

Countries' fiscal consolidation strategies should aim at improving the quality and efficiency of public expenditure, underpinned by structural fiscal reforms targeting unproductive government spending, while minimising distortionary effects of taxation. In addition to bringing some long-term benefits for public finances, these improvements can be expected to further limit the potentially adverse impact on growth of fiscal consolidation.

Substantial progress has been made in recent years in strengthening the EU fiscal governance framework. One milestone of the framework is the fiscal compact, which entered into force on 1 January 2013 as part of the Treaty on Stability, Coordination and Governance (TSCG). The main goal of the fiscal compact is to strengthen national fiscal discipline and foster national ownership of the EU fiscal governance framework. In particular, contracting parties are obliged to transpose into their national legislation the commitment to achieve a balanced budget in structural terms and to introduce an automatic correction mechanism for potential deviations. The deadline for implementing the fiscal compact was set at one year after the entry into force of the TSCG, i.e. 1 January 2014.⁴ To fully reap the benefits of the strengthened framework, it is therefore important that countries fully comply with the requirements and implement the new provisions. While most countries have met the deadline, there seem to be large cross-country differences regarding the transposition of the fiscal compact into national legislation. Indeed, a few countries have not yet implemented the necessary legal instruments. Against this background, the European Commission is expected to assess "in due time" whether countries have implemented the fiscal compact.⁵ If the Commission finds cases of non-compliance, countries are expected to swiftly undertake steps to adjust their legislation accordingly. The success of the fiscal compact and thus the credibility of the strengthened governance framework will crucially depend on whether countries fully meet their commitments.

4 For euro area countries that had not ratified the TSCG by 1 January 2013, the deadline for implementing the fiscal compact is set at one year after the TSCG was ratified by them.

5 See Article 8 of the TSCG.

Box 6

KEY CHALLENGES FOR THE SURVEILLANCE OF ECONOMIC AND FISCAL POLICIES UNDER THE 2014 EUROPEAN SEMESTER

The build-up of vulnerabilities in euro area countries before and during the economic and financial crisis was partly due to insufficient compliance with the agreed rules underpinning EMU as laid down in the Stability and Growth Pact (SGP) and the insufficient effectiveness of overall EU economic policy coordination. In addition, EMU lacked a tool to address the emergence of macroeconomic imbalances. In response, the EU economic and fiscal governance framework has been enhanced, notably by the "six-pack" legislation, which entered into force in December 2011, and the "two-pack" regulations, which entered into force in May 2013.¹ EU economic policy recommendations and country-specific surveillance now take place throughout the year under the "European Semester", covering both fiscal and economic policies. These reforms are aimed at ensuring that countries correct past fiscal and macroeconomic imbalances and deliver the reforms needed to prevent future crises. In the light of experience

1 See the box entitled "Stronger EU economic governance framework comes into force", *Monthly Bulletin*, ECB, December 2011 and the box entitled "The "two-pack" regulations to strengthen economic governance in the euro area", *Monthly Bulletin*, ECB, April 2013.

with the implementation of the enhanced governance framework over the past few years, this box presents the key challenges for the 2014 European Semester.

The 2014 European Semester

The 2014 European Semester opened with the publication of the European Commission's Annual Growth Survey in November 2013, which gives broad policy guidance on priority action to be taken at EU and national levels, the Alert Mechanism Report, which screens Member States for economic imbalances, and the review of draft budgetary plans for 2014. The 2014 Annual Growth Survey rightly stressed that substantial structural reforms, especially those supporting growth in the short to medium term, are still necessary in EU and euro area countries. With respect to fiscal policies, it emphasised the urgent need to continue fiscal consolidation, designed in a growth-friendly manner, in order to reduce continuously high – and often still rising – debt ratios. Policy advice tailored to each country is issued by the Commission later in the year in the form of country-specific recommendations (CSRs).

Need for stricter implementation of country-specific recommendations

CSRs issued to euro area countries are particularly important to ensure that national policies do not pose a risk to the smooth functioning of EMU. Against this background, compliance with these CSRs needs to be closely monitored. Looking at the last two European Semester exercises, the Commission assessment indicates that compliance with CSRs in 2012 and 2013 has been limited overall, i.e. necessary reforms have not been sufficiently implemented.² To ensure a higher degree of implementation in the future, it would be advisable to make the CSRs more time-bound, in particular for pressing issues, adding implementation timelines within the year. In addition, the current monitoring of compliance with CSRs could be strengthened to keep track of the implementation of necessary reforms throughout the economic cycle.

Economic surveillance needs to ensure that remaining excessive imbalances are detected and corrected

A dedicated macroeconomic surveillance process was implemented at the EU level in 2011 with the macroeconomic imbalance procedure (MIP), which facilitates the EU-wide detection, prevention and correction of macroeconomic imbalances. While overall imbalances have begun to adjust throughout euro area countries, the remaining level of imbalances leaves several countries substantially vulnerable to adverse shocks that could potentially lead to disorderly corrections. Such disorderly corrections undermine the smooth functioning of EMU. Therefore the excessive imbalance procedure (EIP) – the corrective arm of the MIP – should be applied in all cases where imbalances are deemed excessive. Indeed, in the case of euro area countries, the EIP offers the highest degree of traction for countries experiencing excessive imbalances as it foresees the implementation of a corrective action plan by the country concerned that can be enforced through financial sanctions. Proper application of this tool would allow closer surveillance and help to ensure that intended policy action is fully implemented. So far, however, the EIP has not been applied, although imbalances were found to be excessive in some countries.³

² See the 2012 and 2013 European Commission Staff Working Papers accompanying the CSRs.

³ See the box entitled "The 2013 Macroeconomic Imbalance Procedure", *Monthly Bulletin*, ECB, May 2013.

As regards the 2014 MIP, the European Commission on 5 March 2014 published the in-depth reviews (IDRs) for all 17 EU countries⁴ selected. The assessment on the nature of imbalances was published alongside the country-specific IDRs, concluding, inter alia, that imbalances are excessive in Croatia, Italy and Slovenia. Nevertheless, the decision on the appropriate procedural follow-up, and most importantly whether to initiate the EIP for those countries, will only be taken in June 2014 together with the release of the 2014 CSRs.

Countries formerly covered by an EU-IMF financial assistance programme are subject to post-programme surveillance (PPS). PPS is a complement to the regular EU economic country surveillance, designed to ensure that Member States exiting financial assistance programmes maintain financial stability and fiscal sustainability. The PPS monitoring includes biannual missions to Member States to assess their economic, fiscal and financial situation and whether further measures are needed. For countries under PPS, the EU Council may, acting on a proposal by the Commission, recommend the adoption of corrective measures. Furthermore, the European Parliament and the national parliament of the country concerned may be involved in an exchange of views on the PPS.

Progress towards sound fiscal positions needs to be sustained over the medium term in line with the Stability and Growth Pact

Over the last five years euro area countries have made significant progress towards correcting the budgetary imbalances built up before and during the crisis. However, sizeable further structural adjustment is still required to ensure that countries meet their medium-term budgetary objectives, which ensure sound fiscal positions in the medium term. Moreover, while the euro area's general government debt-to-GDP ratio is expected by the European Commission to stabilise in 2014 and to decline in 2015, government debt ratios are forecast to continue rising until the end of the forecast horizon (2015) in eight out of 18 euro area countries. In its fiscal policy guidance to Member States issued in February 2014 under the 2014 European Semester, the EU Council therefore stressed that “it is crucial for all Member States to stay on course with the agreed growth-friendly, differentiated fiscal consolidation strategy in order to ensure the sustainability of public finances”.

Despite the remaining, often substantial consolidation requirements, the 2014 draft budgetary plans of euro area non-programme countries, released by the European Commission on 15 November 2013, showed a structural improvement of only 0.23% of GDP in 2014 for the euro area as a whole – markedly below the 0.5% of GDP benchmark foreseen under the SGP.⁵ Accordingly, the opinions of the Commission delivered at the time of the assessment of the plans highlighted that structural efforts were, in the absence of additional measures, at risk of falling short of commitments under the SGP in 2014 in many euro area countries, in particular Spain, Italy, Luxembourg, Malta and Finland. In Spain, Italy and Malta, the structural balance will, according to the European Commission's European Economic Forecast for winter 2014, improve somewhat more than expected in autumn 2013, while still falling short of the requirements under the SGP in all three Member States. But in seven countries (Belgium, Germany, Estonia, France, Luxembourg, the Netherlands and Slovenia), the structural balance in 2014 is projected

4 The list of countries comprises Belgium, Bulgaria, Denmark, Germany, Spain, France, Croatia, Italy, Luxembourg, Hungary, Malta, the Netherlands, Slovenia, Finland, Sweden and the United Kingdom. Ireland has been added to this list following the end of the EU-IMF financial assistance programme.

5 See also the box entitled “Fiscal consolidation in the euro area: past progress and plans for 2014”, *Monthly Bulletin*, ECB, December 2013.

Structural efforts in response to the European Commission's opinions on 2014 draft budgetary plans

(percentages of GDP; percentage points)

European Commission opinion on compliance of 2014 draft budgetary plans with SGP (SGP commitment)	Budget balance		Structural effort		Structural effort commitment under the SGP
	2014 EDP target (if applicable)	winter 2014 forecast	autumn 2013 forecast	winter 2014 forecast	
Compliant					
Germany (preventive arm)		0.0	0.0	-0.1	(at MTO) ¹⁾
Estonia (preventive arm)		-0.4	0.5	0.4	0.5 benchmark
"Compliant but without any margin for possible slippage"					
France (2015 EDP deadline)	-3.6	-4.0	0.7	0.5	0.8
Netherlands (2014 EDP deadline)	-2.8	-3.2	0.4	0.0	0.7
Slovenia (2015 EDP deadline)	-3.3	-3.9 ²⁾	0.7	0.3	0.5
"Broadly compliant"					
Belgium (2013 EDP deadline)		-2.6	0.4	0.1	0.5 (debt benchmark)
Austria (2013 EDP deadline)		-2.1	0.1	0.1	0.5 benchmark
Slovakia (2013 EDP deadline)		-3.3	-0.8	-0.2	0.5 benchmark
"Risk of non-compliance"					
Spain (2016 EDP deadline)	-5.8	-5.8	-0.1	0.1	0.8
Italy (transition period: debt benchmark)		-2.6	0.1	0.2	0.66
Luxembourg (preventive arm)		-0.5	-0.6	-0.7	(at MTO) ¹⁾
Malta (2014 EDP deadline)	-2.7	-2.7	-0.1	0.2	0.7
Finland (preventive arm)		-2.5	-0.2	-0.2	0.5 benchmark
Memo item: euro area			0.23	0.13	0.5

Sources: European Commission's winter 2014 forecast and national draft budgetary plans for 2014.

1) No target has been set as the country has achieved its medium-term budgetary objective (MTO).

2) -3.2% of GDP excluding bank recapitalisation.

to improve less or deteriorate more than expected in autumn, and only in Austria and Finland is the adjustment likely to be as expected. As a result, the overall improvement in the structural balance in 2014 is expected to decline further and to equal only 0.13% of GDP – just a quarter of the 0.5% of GDP benchmark foreseen under the SGP. Against this background, the Commission used its new powers under the two-pack regulations to issue autonomous recommendations to France and Slovenia on 5 March 2014 in line with Article 11(2) of Regulation (EU) No 473/2013. These countries must make efforts to ensure full compliance with the EU Council recommendations issued under the EDP. To this end, they are expected to detail the necessary measures in a dedicated section of their forthcoming 2014 Stability Programme updates. If these measures are deemed insufficient, the EDPs may be stepped up.

The priority in 2014 will be first and foremost the effective and credible implementation of the existing surveillance procedures. As regards fiscal policies, it is crucial that compliance with both nominal deficit targets and structural efforts required under the EDP recommendations is ensured. Furthermore, fiscal rules need to be applied in a symmetrical manner, meaning that fiscal discipline is also fully enforced in improving economic times, so that countries build up sufficient fiscal buffers before the return of worse times.⁶ Moreover, for the future, it is important to ensure that EDP deadline extensions are granted only for one year, in line with the existing Regulation.⁷

6 See also the box entitled "Implementation of the excessive deficit procedure under the reinforced Stability and Growth Pact in euro area Member States", *Monthly Bulletin*, ECB, September 2013.

7 Article 3(5) of Regulation (EU) No 1467/97, as amended, foresees the possibility of deadline extensions by "one year as a rule".

At the same time, 2014 represents a window of opportunity for the improvement of the governance framework, with a review of the implementation of the six-pack legislation to be carried out by the Commission by the end of the year. This occasion could be used to clarify further the application and enhance the consistency of the various steps of the MIP and SGP procedures.

Conclusion

While the instruments of the economic governance framework have been strengthened over recent years, their potential has not been fully exploited so far. Against this backdrop, the main policy priorities for the 2014 European Semester remain the implementation of structural reforms and the adjustment of macroeconomic imbalances, as well as the reduction of high debt ratios through continued fiscal consolidation, designed in a growth-friendly and sustainable manner. This requires an effective and credible application of the existing surveillance tools, including the excessive imbalance procedure, once imbalances are defined as excessive in a country, and a strict, consistent and symmetrical application of the SGP framework.