Macroeconomic surveillance and coordination

What is it and why are constraints on national economic policy-making needed?

When countries become closely integrated with each other, what happens in one economy can have repercussions for others. If consumers in one country spend more, some of this spending will be on imports from partner countries, increasing growth and jobs in the latter. This can be a positive 'spillover' insofar as both sides gain from it. However, as the years of economic crisis have shown, instability or financial contagion can spread from one country to another, leading to a downward spiral from which everyone loses. In an economy as closely integrated as the EU, and even more so the Eurozone, there is a clear interest in ensuring that policy decisions in individual Member States support positive spillovers and minimise negative ones.

Moreover, when problems do arise, a suitably coordinated response, in which all countries pull in the same direction, will spread the burden and enable the Union as a whole to cope more effectively. Eight rowers pulling together make for an effective force, but they need the cox to steer the boat and to set the tempo. In an uncoordinated rowing 'eight', oars will clash and the collective effort will be less than the sum of the parts.

The main mechanisms of policy coordination in the EU

The EU approach to policy coordination combines formal legal instruments, enshrining rules according to which national governments are supposed to conduct their economic policies, and various 'softer' processes in which recommendations are issued. The Treaty (Art. 126, TFEU) enjoins Member States to 'avoid excessive government deficits' and sets out provisions for enforcing this commitment, defining it in a protocol. Over the years, many governments have been found to be in excessive deficit and have come under pressure to redress this.

A key mechanism for this purpose is the *Stability and Growth Pact* (SGP) which has a legal base in two EU regulations first agreed in 1997 and since revised, most recently in 2011. The first regulation is intended to prevent excessive deficits arising in the first place. It calls for governments to manage their public finances so as to achieve a medium term objective (MTO) of public finances 'close to balance or in surplus'. It sets thresholds as a proportion of the country's GDP of 3% for the public sector deficit and (since the 2011 reform) of 60% for public debt. The second arm of the SGP is corrective, setting out the sanctions to which delinquent Member States will be subject if they fail to correct an excessive deficit.

Following criticism of earlier versions of the Pact which focused on actual deficits, it now refers to the cyclically adjusted budget deficit. The latter takes account of the fact that economies can, at times, either exceed or under-shoot their long-run growth potential. In a downturn, tax receipts tend to fall and some components of public spending, such as for unemployment benefit, rise. These 'automatic stabilisers' aggravate the measured deficit in the short-term, but can still be consistent with sound budgetary policy because the expectation is that the economy will return to its medium-term growth rate. Latterly, the European Commission, responding to concerns expressed, notably, by France and Italy, has spelt-out criteria under which Member States will be able to exceed agreed norms, for example if they can show that they are increasing growth-friendly public investment.

In addition, there is an agreement known as the *Fiscal Compact*, currently part of a separate inter-governmental treaty because UK opposition blocked its adoption in 2011 as a full EU measure, with David Cameron famously deploying his veto at the European Council. The *Compact* sets out measures that its signatories (the UK is now the only EU country not party to it) agree to take to maintain discipline in their public finances. In particular, they are required to adopt national laws consistent with the EU's fiscal rules.

Other elements of an increasingly complex system

Further measures to instil and enforce fiscal discipline have been adopted by the EU. They include an obligation to enact national fiscal rules to constrain government discretion and, for Eurozone members, to establish an independent fiscal council to assess the sustainability of public finances. The UK, while not bound to do so, established an equivalent body in 2010: the Office for Budget Responsibility (OBR). One model for a fiscal rule is the German *schuldenbremse* (debt brake) which imposes a legally-binding commitment on the German government to lower its public debt. Also, in the autumn of each year, members of the Eurozone are obliged to submit advance drafts of their national budgets for the next year to the European Commission for scrutiny. They are then either given a seal of approval or warned about risks to the sustainability of their public finances.

Yet another innovation agreed in 2011 is the Macroeconomic Imbalances Procedure (MIP) which focuses on sources of economic instability other than public finances, notably in the property market or in the country's external accounts, as revealed by the balance of payments. The rationale for these measures is that (as happened in Ireland and in Spain at the height of the euro crisis), a country with apparently robust public finances can nevertheless rapidly face acute problems. For example, a collapse in house prices can lead to bankruptcies, defaults on loans and, *in extremis*, the need for the banking system to be bailed-out by the taxpayer, putting the public finances under severe strain.

The MIP emulates the SGP in having preventative and corrective arms, both in the form of EU regulations, although its operation so far has been more as part of the European semester process, the annual cycle through which coordination takes place. In an early stage of this cycle, the Commission assesses each Member State on a range of indicators (the alert mechanism) and, where called-for, conducts in-depth reviews of countries potentially at risk of imbalance. Subsequently, country-specific recommendations are issued, highlighting priorities for policy action.

Is the UK affected, whether directly or indirectly? How effective is the system?

The UK is only subject to the preventative arms of the various surveillance mechanisms and, in practice, can pay little or no heed to them without any consequences. In fact, the UK has been deemed to be in excessive deficit since 2009 – accurately, because even after years of supposed austerity policies, the UK deficit is not now expected to fall below the three percent threshold until 2017 – yet has essentially been able to ignore the criticism. The UK has also been subject to successive in-depth reviews of its macroeconomic imbalances and, in 2015, was given recommendations regarding its excessive deficit, the housing market and skills shortages.

By contrast, the members of the Eurozone could, in principle, be subject to financial penalties if they fail to correct an excessive public sector deficit or take the action required to diminish a macroeconomic imbalance. All sides recognise, however, that it will be politically very hard to impose such penalties and, moreover, that penalising a country already in deficit might exacerbate the problem. As the Commission noted in a review published late in 2014, the number of countries in excessive deficit has declined, but as yet the corrective provisions have not been applied, so that the full effectiveness of the system remains untested.

Further reading

The Directorate-General for Economic and Financial Affairs of the European Commission provides a number of guides to the different mechanisms of macroeconomic surveillance, several of which are pointed-to in the hyperlinks in this document.

Critical assessments of the system have been proliferating. Examples include: CEPS, European Parliament, VOXEU and the CER

Link to ESRC Research Initiative on *The UK in a Changing Europe*: http://ukandeu.ac.uk/ Email: iain.begg@lse.ac.uk