting of social transfers.	Evaluate the need for fur- ther labour market reforms; Improve unemployment

against worse-than-expected macroeconomic conditions". The risk premia of Italy and Spain are broadly similar. The quoted principle was probably applied to Italy ("Ensure that the deficit remains below 3% of GDP in 2013"), but not to Spain, a country (along with France and the Netherlands) that was given more time to meet the nominal deficit target of 3 percent of GDP. We note that it was the right decision to extend the deadline for meeting the nominal targets at a time when the economic situation became worse than expected, but it is unwise to set principles and to apply them differently in different countries.

4 The fiscal strategy continues to reflect a consolidation bias, which is not consistent with the economic situation of the euro area. We have noted that the euro area's challenging cyclical situation warrants a less-austere aggregate fiscal stance. But by recommending that Germany preserves its sound fiscal position, and that other countries pursue fiscal consolidation, the aggregate fiscal stance of the euro area will be too tight, even if the pace of consolidation at the euro-area aggregate level slows down[6]. According to the European Commission, Germany has met her medium term objectives (MTO) with a wide margin in the preventive arm of the Stability and Growth Pact (SGP) and is forecast to have a 0.3-0.4 percent of GDP structural budget surplus in 2013-14, well above the 0.5 percent structural deficit threshold of the Fiscal Compact. The deficit goals at the federal level under the national debt brake rule were also achieved well ahead of schedule. Therefore, the fiscal rules would have allowed more broad-based tax cuts to stimulate private investment and consumption and measures to increase public investment, but no such recommendations are made for Germany.

5 A major weakness is that demand management is only indirectly included in the euro-area recommendations, and the recommendation for Germany is feeble. The Council's proposal for coordinating the aggregate fiscal stance of the euro area and attempting to reduce unemployment may increase demand. However, we have already argued that the aggregate fiscal stance is largely an empty concept; furthermore, there was no direct recommendation for the euro area to increase demand, despite the continued decline in private consumption and investment. Among the five countries that we consider, only Germany received a suggestion that it should boost domestic demand. Yet while the actual text includes important policy goals, overall, it fails to emphasise the main point of stimulating aggregate private demand: "Sustain conditions that enable wage growth to support domestic demand. To this purpose, reduce high taxes and social security contributions, especially for low-wage earners and raise the educational achievement of disadvantaged people. Maintain appropriate activation and integration measures, especially for the long-term unemployed. Facilitate the transition from non-standard employment such as mini-jobs into more sustainable forms of employment. Ta/andard emplo.008 Tc .036

6. We also note that France has – correctly – not received a recommendation to implement public spending cuts, though it has one of the highest public spending ratio (relative to GDP) in the EU.

7. Among the 17 euro-area countries, the Netherlands had the highest labour force participation rate (79.3 percent) and the highest employment rate (72.5 percent) in 2012, followed by Germany (77.1 percent and 72.8 percent, respectively), while the euro-area averages are 72 percent and 63.8 percent.

4 CONCLUSIONS

The July 2013 Council recommendations for the euro area and for its member states recognise a number of fiscal and macrostructural challenges but do not go far enough in exploiting the policy options offered by the European economic governance framework.

The recommendations are most comprehensive when they deal with structural reforms, including labour market reform and fiscal governance. The recommendations also rightly stress the significant potential growth that could be stimulated by opening domestic markets to greater competition, particularly in the service sectors, though several regulatory issues are delegated to the national level when EU-level initiatives are also needed.

The opposite is true for macroeconomic policies: certain suggestions are made for the euro area, such as achieving an adequate aggregate fiscal stance in the euro area, symmetric adjustment of intra-euro area imbalances and financial sector repair, but these suggestions are not (or not properly) reflected in the country-specific recommendations. It is therefore unclear who will implement the euro-area recommendations.

- The concept of "aggregate fiscal stance of the euro area" has no implications for policy, because the optimal fiscal stance of the euro area is not defined and each country is advised to implement its own fiscal strategy, without any regard to its impact on 5t1

12. See Zachmann (2013) for a blueprint on how to reap significant benefits from an integrated European electricity market.

ANNEX: IMF Article IV recommendations for the euro area

TABLE 2: SUMMARY OF JULY/AUGUST 2013 MAIN RECOMMENDATIONS BY THE IMF

	Euro area	Germany	Netherlands	France	Italy	Spain
Fiscal policy	Define and assess fiscal cons tion in structural terms; Even revised deadlines may b strict for some countries; Credible medium-term framew needed to counteract slower s term consolidation.	A projected modest loosening 2013 is appropriate; The fiscal stance is appropriat Fiscal over-performance to be avoided; If growth disappoints, fiscal po cies need to be recalibrated.	Fiscal policies should focus or structural targets and allow au matic stabilizers to operate; No further consolidation for 20	2014 consolidation should be eased; Reorient towards expenditure tainment; Medium term: tighter spending c trol by local authorities and impr efficiency of social spending.	Rebalance adjustment to support g Favour spending cuts offset by decreases; Broaden tax base (keep property Combat tax evasion; Binding multi-year expenditure cei Independent budget office.	Consolidation should continue in a gradual and growth-friendly fash- ion.
Demand management	Stronger ECB policies (forward gu rate cuts, lower haircuts, new LTR asset purchases); Do not react to further negativ prises by tighter fiscal policy; Reducing general euro area u tainty would catalyse investme	See above; Financial reform should promc domestic investment.	(see above)	Undertake a growth friendly ta reform to support the consolid tion.	Accelerate payment of govern arrears; Increase public investment.	