



## Does the European Semester deliver the right policy advice?

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Draft Briefing Paper submitted in advance of the Economic Dialogue with the President of the Eurogroup in ECON  
5 September 2013

### Abstract

The July 2013 Council recommendations for the euro area recognise a number of fiscal and macrostructural challenges, but they do not go far enough in exploiting the policy options rendered possible by the European economic governance framework. There are particular problems with the Council's suggestions for the euro area as whole, because these suggestions are not (or are not adequately) reflected by the country-specific recommendations. A major drawback is that the Council recommendations do not give sufficient importance to symmetric intra-euro area adjustments. Reference to the euro area's 'aggregate fiscal stance' is empty rhetoric. By contrast, the recent IMF recommendations seem more appropriate in our view. The President of the Euro Group should continue the discussions on the completion of the economic governance framework, including the completion of the banking union and the setting-up of a euro-area institution responsible for managing the euro area's aggregate fiscal stance.

## **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<sup>1</sup>. Instead, in addition to recommendations for the euro area as a whole, we assess the recommendations for the euro area's five largest economies: Germany, France, 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.

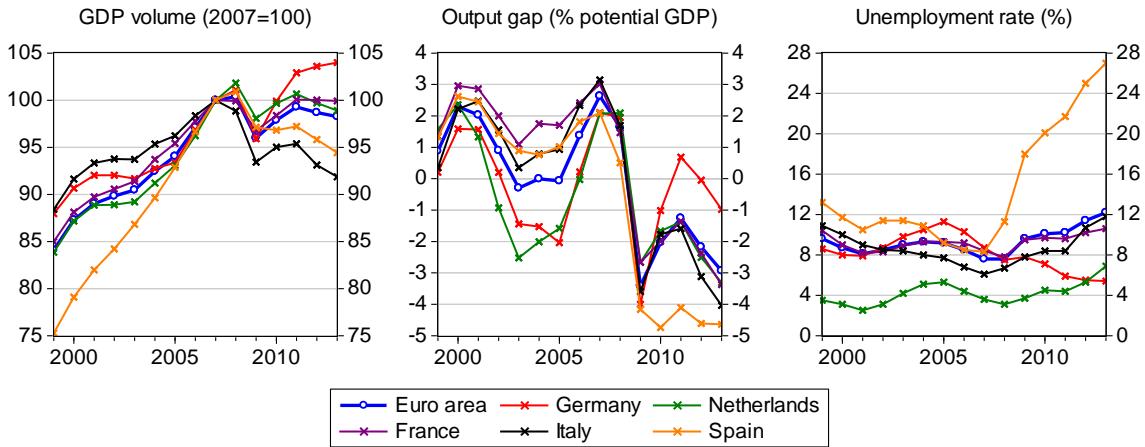
## **2. Economic and fiscal developments in the euro area**

The figures in this section highlight the main economic and fiscal developments in the euro area.

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<sup>1</sup> See Table on the 2012 and 2013 recommendations and the European Commission's assessment of the implementation of the 2012 recommendations for all euro-area member states, as well as the recommendations for the euro area, in European Parliament (2013). See an independent assessment of the first two rounds of the European Semester in Hallerberg, Mazinotto and Wolff (2012a,b).

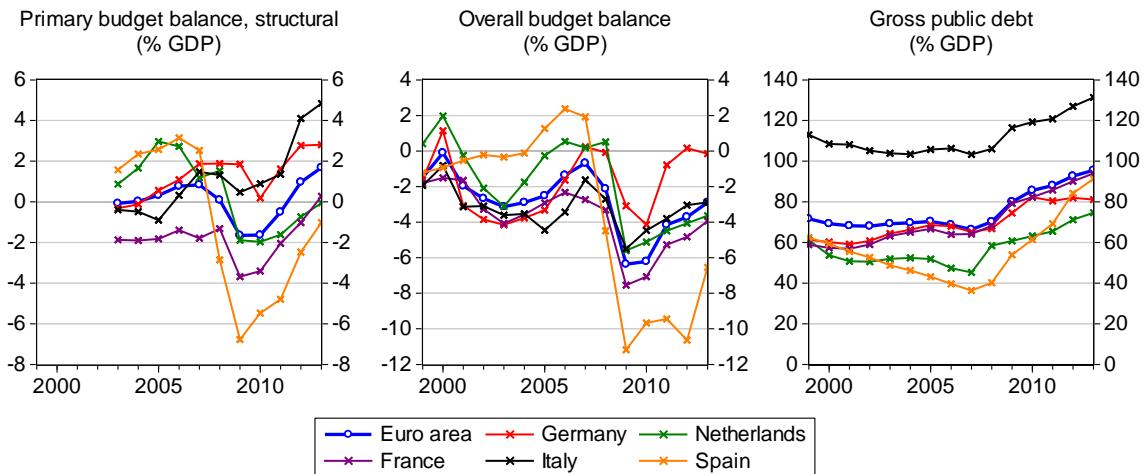
*Figure 1: Main indicators of the economic cycle*



Source: European Commission Spring 2013 forecast.

In 2012, euro-area GDP fell. 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 unemployment rate has also increased in all countries except Germany in recent years. Private consumption and private investment have also declined in the euro area during the past two years. Overall, the cyclical position in the whole euro area has clearly worsened since 2011.

*Figure 2: Main public finance indicators*



Source: European Commission Spring 2013 forecast.

The euro area's structural primary budget balance (ie the balance excluding interest payments and cleaned from the impact of the economic cycle and one-time items) is expected to improve from -1.6 percent of GDP in 2010 to 1.7 percent in 2013, reflecting an annual fiscal consolidation effort of 1 percent of GDP per year during the past three years.

Therefore, a rather significant fiscal consolidation has been implemented at a time when the cyclical position of the euro area has deteriorated considerably. There is no model that claims that this was an optimal policy (see Box 1). Instead, fiscal stabilisation should

allow automatic stabilisers to run in a cyclical downturn (in which case the structural deficit remains stable and the actual deficit worsens), or even implement a fiscal stimulus (when the structural deficit also worsens).

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 particularly in Spain, and therefore there was no alternative to fiscal consolidation (the only 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 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<sup>2</sup>. As a comparison, the US and Japan continue to borrow at low interest rates despite their much higher public debts and deficits.

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 inhibiting 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<sup>3</sup>.

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

#### ***Box 1: Academic findings on fiscal stabilisation, including in a monetary union***

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

*The textbook role for fiscal policy in a multi-country monetary union is to counteract national shocks. Ferrero (2009) argued that countries should respond to idiosyncratic shocks by varying distorting taxation and government debt. Gali and Monacelli (2008) concluded that when the central bank targets aggregate price stability, national fiscal policy to smooth idiosyncratic shocks is desirable both from the viewpoint of the individual country and the entire monetary union.*

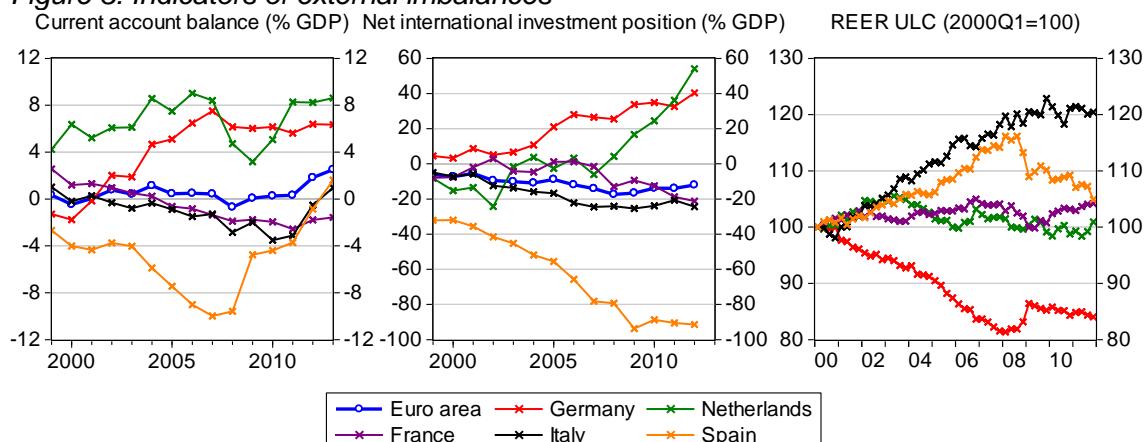
<sup>2</sup> Buti and Carnot (2013) challenge some criticisms of the EU's fiscal strategy and essentially conclude that fiscal consolidation was necessary in southern Europe, with which we agree. But they are silent on developments of the aggregate fiscal stance of the euro area, in particular, on the major fiscal consolidation by 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, which they regard correct: again, this assessment does not consider the implication of German fiscal stance for the aggregate euro-area fiscal stance.

<sup>3</sup> Darvas (2010) warned that premature fiscal consolidation at the euro-area level will likely lead to these four side effects.

Nevertheless, in the current situation, countries that could most use fiscal policy flexibility do not have, or are at risk of losing, market access. Therefore an important question is whether fiscal expansion in countries with fiscal space would have positive spillover effects and could be used as an (imperfect) substitute. Hebois and Zimmermann (2013) found that the effect on output of a currency union-wide fiscal shock is greater for most countries than the effect of a similarly sized national shock. As the fiscal costs of an aggregate shock are considerably smaller for each single country than the costs of purely domestic expansion, this favours coordination of fiscal policies. However, the impact on particular countries depends on their openness and trade links. For instance, Cwik and Wieland (2011) argued that the spillover effects are quantitatively small.

It is not realistic though to expect first-best coordination of fiscal policies decided by 17 euro-area national parliaments. Therefore, there is on-going discussion about the need for a European federal fiscal authority (Wolff, 2012). Proponents of this argue that it would act as a stabiliser during an economic downturn. Asdrubali et al (1996) estimated in their seminal paper that the US federal state smoothed about 13 percent of shocks to regional output between 1963-90. Cross-border flows of capital income and credit markets smoothed another 62 percent of shocks. In another study, Mélitz and Zumer (2002) found that the central government absorbed about 20 percent of regional shocks to personal income in the United Kingdom, the US and France, while the share was lower in Canada. Finally, Furceri and Zdzienicka (2012) showed that risk sharing in the euro area is substantially lower than elsewhere. Furthermore, it is considerably lower during large downturns when it is most needed. Fiscal integration could therefore contribute to the stabilisation of the economic cycle in the euro area, and to further development of cross-border credit and capital markets.

**Figure 3: Indicators of external imbalances**



Source: European Commission Spring 2013 forecast (current account balance), Eurostat (net international investment position) and Darvas (2012a) (unit-labour cost based real effective exchange rate = REER ULC).

Note: The REER was calculated against other euro-area partners. The REER considers the business sector excluding construction, real estate and agriculture, and was calculated using constant 2008Q1 sectoral weights in order to limit the impact of compositional changes on the REER.

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 effective exchange rate has depreciated significantly (though Italy's has not)<sup>4</sup>.

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 competitiveness and the collapse of domestic demand in the

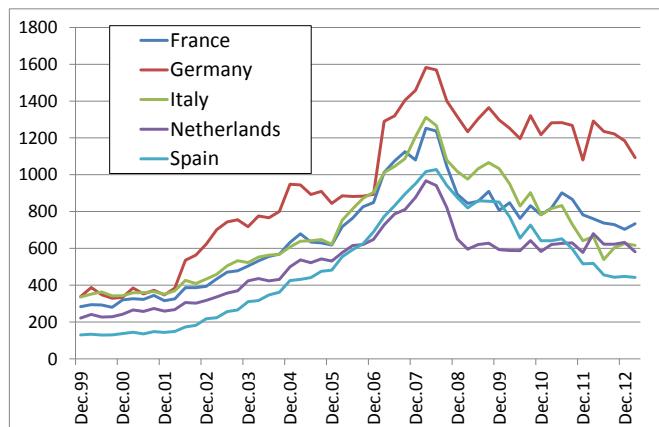
<sup>4</sup>

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

improvement of the trade balance<sup>5</sup>. Spain has a close to minus 90 percent of GDP net international 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 economic growth was low even before the crisis. Real exchange rate depreciation could foster the development of the tradable sector, which in turn could improve overall economic growth as a larger share of the economy would face international competition, fostering productivity growth. Therefore, major adjustments still lie ahead. Since euro-area member states do not have a stand-alone currency, intra-euro adjustment is necessary (though not sufficient).

Finally, the weak state of domestic banking systems in southern Europe constrains access to credit. Non-performing loans continued to increase in Italy and Spain in 2012. Domestic problems are accentuated by the simultaneous re-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). 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 Germany and the Netherlands was more related to the Lehman Brothers crash, and exposure broadly stabilised soon after.

*Figure 4: Foreign claims by European banks on selected countries (bn USD), 1999Q4-2013Q1*



Source: BIS.

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 and consumption;

<sup>5</sup> Using a simple accounting 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 constant-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, due to the collapse of domestic demand, some products may have forced to export, even if it is less profitable (and therefore less sustainable). Therefore, there is much controversy about the roles played by improved competitiveness and the collapse of domestic demand in the improvement of the trade balance.

- Reducing unemployment in the harder-hit countries by either creating jobs in those countries, or helping intra-EU mobility;
- Fostering the adjustment of intra-euro price/wage divergences;
- 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.

**Table 1: Summary of July 2013 main recommendations adopted by the Council**

	Euro area	Germany	The Netherlands	France	Italy	Spain
Fiscal policy	- aggregate fiscal stance of the euro area should ensure growth-friendly and differentiated fiscal policy - allow automatic stabilisers to function along the adjustment path	-preserve sound fiscal position	-correct excessive deficit by 2014 and achieve MTO by 2015	-correct excessive deficit by 2015 and achieve MTO by 2016	-deficit below 3 % in 2013 -achieve MTO by 2014	-correct excessive deficit by 2016 and achieve MTO by 2018
Demand management	-coordinate aggregate fiscal stance - address employment crisis	-promote wage growth by reducing high taxes and social security contributions	-protect growth-sensitive public expenditure	-growth friendly consolidation and tax reform	-growth-friendly fiscal consolidation -upgrade infrastructure	-reduce government arrears
Labour market	-coordinate and monitor national reforms - tackle the social consequences of the crisis and rising unemployment, along the Compact for Growth and Jobs and the EU Youth Guarantee	-improve incentives to work for second-earners and low-skilled -integrate long-term unemployed	-increase labour market participation by reducing tax disincentives on labour and reforming employment protection legislation	-unemployment benefit system reform -increase labour market participation (focus on older workers) -promote apprenticeship	-increase labour market participation -improve incentives to work for second-earners and low-skilled -better targeting of social transfers	-evaluate the need for further labour market reforms -improve unemployment agencies -Youth guarantee -active labour market policies to improve employability

Product market /business environment	-coordinate and monitor national reforms	-stimulate competition in services	(nothing)	-stimulate competition in services -foster innovation and exports -improve the business environment	-stimulate competition in services -growth-friendly tax reform (reduce taxes on labour and capital; increase taxes on consumption, property and environment)	-stimulate competition in services -improve the business environment
Financial system	-assess reasons for differences in lending rates to SMEs - stress tests and banking balance sheet repair -burden sharing in bank recapitalisation -credible fiscal backstop -remove supervisory incentives for financial fragmentation -accelerate banking union	-pursue consolidation in the sector	(nothing)	(nothing)	-extend good corporate governance -asset-quality screening -promote non-bank financing	-recapitalise banks and promote non-bank financing
Intra-euro area adjustment	-address national distortions to saving and investment in both current account deficit and surplus countries -implement effectively the MIP	(nothing)	(nothing)	-lower labour costs	- labour market and wage setting reform to align productivity and wages	-Support schemes for internationalisation of firms
Private debt	(nothing)	(nothing)	(nothing)	-reduce debt bias in corporate taxation	-resolution of non-performing loans	-reduce debt bias in corporate taxation -review insolvency frameworks for companies and individuals
Public sector management	(nothing)	-implement debt brake in all Länder - cost-effectiveness of healthcare spending - efficiency of the tax system -extend public procurement	-pension, health and long-term care reform	-reform of the relation between central and local governments - cost-effectiveness of healthcare spending - efficiency and simplification of	-efficiency and quality of public expenditures -improve coordination between layers of government -public expenditure efficiency -extend public	-independent fiscal council by 2013 -reform of local administration - cost-effectiveness of healthcare spending -efficiency of overall public

				the tax system -public expenditure efficiency -pension and health reform	procurement -improve tax collection	administration -remove indexation of public expenditures -pension reform -tax reform
Other reforms			-housing rental market -reduce mortgage tax deductibility		-judicial system efficiency -repress corruption -improve the management of EU funds -education reform -fight tax evasion and the shadow economy	-judicial system efficiency -education reform -housing rental market

Source: Bruegel based on official documents.

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<sup>6</sup>. 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 reflected in country-specific recommendations. Who will be responsible for allocating among euro-area member states the tasks for the euro area if the Council does not do this? We note that the country-specific assessments of the 2012 Council recommendations by the European Commission only assessed the implementation of the country-specific recommendations, but not the contribution of the particular country to the implementation of the euro-area recommendations. There has therefore been no improvement since Hallerberg, Marzinotto and Wolff (2012) concluded that "...the European Commission and Council issue... separate recommendations to the euro area. Still, this seems like an empty exercise. It is not clear who the euro-area recommendations are addressed to and who is supposed to implement them. Euro-area considerations should not be treated in a separate document, but should cut across all country-specific recommendations for euro-area countries."
2. A specific example of the above is the concept of the "aggregate fiscal stance of the euro area", which is mentioned several times in the euro-area

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<sup>6</sup> For a summary of EU's economic governance, see MEMO/13/318. Available at [http://europa.eu/rapid/press-release\\_MEMO-13-318\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-13-318_en.htm?locale=en).

recommendations, but in our assessment is a largely empty concept. The fiscal strategy continues to be based on the prominence of fiscal consolidation – except for those countries that have already reached a ‘sound fiscal position’ – but the country-specific suggestions do not consider the spillover effects from one country to other countries or the euro area as a whole of the measures (or the lack of them)<sup>7</sup>. 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, considering the weak cyclical position.

In our view, mere coordination of fiscal policies will not achieve an optimal fiscal policy for the euro area, because national fiscal policies are 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 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 against worse-than-expected macroeconomic conditions*”. The risk premia of Italy and Spain are broadly similar (Italy’s premium is slightly lower than Spain’s). 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).
4. Demand management, such as by coordinating the aggregate fiscal stance and by tackling unemployment, is only indirectly included in the euro-area recommendations. Among the five countries that we consider, only Germany received a suggestion that it should boost domestic demand. Yet the actual text consists of several convoluted sentences, which all include important policy goals. But overall, they fail to emphasise the main point of stimulating aggregate private demand, when e.g. raising the educational achievement of disadvantaged people is highlighted a major channel for increasing demand, or when several sentences emphasise the importance of increasing employment in a country in which the unemployment rate is at two-decade low. Undoubtedly, these are important policy goals, but they are unlikely to contribute to a significant increase in domestic demand. Here is the complete text of this recommendation: “*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. Take measures to improve incentives to work and the employability of workers, in particular for second earners and low-skilled, also with a view to improving their income. To this end, remove*

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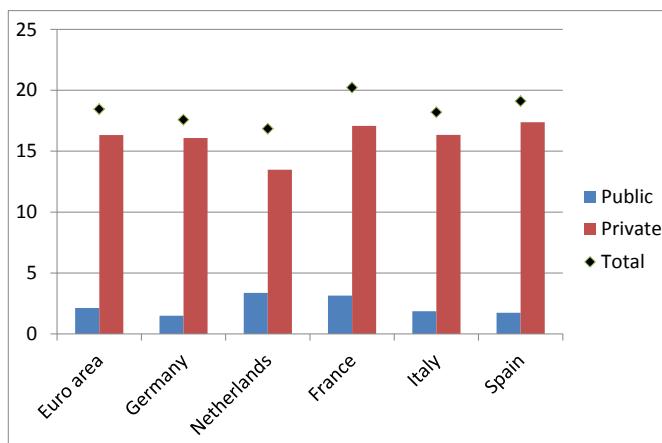
<sup>7</sup>

We also note that France is not recommended to implement public spending cuts, while it has one of the highest public spending ratio (relative to GDP) in the EU.

*disincentives for second earners and further increase the availability of fulltime childcare facilities and all-day schools.”*

5. Related to the previous point, while the 2012 euro-area recommendations stated the goal of increasing public investment, this recommendation was not made in 2013. Also, no recommendations were made for Germany to increase public investment (which is among the lowest in the euro area relative to GDP – see Figure 5) or to stimulate private investment. We single out Germany here because it is the country with the largest external surpluses and could arguably benefit from more domestic sources of growth. Because of its size, its actions also have the most significant spillover effects on other countries.

*Figure 5: Gross fixed capital formation (% of GDP) in 2012*



Source: AMECO.

6. According to the Council, intra-euro area competitiveness adjustment should be largely one-sided, ie only deficit countries should adjust. One of the 2012 Council recommendations for Germany was “*create conditions for wages to grow in line with productivity*”, yet even this sentence was not ambitious enough, because it referred to future developments and not to the correction of past divergences. But the 2013 recommendations for Germany do not even mention the relationship of wages to productivity, but provide only a general comment on wage growth, as we noted in point 4. The recommendations for Germany and the Netherlands also fail to mention these countries' current-account surpluses, which are larger than the threshold in the MIP<sup>8</sup>. The background document for Germany does say that Germany and the rest of the euro area would benefit from the unwinding of current account surpluses in Germany, but this is said very cautiously and hidden somewhere in a 30-page working document<sup>9</sup>.
7. The suggestions for financial sector repair go in the right direction, but remain too timid. Although the euro-area recommendations include a call to limit national supervisory incentives for re-nationalisation of bank assets and liabilities, this is absent from the country-specific recommendations. Another issue that is not properly addressed is the general under-capitalisation of the European banking system, which extends to the core countries. The US

<sup>8</sup> Note that the MIP thresholds for current account balances are asymmetric: plus 6 percent of GDP for surpluses and minus 4 percent of GDP for deficits (considering the 3 year backward moving average of the current account balance as percent of GDP).

<sup>9</sup> We also note that in 2011 and 2012 Germany overtook China to become the country with largest current account surplus in the world.

banking system remains better capitalised, although the euro area should arguably aim even higher.

8. The recommendations that seem to be the most comprehensive are those on structural reforms aimed at improving the functioning of labour and product markets and making the business environment more growth-friendly. There are several specific suggestions for, for example, France, Italy and Spain on complementing labour market reforms. These are important questions to be addressed to ensure the long-run viability of the monetary union and national social contracts.
9. The recommendations highlight the need for domestic markets to be opened to greater competition, particularly in the service sectors and in public procurement. The recommendations rightly stress the significant potential growth that could be stimulated by opening up regulated professions, which are generally protected by high barriers to entry. But the recommendations focus on country-specific solutions. However, crafts have powerful tools for lobbying national parliaments; these tools have traditionally been used to shield professions from external competition, making national progress slow and often incomplete. It is therefore desirable to promote complementary initiatives at the EU level in order to speed-up the convergence of professional services regulation in member states, and to increase domestic competition. The 2006 Services Directive could serve that purpose, but additional effort at EU level is needed in order to promote the effective and uniform implementation of the Directive throughout Europe. Likewise, the recommendations rightly stress the need for an increase in competition in network industries, such as telecommunications, energy and transport (and, particularly, railway services). It appears however that a key role in the opening of national markets to competition should be played at a EU level, by reducing single market fragmentation and stimulating cross-border competition<sup>10</sup>.

Based on these observations, we therefore conclude that the main priorities of the Council's country-specific recommendations are:

- Complete fiscal consolidation, with a view to the composition of the adjustment ('growth friendly');
- Reform of labour markets; To stimulate competition in services and improve the business environment;
- To improve public sector management through institutional reforms.

Meanwhile, the following areas are not a priority in *country-specific* recommendations in an appropriate way:

- Demand management;
- Intra-euro area competitiveness and current-account adjustment (even though the euro-area recommendations underline the importance of adjustment of both current account surpluses and deficits);
- Repair and reform of the financial system (even though the euro-area recommendations emphasise the importance of bank balance-sheet clean-up and the completion of the European banking union).

Therefore, even considering the limitations inherent in the European economic governance framework, the July 2013 Council recommendations do not go far enough in

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<sup>10</sup> This assessment was made by Mario Mariniello.

addressing a number of important challenges. Furthermore, certain tasks that pertain to the national authority are assigned to the euro area with little prospect of meaningful action.

Table 2 in the Annex summarises the IMF's July/August recommendations as concluded in its Article IV consultations. There is a stark contrast between the Council and the IMF recommendations. The latter favours a less-austere fiscal stance for the euro area, highlights a number of concrete measures for demand management, suggests measures to achieve more symmetrical intra-euro area adjustment and makes suggestions for financial-sector repair. And beyond the overall suggestions for the euro area, the IMF's country-specific Article IV recommendations allocate the to-do list to the country level.

#### **Box 2: Energy sector recommendations**

*The Council's structural recommendations also include suggestions for the energy sector, and highlight a number of serious short-term issues, such as the tariff deficits in Spain, high renewables cost in Germany and inadequate national and/or international networks in France, Germany, Italy and Spain.*

*However, important long-term developments that undermine the functioning of the internal energy market are not addressed. France and Germany are moving ahead with the implementation of national capacity mechanisms that might result in national schemes driving investment, instead of a European market incentivising the most economic solution. Nor do the Council's recommendations address the direct and indirect inefficiencies of national renewable support schemes – compared to using existing cooperation tools. Developments like the discussion on a special coal tax in the Netherlands, which would undermine the EU emissions trading system – the cornerstone of European decarbonisation efforts – are also not on the Council's radar screen. Finally, volatile and uncoordinated national energy policymaking that lacks a clear vision about how energy investments should be remunerated in the future are not discussed. Such ad-hoc measures not only make the sector 'uninvestable' but also prevent the development of a stable European regulatory framework.*

*Overall, the Council documents do not address the worrying trends of divergence in the European internal energy market.*

*This box was prepared by Georg Zachmann.*

#### **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 various structural reforms, 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, but these suggestions are not reflected in the country-specific recommendations. It is therefore unclear who will implement the euro-area recommendations. Phrases such as "*aggregate fiscal stance of the euro area*" have no implications for policy, because each country is advised to implement its own fiscal strategy, without any regard to its impact on the rest of the euro area. We have shown that the overly tight aggregate fiscal stance in the euro area was inconsistent with the deteriorating cyclical position of the euro area during the past two years. Based on the Council recommendations, the aggregate fiscal stance of the euro area will not be more conducive to cyclical stabilisation in the future, even if some countries have been given more time to meet their nominal budget-deficit targets.

Similarly, the country-specific Council recommendations do not place enough importance on symmetric intra-euro area competitiveness and current-account adjustments. This

shortcoming will make adjustment in former deficit countries much more difficult. Suggestions for the repair and reform of the financial sector are also too timid, and there are inconsistencies between the euro-area and country-specific recommendations particularly when it comes to financial fragmentation.

The IMF's July/August 2013 recommendations make a stark contrast to the Council recommendations. The IMF favours a less-austere fiscal stance for the euro area, highlights a number of concrete measures for demand management, suggests measures to achieve a more symmetric intra-euro area adjustment and also makes suggestions for financial sector repair. Beyond its suggestions for the euro area as a whole, the IMF also allocates the to-do list to the country level.

The President of the Euro Group is in a difficult position to facilitate the collective and individual actions of the euro area's member states. If a country is in a somewhat better economic situation than the rest of the euro area (eg Germany), it is difficult to convince its leaders and parliamentarians that they should implement certain measures (partly) for the sake of other countries. Conversely, a country in a worse economic situation than the rest of the euro area (eg Italy) might not have the fiscal space to address its own demand-shortage problem. Overall, this renders the euro area's aggregate fiscal stance overly tight. These inherent difficulties highlight the incompleteness of the euro area's economic governance framework and underline the need for further reforms, including the establishment of a fiscal authority responsible for the management of private demand and the euro area's aggregate fiscal stance.

#### **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 consolidation in structural terms -even revised deadlines may be too strict for some countries -credible medium-term frameworks needed to counteract slower short-term consolidation	- Small loosening in 2013 appropriate	-Fiscal policies should focus on structural targets and allow automatic stabilizers to operate - no further consolidation for 2013	-2014 consolidation should be eased -reorient towards expenditure containment - In the medium term, tighter spending control by local authorities and improved efficiency of social spending	-rebalance adjustment to support growth favour spending cuts offset by tax decreases -broaden tax base (keep property tax) -combat tax evasion -binding multi-year expenditure ceilings -independent budget office	-consolidation should continue in a gradual and growth-friendly fashion
Demand management	-Stronger ECB policies (forward guidance, rate cuts, lower haircuts, new LTROs, asset purchases) -do not react to further negative surprises by tighter fiscal policy	-fiscal over-performance to be avoided given low growth - if growth disappoints, fiscal policies need to be recalibrated	(see above)	- Undertake a growth friendly tax reform to support the consolidation	- accelerate payment of government arrears -increase public investment	-nominal (and possibly even structural) targets should be flexible if growth disappoints

	- reducing general euro area uncertainty would catalyse investment					
<b>Labour market</b>	-tackle labour market dualism -foster migration	-lower the tax wedge, in particular for the low skilled -improve quality and availability of early childhood education -review the family policy to improve its efficiency	-reduce duality -limit unemployment benefits to two years -pension reform	-tackle cost of labour -reduce bite of minimum wage - reduce inactivity traps for young and low-skilled workers -better job search	-raise low employment, especially among the young and women -reduce duality -lower taxes on second earners -encourage firm level flexibility	-increase firms' flexibility -reduce duality -enhance opportunities for unemployed -social agreement combining employment promises, wage moderation and fiscal incentives
<b>Product market/business environment</b>	-promote single market (e.g. via services directive) -promote new FTAs -flexibility at the firm level -lower barriers to entry and exit	-remove disincentives to invest in higher risk, higher growth sectors. -promote widespread use of ICT -accelerate the integration of pan-European transportation and energy networks and increase competition in network industries	-distortions in housing market need to be eliminated -support basic research and education	-liberalize product market, in particular services	- reduce high entry barriers and regulations (particularly in services) -reduce high cost of energy -enact privatization agenda -legal reform	-enact proposed reforms to remove regulation that fragments markets, promote entrepreneurship and professional services
<b>Financial system</b>	-support credit provision to SMEs (ECB, EIB, EC) -asset quality review followed by recapitalization -agree on a common backstop (ESM?) -finalize SSM -introduce SRM -clarify bail-in rules	-continue reforms -raise capital levels	- recapitalisation and reduced reliance on wholesale funding necessary	- tax incentives on financial products should be better aligned with bank regulatory objectives	-increase tax deductibility of loan losses -ensure adequate capital and liquidity buffers -enhance corporate governance -support SME financing	-increase capital -clean up loan books -remove credit supply constraints
<b>Intra-euro area adjustment</b>	- surplus countries need to increase productivity in non-tradables - deficit countries need to continue the reallocation of resources to	-increase labour share of national income -tax and financial reforms should make domestic investment more attractive	(nothing)	-tackle labour costs -risk of falling behind Southern crises that are experiencing large competitiveness gains		-so far, little devaluation relative to euro area, which would be helpful to improve competitiveness

	the tradable sector					
<b>Private debt</b>	-resolve bad private sector debt -use insolvency procedures more boldly		(nothing)	(nothing)	-accelerate write-off of bad loans -expedite the judicial process of write-downs	-reform insolvency regime to incentivize write-offs and corporate balance sheet clean-up

Source: authors' elaboration based on official documents.

Note: the Dutch document is from March 2013; all other documents are from July/August 2013.

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