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Economic policy coordination in the euro area under the European Semester

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Forms of policy coordination

- **Categories**
  - **Type 1: Information sharing**
    Communication, peer reviewing, and best-practice exchange
  - **Type 2: Contingent policy making**
    Decision in country A made dependent ex ante on decisions abroad
  - **Type 3: Harmonization**
    Similar polices in all Member States
  - **Type 4: Centralization**
    Shifting competences from the national level to EMU institutions
- **Enforcement**
  - **Soft**: Non-binding nature, based on insight and consensus finding
  - **Strict**: Rule-based mechanisms with automatic legal sanctions

⇨ **Key success factor: Ownership**

Tradeoffs

- Subsidiarity vs. policy coordination
- Soft vs. strict enforcement
- Short-run vs. long-run requirements

Subsidiarity vs. policy coordination

- Incentive structure
- Availability of information
- Access to adequate instruments
- Democratic legitimacy

Subsidiarity → Diversity
(strength, not weakness)

Room for **learning and pioneering**
(strong case for peer-reviewing)

Integration is not an end in itself, …
… but comes at extra **governance cost**

⇨ **Identification of common interests (EMU-specific public goods)**

⇨ **Systemic negative spillovers, not pecuniary „external" effects**

⇨ **EMU: Primacy of financial stability (robustness of the monetary system)**

Soft vs. strict enforcement

- Soft forms policy coordination
  - » Dissent: relatively poor implementation rates (lack of ownership)
  - » Consensus: high level of ownership
  - ⇨ **Soft ≠ weak**

- Stricter enforcement mechanisms
  - » Optimal rules, indicators, and thresholds vary across countries
  - » Resulting recommendations notoriously sub-optimal (weakening ownership)
  - ⇨ **Strict ≠ strong**

Short-run vs. long-run requirements

- Scope for policy coordination within the European Semester depends on the general institutional EMU-framework
  - Stability of the financial sector
  - Fiscal soundness of the Member States

⇨ **Long-run**

- Primacy of monetary robustness (financial stability)
- Soft forms of policy coordination (except for financial regulation)

⇨ **Short/medium-run**

- Additional coordination to prevent systemic destabilization
- Stricter forms of policy coordination (fiscal soundness)

Recommendations (1/3)

- Explicitly **differentiating** between policy areas that are relevant for the functioning of the EMU as a whole and those that are relevant for the economic development of a single Member State, and clearly **prioritizing** the former in the European Semester
- Using **strict enforcement** mechanisms (rule-based automatic sanctions) in those areas that are relevant for well-functioning of the EMU as a whole and **soft enforcement** mechanisms in other policy areas.
- Assigning only **one target** to **one instrument** (Tinbergen rule)
  - » Stability and Growth Pact: Public debt sustainability
  - » MIP: Financial stability from a macroeconomic perspective
  - » Other instruments for structural reforms

Recommendations (2/3)

- Making **full use of soft enforcement mechanisms** by increasing peer-pressure and facilitating implementation of appropriate policies through more transparency and current information on the process of implementation. Tighten, if necessary, the strict enforcement mechanisms.
- Elaborating a **coherent theoretical framework** for those events that threaten the functioning of the EMU as a whole. A **common understanding** is crucial for creating ownership for policy initiatives that are supposed to address common interests shared by all Member States.
- **Euro area macro management is highly problematic** and may weaken economic policy coordination within the euro area.

Recommendations (3/3)

- Communicating that the **European Semester is no panacea**. Like any other macroeconomic surveillance and coordination mechanism its capacity to prevent systemic economic crises will be limited
- Prioritizing the **prevention of excessive risk-taking** rather than creating risk-sharing mechanisms (safety nets, EMU-wide macroeconomic shock absorbers). The EMU should strive for becoming the **world's financially most robust, market-oriented economic area** thereby dramatically reducing the scope for economic policy coordination and making full use of the advantages of diversity within the E(M)U


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