ECONOMIC POLICY AND SURVEILLANCE IN EUROPE: INTRODUCTION

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Economic governance within the EU continues to evolve; a process which has accelerated since the onset of the Global Financial Crisis. In particular, additional rules and processes have been created to support the completion of Economic and Monetary Union (EMU). It is within the Euro Area that we see the greatest manifestation of the new rules for economic governance at a supranational level. The ambition for the completion of EMU is exemplified in the Five Presidents' Plan which provided a map for the completion of 'genuine' Economic , Financial , Fiscal and Political Union (Junker *et al*., 2015). Reforms across these broad fronts have evolved at varying speeds, with some areas significantly more advanced than others. The completion of 'genuine' EMU by 2025 is a far from certain prospect.

The fiscal arena is one of the areas that has seen a significant increase in rules over the past half decade. This increase is not surprising given the increases in public debt we have observed in the past decade. Preventative and corrective procedures are in place to constrain the policymakers of Member States. With this is mind, it is worth analysing the rules we have in place, their effectiveness, and where possible provide advice on improvements to the economic governance architecture of the EU. The FIRSTRUN project has been commissioned to contribute to this debate and is a European Union funded multinational research project that aims to investigate the fiscal policy coordination in the EU, to assess the coherence of the recent reforms within the economic governance framework, and to identify reforms that could fill possible gaps. The project commenced in March 2016 and will continue to February 2018. There is much research content available on the project's dedicated website,[1] and the first three papers in this edition of the *Review* are outputs from FIRSTRUN.

Iain Begg (London School of Economics) examines the political economy of compliance with the rules of the EU. He highlights how the rules adopted by EU Member States have become ever more "extensive and intrusive". Indeed, one response to the Euro Area crisis has been a proliferation of rules. He raises important questions about whether the decisions that appear to be based on political expediency risk undermining the "integrity and effectiveness of the rules". He reminds us that half the Euro Area has breached the 60 per cent of GDP debt limit for more than 50 per cent of the time since the creation of the Euro Area, Greece and Portugal missed the 3 per cent of GDP deficit target in most years prior to the Global Financial Crisis, and then there is the most notorious case of the rejection of the Stability and Growth Pact (SGP) sanctions for breaches by France and Germany in 2002/3. Begg highlights that, since 2011, Member States have been required to introduce budgetary frameworks in response to credibility concerns about the enforceability of EU rules. Indeed there has been a steady increase in the number of national level fiscal rules and a significant increase in the presence of fiscal councils. Begg's evidence suggests these have not necessarily been successful in ensuring compliance with EU rules, such as the SGP. He concludes with the important observation that "the EU faces the dilemma that reliance on fiscal and other rules is not enough to assure sustainable macroeconomic stability in a context in which politicians are not only adept at circumventing them, but garner popular support for doing so".

Tero Kuusi (Research Institute of the Finnish Economy, Helsinki) analyses the methods used by the Commission to estimate the structural budget positions of Member States. The Commission's estimates of the structural budget play an important role in the Stability and Growth Pact, where the estimates of the structural budget guide the path for the elimination of an excessive deficit. Such estimates are a prominent output of the European Commission, appearing in the forecasts of the Commission published three times a year. The unreliability of real time output gap estimates has been

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https://doi.org/10.1177/002795011723900109 Published online by Cambridge University Press

the focus of research (see Mitchell, 2005, for example). Kuusi explores the performance of the Commission's approach from the perspective of the evolution of the Finnish economy since 1984, and concludes that the method employed performs poorly in steering policy in a countercyclical fashion. If anything, real-time output gap estimates for Finland would steer fiscal policy in a pro-cyclical fashion. This is a result that is, perhaps, not a surprise to many. Kuusi's analysis though, most interestingly investigates alternative methods for fiscal evaluation that are currently part of the EU's legislative framework and used by the European Commission: an expenditure rule and a 'bottom up' approach that attempts to detect fiscal policy changes directly. He concludes that these alternative methods are more able to act as a guide for countercyclical fiscal policy.

Tomáš Domonkos, Filip Ostrihoň, Ivana Šikulová and Mária Širaňová (all of IER SAS, Bratislava) examine the Macroeconomic Imbalance Procedure (MIP). The MIP, introduced by the European Commission in the wake of the global financial crisis, is a surveillance mechanism designed to identify potential risks stemming from the build-up of macroeconomic imbalances within an economy. The paper begins by discussing the operation of the MIP in the context of its use as an early warning system. In 2011 the MIP focused on eleven indicators designed to capture external imbalances (current account balance, net international investment position, real effective exchange rate, export market share and nominal unit labour costs) and internal imbalances (house price inflation, private sector debt as a per cent of GDP, private sector credit flows as a per cent of GDP, general government gross debt to GDP ratio, the unemployment rate and growth in total financial sector liabilities). More recently, the labour market activity rate, long-term unemployment rate and youth unemployment rate have also been added to the list of MIP indicators. Developments in these indicators relative to Commission thresholds determine whether a 'corrective' Excessive Balance Procedure is initiated. It is perhaps no surprise, given this list of indicators, that this latter process has been criticised as somewhat vague. This is where Domonkos and colleagues have made a valuable contribution. Using data for all 28 Member States, they treat the MIP indicators as a system and estimate an multivariate unbalanced logit model that can provide rigour to the in-depth reviews undertaken by the Commission each Autumn. They complement this with factor analysis of the set of indicators. From this analysis, three broad factors were derived in a mechanical fashion. It will be an important step forward for the MIP if they adopt tools such as those developed in this paper.

The final paper, by Jan in't Veld (European Commission), presents a timely analysis of the impact from public investment programmes in countries running current account surpluses, and crucially the spillovers from these stimuli to the rest of the Euro Area. There is currently a debate about the use of fiscal space to support global demand (for example, see OECD, 2016), and in't Veld's contribution is important, focusing specifically on the efficacy of increasing Euro Area demand. Focusing on productivity enhancing public investment, he uses the Commission's macroeconomic model, QUEST, to illustrate the spillovers from a 1 per cent of GDP expansion, for ten years, in two current account surplus countries (Germany and the Netherlands) to other member states. The productivity enhancing nature of the investments in the scenarios have significant positive effects on GDP in the stimulus countries, while in monetary union the benchmark scenario shows relatively few spillovers in the absence of accommodation by the ECB. However, in the current debate, it is unclear whether the ECB would tighten its monetary response to any form of fiscal loosening. In't Veld's scenarios with monetary accommodation in this context become interesting. With monetary policy rates exogenised for the first two years of the scenario, the spillovers from fiscal stimulus to boost demand within the rest of the Euro Area are substantial. These fiscal efforts are funded through increased borrowing/smaller surpluses in the stimulus economies, but within the context of low borrowing costs the effect on public finances is muted. With current and expected growth in the Euro Area subdued, it is likely that pressure on Member States to 'do more' will grow. In't Veld's contribution to this debate is an important one that I am sure we will revisit over the course of the next few years.

NOTE

1 See http://www.firstrun.eu/.

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https://doi.org/10.1177/002795011723900109 Published online by Cambridge University Press