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Macroeconomic Policy Coordination in the EU

The European Economic and Monetary Union (EMU) has long been confronted by the problem that monetary union – in the form of the euro – has become a reality faster than broader economic union. While all eurozone members share a currency, their economic circumstances still greatly differ. Furthermore, the European Union's (EU) mechanisms for managing these differences through macroeconomic coordination have tended to be weak and ineffective. To skeptics – some of whom have made the same case for decades – the sum product of EMU is a community of economically disunited and divergent countries sharing a single monetary policy that straitjackets economies into maladaptive policies.

The potential problems with such a monetary-economic divergence are many. For example, mature core economies with low inflation may favor interest rates that would lead to overheating in rapidly growing peripheral economies resulting in dangerous mismatches between high demand for consumption in the periphery and high demand for yield in the core. This could produce structural macroeconomic imbalances with mature economies sending both money and goods to an increasingly indebted periphery. Moreover, either excessively low interest rates or simple fiscal profligacy might lead to wage inflation that, when combined with fixed exchange rates, could cause inflationary pressure on the euro and render certain countries' exports uncompetitive. Finally, without economic transfers and within a fixed exchange rate regime, poorer or crisis-stricken countries would have few options for stoking growth.

With the benefit of hindsight, it is clear that these concerns were not merely hypothetical. While the EU has not been completely blind to such negative outcomes, its attempts to mitigate the dangers of economic divergence have been historically unsuccessful. This brief will succinctly outline previous attempts at macroeconomic coordination before discussing the three recent initiatives that emerged during the present eurozone crisis: the December 2011 "six-pack," the Treaty on Stability, Coordination and Governance (TSCG, which includes the fiscal compact), and the "two-pack" of additional proposals still under discussion.

Maastricht and the Stability and Growth Pact

The Maastricht Treaty establishing the EU and setting the roadmap for completing EMU contained two procedures to ensure that the economic convergence continued after the irrevocable fixing of exchange rates. One, the multilateral surveillance procedure, was established as a loose requirement that member states set their macroeconomic policies with communal interests in mind. Any deviation would be met with a public hand-slap by the European Council. The second, the excessive deficit procedure, defined a 3%

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maximum annual deficit and 60% maximum debt in terms of GDP and envisioned tangible, if vaguely defined, penalties for rule-breakers.

These requirements, seen as too ambiguous and flexible by Germany in particular, were ostensibly strengthened by the 1997 Stability and Growth Pact (SGP). The SGP dealt less with the 60% debt limit than with the 3% deficit cap, redefining the excessive deficit procedure as a more formal system of warnings, recommendations, and ultimately fines in order to dissuade governments from running large deficits. Once approved, however, the pact was soon rendered irrelevant in 2002-03, when both France and Germany blocked implementation of the procedure after they ran excessive deficits themselves.[1] Ultimately, neither multilateral surveillance nor the excessive deficit procedure – before or after the 2005 reform of the SGP – have been implemented to great effect.

The Six-Pack

The six-pack, which entered into force on December 13, 2011, is a significant attempt to change this track record of failure. It encompasses five pieces of legislation and a directive which, taken together, reasserts the SGP as a mechanism for punishing rule-breakers, subjects a host of potential macroeconomic imbalances to EU oversight, and calls for more meaningful observation of member state budgets in order to prevent excessive deficits or imbalances in the first place.

The revisions to the SGP are intended to increase the speed with which the excessive deficit procedure is applied, ensure that sanctions are more automatic than in the past, and punish any misrepresentation of fiscal statistics. The first significant departure from previous practice is that any deficit which would not reduce the country's debt-to-GDP ratio to 60% within 20 years is now prohibited, making the debt criteria as important as the deficit criteria in defining whether a country has violated the pact. Furthermore, the process has been outlined in greater detail and with more deadlines: any state found in breach of the rules will be warned behind closed doors. From that point, it has a maximum of six months to take corrective action, defined as a 0.5% annual improvement of the deficit. If it fails to do so, the finding is made public and the government is given a further two months to respond. If an acceptable remedy is still not forthcoming, the European Council is compelled to decide whether or not to initiate sanctions within 16 months.[2]

At this point the process becomes more difficult to block than the old excessive deficit procedure. Upon receiving the Council's request to consider sanctions, the Commission has 20 days to propose a punishment. Options include the confiscation of a deposit amounting to 0.2% of GDP which can either be interest-bearing or not depending on the egregiousness of the violation in question. In severe cases, the Commission can recommend an outright fine of 0.2% of the country's GDP. A similar fine can also be imposed for negligent misstatement of macroeconomic statistics, the improvement of which is a major focus of the directive to member states.[3] Upon receiving the proposed sanction, the Council has 10 days to overrule the Commission's recommendation by a

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qualified majority vote of eurozone members. If they do not act to override the recommendation, it automatically enters force.[4]

By limiting the potential for indefinite delay and by forcing the Council to overrule the Commission's final recommendation rather than approve it, the SGP would seem to have sharper teeth than it did prior to December 2011. Yet there remains plenty of opportunity to slow or halt the process. Affirmative votes are still required to move the procedure into the more-or-less automatic phase. Moreover, the idea of fining countries for being in fiscal distress continues to be problematic. Spain's current deficit is well above the excessive deficit procedure's limits and its Prime Minister has publicly chafed at demands from Brussels to lower it. Yet the country is in such a dire fiscal situation that demands for further cuts – let alone a fine or punitive deposit – would be counterproductive. This has left the EU once again looking for a compromise that maintains the integrity of the rules without applying them in a "stupid" fashion.[5]

In addition to increasing oversight of member states' fiscal policy, the six-pack creates a mechanism for much broader oversight of macroeconomic imbalances. The legislation envisions a "scoreboard" that will publicly track macroeconomic and macrofinancial indicators. These indicators will cover internal imbalances – such as those stemming from asset bubbles, credit market developments, or unemployment – as well as external imbalances such as in the balance of payments, exchange rates, productivity measures, and export shares. The values will be compared to threshold "alert levels" which will signal that a country has a macroeconomic imbalance which may require review by the Commission.[6]

In the event that the Commission finds a country to have an excessive imbalance, a procedure that closely parallels the excessive deficit procedure is triggered. Countries with excessive imbalances will be offered multiple opportunities to comply with the Council's recommendations, with escalating consequences for inaction. If the country repeatedly fails to act, the Council can deem their efforts insufficient and trigger a Commission-led sanctioning process with the power to fine countries up to 0.1% of GDP. As with the excessive deficit procedure, the final recommendation of the Commission enters force automatically unless overturned by qualified majority vote.[7]

While certainly an important development, it remains to be seen whether such a vision is practical. Professional economists frequently disagree over the nature, severity, and significance of macroeconomic imbalances; it is unlikely that politicians will be more successful. Nevertheless, these efforts broaden the discussion of macroeconomic problems beyond an overly narrow focus on states' fiscal policy.

The final major element of the six-pack calls for more rigorous coordination in the medium-term macroeconomic planning of EU members. It clarifies and formalizes a "European Semester" for economic policy coordination – an annual cycle of economic policy planning for the entire Union. The Council formulates broad economic goals for the Union as a whole while individual countries submit stability plans (for eurozone

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members) or convergence plans (for non-eurozone members) that fit within these broader goals. The chief purpose of these stability and convergence plans is to define medium-term budgetary objectives (MTOs) for each member state. Developing and then following these objectives are meant to serve as protection against fiscal deficits or excessive imbalances.

The plans and MTOs will be submitted each spring for consideration by the Council and Commission. They then evaluate the plans in light of the Union's broader economic objectives, states' obligations under the revised SGP, and the new macroeconomic imbalances procedure. The MTOs will be particularly assessed based on a comparison of government expenditures and a realistic assessment of GDP growth. Aside from cases of justifiable public investment, the two should track closely together to ensure near-balanced budgets. If necessary, the Council can adopt an opinion on a country's plan that deems it insufficient and request changes.[8]

This multilateral surveillance system is given added weight by the fact that the Council now has a much larger menu of sanctions should states be found pursuing inappropriate policies that may prove useful. For instance, Ireland in 2000 flaunted the Council's recommendation to reign in the country's rapid output growth through countercyclical fiscal policy. Because the country was not in deficit, there was little the Council could do aside from issue a public rebuke.[9] With the excessive imbalance procedure in place alongside the excessive deficit procedure, a similar multilateral detection of an overheating Irish economy could lead to a recommendation backed by the threat of punishment for non-compliance.

The Fiscal Compact

The TSCG has perhaps been the most visible effort to reform European macroeconomic coordination, largely because it must be ratified by member states rather than approved by the European Council and Parliament. However, there have also been numerous misunderstandings of some of the subtleties of its text, particularly with regard to its balanced budget rule. As of the end of April 2012, the agreement has been signed by all but two member states – the UK and the Czech Republic – and will enter force once nine additional eurozone countries join Greece, Portugal, and Slovenia in ratifying it. It is not formally EU law but rather an intergovernmental agreement that sits alongside the EU treaties.

The content of the TSCG largely duplicates the rules put in place by the six-pack. The value added by the treaty is that, while the six-pack rules are EU law, the TSCG compels member states to write their content into their own domestic – "preferably constitutional" – laws.[10] Contrary to much of the public discourse surrounding the compact, it does not represent a major tightening of the rules already agreed under the revisions to the SGP. While the treaty references a maximum budget deficit of 0.5% of GDP (or 1% for countries with low debt burdens), that is a *structural* budget deficit. In other words, it is the deficit that would exist if a country were producing at full output. In contrast, the 3%

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deficit cap in the SGP is on the general budget deficit, including cyclical effects and one-off payments. A country could theoretically run a 3% deficit and be in compliance with both the SGP and TSCG. There is, nevertheless, some minor tightening called for by the treaty: the SGP only imposes a 1% structural deficit limit, which the TSCG narrows to 0.5% for countries with higher debt burdens. The principle is that a country within the structural deficit rules laid out by the TSCG is more likely to meet the SGP's 3% rule, and is therefore also more likely to stick to the longer-term budget plans member states submit as part of the European Semester.

Unfortunately, the idea of a legally operationalized cap on structural budget deficits is highly problematic. Any calculation of a structural deficit is dependent on the determination of an output gap – the difference between actual economic performance and a measurement of where the economy should be in equilibrium. These calculations can be extremely difficult to make in real time and often require large *ex-post* revisions. They also differ depending on who runs the numbers. Between 2003 and 2011, for instance, the EU calculation of the Irish output gap was revised by an average of 1.46% of GDP each year.[11] Governments will effectively be expected to keep their state finances within 0.5% of GDP of a quickly moving target.

The other major innovation of the TSCG is the involvement of the European Court of Justice (ECJ) in resolving excessive deficits. If a country deviates from the structural deficit limits outlined by the treaty, it must put corrective measures – recommended by the European Commission – into place. If the Commission subsequently finds that a country has failed to respond, the signatories to the treaty are obliged to lodge an ECJ case against the country in violation. Additionally, if any signatory simply believes another country is in violation of the rules, it can, independently of the Commission's findings, bring the matter directly to the ECJ. The ECJ then has the power to levy a fine of up to 0.1% of GDP on rule-breakers. This will be paid into European financial assistance funds (for eurozone members) or the EU's operating budget (for non-eurozone members).

Given the fact that a procedure already exists for punishing profligate governments – one in which the Commission, rather than any single member state, plays the role of stern disciplinarian – it is highly unlikely that the grievance provision in the treaty will see much use. Taken together with the technical difficulties in policing structural deficits, the treaty is largely superfluous. However, it may be of some benefit to put the SGP rules into domestic legislation.

The Two-Pack

Two additional pieces of legislation are currently under discussion, both of which would make fairly sweeping enhancements to the EU's oversight of national budgetary decisions.

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The first proposal adds a new level of EU involvement to member states' budget-drafting processes. In addition to submission of the MTOs each spring, each eurozone member would also be required to present its annual budget to the Commission in the autumn. The Commission would review the budget, evaluate whether it was consistent with SGP rules in consultation with eurozone finance ministers, and may ultimately issue an opinion requesting changes from member states. The process is intended to complement the SGP and European Semester by adding another level of early detection and prevention of inappropriate fiscal policy. Essentially, while final decisions remain in the hands of national parliaments, each eurozone government will be obliged to solicit the independent opinion of the Commission as part of their budget-drafting cycle.[12]

The second proposed piece of legislation would create an "enhanced surveillance" procedure for any eurozone country experiencing "severe difficulties with regard to its financial stability" or already receiving assistance from the EU's financial stability facilities. Enhanced surveillance would oblige states to cooperate with the Commission and European Central Bank (ECB) in adopting legislation aimed at addressing the sources of instability, calls for frequent consultation with European institutions regarding regulatory and banking systems, and forces states to accept technical assistance from the Commission if they are deemed to lack the administrative capacity to carry out reforms on their own. For states accepting EU financial stability funds, the Commission can coerce cooperation by threatening to withhold further tranches of assistance. For member states in "severe difficulties" but not yet receiving funds, the most serious sanction is a public statement of no confidence in the state's ability to address the situation on its own.[13]

For member states that currently receive EU funds – Greece, Ireland, and Portugal – the legislation essentially codifies the present status quo. For member states that have not turned to the EU for financial aid but may be considered in "severe difficulties" – for the moment, potentially Spain – the proposals would give the EU greater leverage over states' crisis management decisions.

An Unreceptive Public?

While macroeconomic coordination is widely considered essential to the smooth functioning of EMU, the continued debate over passage and implementation of the new rules has triggered significant member state hostility towards Brussels. In some corners, the tension has been confined to words. Spanish Prime Minister Mariano Rajoy announced that Spain's budget was none of Brussels' business.[14] Similarly, pressure on Belgium to conform to SGP deficit limits prompted one cabinet minister to declare, that the Commission "is today going too far with its measures. Who knows [economic affairs commissioner] Olli Rehn? Who knows where he has come from and what he has done? Nobody."[15]

However, in other cases, the tension has had tangible political implications: in April, the Dutch government collapsed after Geert Wilders withdrew his support over opposition to

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SGP-prompted austerity measures. Wilders is now campaigning on an explicitly anti-Euro platform, the appeal of which remains unclear.[16] In the first round of France's current election cycle, the National Front's Marine Le Pen scored the best result in the history of her far-right party campaigning on a euroskeptic, anti-Euro agenda. Moreover, the Socialist candidate, François Hollande, has openly called for a renegotiation of the fiscal compact to be more growth-oriented.[17] If Hollande is victorious in May's second round – which seems increasingly likely – he could become a powerful advocate for factions hostile to the TSCG in its currently austerity-heavy form, including leftist parties within the European Parliament and many member states.

Ultimately, it is very much unclear that the policies being debated and implemented in Brussels will result in more coordinated macroeconomic policy, let alone *better* economic policymaking. In contrast, it is abundantly clear that efforts to exert EU control over member states' economic policy decisions will stoke anger in the member states, enough even to topple governments. This provides an opening for populist anti-EU politicians, such as Wilders or Le Pen in France, to threaten European economic integration as a whole.

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