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**MONEY FOR STRUCTURAL REFORMS IN
THE EUROZONE:
MAKING SENSE OF CONTRACTUAL
ARRANGEMENTS**

XAVIER VANDEN BOSCH



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Table of Contents

List of abbreviations	3
Executive Summary	5
Introduction	9
1. Early proposals for ‘contracts’	11
1.1. ‘Contractual arrangements’ in the Van Rompuy report	11
1.2. The Commission’s ‘Convergence and Competitiveness Instruments’	12
2. Structural reforms: what is at stake?	13
2.1. The need for internal devaluations to correct external imbalances.	13
2.2. The role of structural reforms in the devaluation process	15
3. Financial support	17
3.1. Incentive and solidarity rationale	17
3.2. How much money is needed?	18
4. Making sense of contractual arrangements	21
4.1. Contracts on a voluntary basis only	21
4.2. Prioritizing in Country-Specific Recommendations is required to determine potential beneficiaries	22
4.3. Financial support required for incentive AND solidarity reasons	23
4.4. Countries under a financial assistance programme should be able to benefit from the new solidarity mechanism	24
4.5. Appropriate funding is required for the solidarity mechanism.	25
4.6. Contracting countries should benefit from ESM precautionary credit lines	26
4.7. Legitimacy of the European Semester will not radically increase	26

5. Possible contract procedure	29
Conclusion	33
Annex I	35
Annex II	39
Annex III	41
References	43



LIST OF ABBREVIATIONS

AGS	Annual Growth Survey
MIP	Macroeconomic Imbalance Procedure
CAP	Corrective Action Plan
CCI	Convergence and Competitiveness Instrument
CSRs	Country-Specific Recommendations
EAR	Euro Area Recommendation
ECB	European Central Bank
EIP	Excessive Imbalance Procedure
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
EMU	Economic and Monetary Union
FFA	Financial Facility Agreement
IDR	In-Depth Review
MoU	Memorandum of Understanding
NRP	National Reform Programme
OMT	Outright Monetary Transactions
SCP	Stability or Convergence Programme
SGP	Stability and Growth Pact
SWD	Staff Working Document
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance

EXECUTIVE SUMMARY

Both the Commission's proposal for a 'Competitiveness and Convergence Instrument' and the 'contractual arrangement' presented by President Van Rompuy share a common concept: associating EU money with national structural reforms under a binding arrangement.

The targeted 'structural reforms' are the labour market reforms and product and services market reforms in eurozone 'peripheral' countries facing the most severe external imbalances. Their implementation would speed up and facilitate the 'internal devaluation' process of these countries. In the worst case scenario, failure to adopt the necessary reforms and to adjust wages and prices downwards may lead the most vulnerable countries to leave the eurozone under social and political pressure. Contracts seek to reduce this risk by increasing compliance with the country-specific recommendations for structural reforms issued by the EU institutions within the European Semester, and in particular with the Macroeconomic Imbalance Procedure (MIP).

As for the financial support, it follows two different, albeit overlapping rationales. First, the perspective of obtaining EU funding would incentivize the governments of vulnerable countries to adopt reforms that would bear a high political and social cost in the short term. That is, without some form of incentive, it is unlikely that the necessary reforms would be undertaken and this could have significant negative consequences for the EMU as a whole. The second rationale amounts to outright solidarity: EU support is needed to cushion the inevitable socio-economic costs implied not only by the structural reform, but also by the internal devaluation taking place.

To make sense of contractual arrangements, some points should be considered in future discussions:

- 1. Contracts on a voluntary basis only:** Contracts cannot be mandatory unlike initially suggested in the Van Rompuy report. This stems not only from the inherent definition of a 'contract' – where mutual consent is key – but also from the non-binding nature of the preventive arm of the MIP. Making the country-specific recommendations issued by the EU institutions systematically binding would imply transfers of sovereignty from the national to the EU level that go well beyond the present discussion. Instead, contracts would introduce *the possibility* of making the preventive arm binding for *some countries* where corrections are most needed and urgent for the EMU as a whole.

2. Better prioritization by the Commission of Country Specific Recommendations is required: Because available financial resources will remain limited

and because contracts should address the lack of reforms where it is most important and urgent, the Commission will have to justify which reforms are the most important across eurozone countries. In practice, it should suggest (i) for which CSR a country may enter into a contractual arrangement, (ii) the size of the financial support that would be made available and (iii) a deadline for proposing a reform agenda.

3. Financial support is mostly needed on solidarity grounds: Some money is needed to incentivize a country to voluntarily engage into a contract. However, overtly justifying it as an incentive would raise much criticism: that no incentive is actually needed, that the sanctioning mechanism foreseen in the Excessive Imbalance Procedure should instead be used and that the Commission would basically be buying off the country's sovereignty to put it under enhanced surveillance. Instead, it should be clear from the onset that the financial support essentially amounts to a conditional solidarity mechanism. This will allow (mostly creditor) countries to cushion some of the unavoidable costs incurred by (debtor) countries undergoing an internal devaluation process. Moral hazard would not be a relevant issue in the discussion on contracts, as financial support is conditional on compliance with the reform agenda which must *speed up*, not *slow down*, the adjustment process.

4. Countries under a financial assistance programme should be able to benefit: Because solidarity would be central, there is no *a priori* reason why Greece, Ireland, Portugal or Cyprus should be excluded from financial support because they have refinancing difficulties – quite the opposite. The money could back some specific reforms being undertaken as part of their adjustment programme, providing EU solidarity in the form of grants next to the loans from the EFSF/ESM.

5. Appropriate funding is required: Total committed funding required over 5 years could vary between €30bn and €75bn (assuming that (i) the net transfers towards beneficiaries will range between 0.2% and 0.5% of their respective GDP (ii) and that the potential contracting countries are those in the eurozone 'periphery'). Recognizing the financing needs from the start would prevent wasting energy and time on discussing what would otherwise be ineffective contracts.

6. Contracting countries should benefit from ESM precautionary credit lines: when entering contractual arrangement, (non-programme) countries should systematically be granted a precautionary credit line from the ESM. Under the ECB's 'Outright Monetary Transactions' programme, this would allow the ECB to act as a genuine lender of last resort and shelter the adjusting country from any adverse events in sovereign bond markets.

7. Legitimacy of the EU Semester will remain limited: well-designed contracts may entice broader support of the reforms by National Parliaments. However, contracts would not as such create greater involvement of the European Parliament, beyond the current 'Economic Dialogue'. The legitimacy issue of the EU Semester as such will thus not be addressed by contracts.

Agreeing on introducing contracts will not be easy. Eurozone countries would be required to commit sufficient funding (a one-off commitment likely ranging from 0.1 to 0.2% of their GDP) – possibly an unpalatable prospect in a period of fiscal consolidation. However, targeted and temporary transfers can be very effective in rapidly prompting and supporting structural reforms in most vulnerable countries. This would facilitate their effective adjustment, a precondition for cross-border financial flows to resume, and ultimately for restoring growth and creating jobs. Contracts would also introduce a solidarity mechanism which would convey an important signal that countries sharing the euro are committed to preserving their union.

However, contracts would not lead to a definitive crisis resolution on their own. Restoring normal lending conditions and reversing financial fragmentation in the eurozone for capital to flow 'downhill' again from creditor to debtor countries would have a larger impact than any form of fiscal transfers within the eurozone. Further steps towards an effective and genuine banking union should complement any initiatives on contracts.

INTRODUCTION

Both the ‘contractual arrangements’ presented in the European Council President Van Rompuy report ‘Towards a genuine Economic and Monetary Union’ (Van Rompuy, 2012) and the ‘Convergence and Competitiveness Instruments’ (CCI) in the Commission’s blueprint (European Commission, 2012) constitute early proposals on the concept of ‘contracts’. A contract would bind the contracting Member State to the EU in adopting the structural reforms most needed for the functioning of the EMU. EU financial support would in turn be granted to the contracting Member State. This kind of arrangement is presented as a first step towards a deeper economic union, aimed at addressing some of the EMU weaknesses revealed by the crisis.

At the December 2012 Council, EU leaders tasked Herman van Rompuy and the Commission with exploring this idea further by June 2013, distinguishing between the ‘*mutually agreed arrangement of a contractual nature*’ and the ‘*solidarity mechanisms for the countries entering into such arrangements*’ (European Council, 2012). In a subsequent communication to the European Parliament and the Council, the Commission presented options and questions to elicit input from stakeholders (European Commission, 2013). The matter should further be explored during the June 2013 Council meeting.

In this paper, I will begin by reviewing the core features of the two early proposals on ‘contracts’: the CCI and ‘contractual arrangement’ (part 1). I will then aim to clarify the content of these ‘contracts,’ which is twofold: on the one hand, the structural reforms that the contracting Member State would commit to implement (part 2), and on the other hand, the financial support that the EU would grant to the contracting Member State (part 3). I will in particular underline their respective rationale. Finally, I will highlight what kind of contracts would make sense by making preliminary conclusions on their possible design (part 4). Following these recommendations I will briefly highlight what the procedure for contractual arrangements may look like (part 5).

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1. EARLY PROPOSALS FOR ‘CONTRACTS’

The main features of both proposals are summarized here: the ‘contractual arrangements’ as they appear in the Van Rompuy report ‘Towards a genuine Economic and Monetary Union’ (1.1) and the Commission’s ‘Convergence and Competitiveness Instruments’ (1.2). Annex I provides some useful background information on how EU economic policy guidance is articulated with the European Semester, and in particular with the Macroeconomic Imbalance Procedure. Annex II provides a detailed comparison of the core features of both proposals.

1.1. ‘Contractual arrangements’ in the Van Rompuy report

Under the report by the European Council President (Van Rompuy, 2012), contractual arrangements would be mandatory for all eurozone countries, but voluntary for other Member States. For countries under the corrective arm of the Macroeconomic Imbalance Procedure (MIP), the contract would be the Corrective Action Plan (CAP) (as defined in regulation 1176/2011).

The proposal stresses the need to detect and correct macroeconomic imbalances by addressing the structural rigidities in the labour markets and product and services markets whose efficiency is required for the well-functioning of the EMU in the absence of exchange rate adjustment. Dialogue with Member States would be increased in order for the Commission to produce in-depth reviews that would be generalized to all EMU countries. Based on their conclusions, the Commission would then recommend the Council to adopt its Country Specific Recommendations (CSRs) by the end of the EU semester. The CSRs would in turn serve as the basis for ‘*further dialogue on the specific and detailed measures contained in the reform arrangements (i.e. the contracts), including a timeframe for implementation*’. The agreement would most likely be of a multiannual nature.

To further ensure national ownership of the reforms, the agreement of National Parliaments would be a requirement. The Commission would inform the European and National Parliaments of the necessity of these measures from an EMU perspective. Accountability would be ensured by effective monitoring of the specific, detailed and measureable reform agenda. Contracting governments would be held accountable by their own Parliament, while the Commission would answer to the European Parliament.

The report also suggests that the structural reforms agreed in the contract *could be supported ‘on a case-by-case basis’ by ‘temporary, limited, targeted and flexible financial support depending on the specific situation of each country’*. Spe-

cific resources, treated separately from the multiannual financial framework, would be necessary to finance this support.

1.2. The Commission's 'Convergence and Competitiveness Instruments'

Convergence and Competitiveness Instruments (CCI) put forward in the Commission's Blueprint are more detailed than the 'contractual arrangements' in the Van Rompuy report while being conceptually very close to them. An important difference is that the CCI bundles together both the contractual arrangement and financial support, thus making the latter an inherent part of the former, rather than presenting it as merely optional.

The Commission's series of 'Staff Working Documents', which assess the National Reform Programme and Stability Programmes submitted by the Member States, would be published earlier to enable a better dialogue on the analysis. Then, the actual coordination of structural policies would start with the publication of a '*horizontal appraisal of the proposed major economic reforms*'. The conclusions of this horizontal document would be discussed in the Eurogroup and the ECOFIN Council in view of '*systematically coordinating ex ante the major reform plans*'. This new step in the EU Semester would be based on Article 11 of the Treaty on Stability, Coordination and Governance.

In turn, the Commission would come forward with a proposal for CSRs that would be '*more detailed, policy-specific and time bound*'. The idea of the Commission is that the improved conditions of the dialogue leading to the CSRs and their greater focus and specificity '*could give a greater impetus to reform efforts in Member States*'. Based on the CSRs, countries under the preventive arm of the MIP could voluntarily submit a contractual arrangement proposal, including specific policy actions they intend to implement, as well as a timetable for those actions. For countries with excessive imbalances under the corrective arm of the MIP i.e. countries under the Excessive Imbalance Procedure, the contract would be mandatory as it would correspond to the Corrective Action Plan (as provided for by regulation 1176/2011). Countries voluntarily submitting a contract would follow similar procedures and deadlines as under the corrective arm, except that sanctions would not apply (Art 8 to 12 of regulation 1176/2011).

Financial support would consist in a lump sum to be attributed per contractual arrangements, '*not earmarked to specific reforms*'. However, disbursement would be conditional upon the measures/reforms agreed being implemented. The instrument would be financed based on a contribution key dependent on GNI via external assigned revenues to the EU budget (thereby avoiding the ceiling on the Multiannual Financial Framework).

2. STRUCTURAL REFORMS: WHAT IS AT STAKE?

The concept of ‘structural reforms’ is vague enough to potentially refer to an endless amount of policies. But reforms are always means to an end. In the context of the eurozone crisis, reforms have a specific purpose and meaning. Their underlying objective is the correction of external imbalances of several eurozone countries (2.1). To reach this objective, structural reforms mostly seek to liberalize labour markets, as well as product and service markets (2.2). The rationale exposed here largely underlies the Commission and Van Rompuy proposals for contractual arrangement highlighted in the previous section.

2.1. The need for internal devaluations to correct external imbalances

The build-up of external imbalances

In the run-up to the crisis, several countries of the eurozone ‘periphery’ (Greece, Portugal, Ireland, Spain) had large current accounts deficits which deteriorated their net international investment position (NIIP) – i.e. the stock of liabilities vis-à-vis the rest of the world. However, these external imbalances were not considered to be an issue but rather the result of a successful European financial integration. The relation between domestic savings and investment was thought to have become irrelevant as countries could rely on international financial markets to finance their current account imbalance. Capital flows from the core of the eurozone to the ‘periphery’ would develop the higher growth potential of the ‘periphery’, channeling excess northern Europe savings into investments offering better return prospects.

With hindsight, too much faith was put into the effectiveness of international allocation of capital and in the sustainability of economic convergence within the eurozone. Private financial flows from the core to the periphery, instead of leading to sustainable domestic growth and productivity gains, notably promoted the emergence of bubbles in the real-estate and construction sector (Spain and Ireland) and excessive consumption (Greece and Portugal). All in all, external financing dynamics fueled current account deficits rather than the trade performance (Gros 2012; Holinski et al 2012).

The reasons invoked for such unsustainable developments are multiple. The convergence of interest rates following the introduction of the euro had been promoted by financial regulation and the ECB policy which both assumed all eurozone countries were equally safe. With low converging interest rates, the common monetary policy was too accommodating to the south, which displayed higher inflation rates. This translated into lower real interest rates in the

periphery which favored investment and consumption, hence further inflation. The credit boom was further fueled not only by specific features of local credit market, but also by a general context of ample liquidity availability feeding a high risk appetite throughout global financial markets (Gros, 2012).

With growth perspective deteriorating as the financial and eurozone sovereign debt crises were unfolding, risks were being radically reassessed. What followed was a ‘sudden stop’ – a sudden reversal of private financing of the large current account deficits in the eurozone periphery (Merler and Pisani-Ferry, 2012). As private funding receded, and both the public and private sector faced important refinancing constraints, alternative sources of financing partly replaced external private funding. Official flows acted as a buffer to the withdrawal of private flows: the liquidity provided by the ECB (as witnessed by the TARGET liabilities increase) and official loans provided to programme countries (bilateral/EFSM/EFSF/ESM/IMF loans).

The internal devaluation process

But in essence, these buffers only temporarily cushion the need for deficit countries to rebalance their external indebtedness. As private external financing has largely receded, deficit countries are now constrained to reduce their current accounts deficits to a level deemed sustainable (which may be defined as the level that stabilizes the country’s net international investment position) (Buti and Turrini, 2012).

While adjusting, countries still service their accumulated foreign liabilities (they have a negative income balance), and this further depresses their current account and fuels their negative NIIP. Such servicing of external liabilities makes up about two-thirds of the current account imbalances of Greece, Spain, Portugal and Ireland (on average since the introduction of the euro – Holinski et al, 2012). As a consequence, these countries borrow on average the equivalent of about 5% of GDP from the rest of the world only to service their debt.

Hence, to break the vicious circle and stabilize their external position, a positive net trade balance is required, which can be attained by reducing imports and/or increasing exports. Decreasing imports implies an inevitable drop in domestic demand which means a lower GDP. An export-led recovery is thus largely advocated – or hoped for – as it would not imply the same pain.

How can such an export-led rebalancing occur? Stuck with a euro that is too expensive and the need to reduce imbalances, the country must necessarily increase its competitiveness, which is largely considered in its cost and price dimension. This implies relative deflation (disinflation) in the deficit countries compared to their main trading partners – the creditor countries in the euro-

zone's core (Blanchard, 2007; Krugman, 2011; Buti and Turrini, 2012; Sinn, 2012). A decrease of relative wages, an increase in productivity and finally a relative decrease in price would allow the deficit countries to restore their competitiveness and attractiveness. And this would ultimately restore growth and create jobs.

Such an 'internal devaluation' substitutes for a possible 'external devaluation' made impossible since deficit countries have relinquished their own currency in favour of the euro. According to some estimates, prices in Spain, Greece and Portugal would need to be reduced by 25% to 35% compared to the eurozone average (Goldman Sachs, 2013). If the actual effort is difficult to measure, an internal devaluation is generally assumed to be long and painful. The principle is the following for the most affected countries: in the years following the introduction of the euro, convergence with northern countries was actually excessive as it was unsustainably fueled by credit booms; wages rose beyond what productivity would suggest and prices increased above the EU average. These countries therefore need to '*rewind the clock*' to realign wages and prices to a sustainable equilibrium: years of excessive convergence must be followed by years of divergence, until southern countries become 'cheap' again relative to the core of the eurozone (CESifo, 2012).

2.2. The role of structural reforms in the devaluation process

Structural reforms mostly encompass two categories of supply-side reforms: (i) labour market reforms and (ii) product and service market reforms. Labour market reforms are generally considered to be the most important in the devaluation process. Structural reforms can facilitate the correction of excessive external imbalances and also help absorb future asymmetric shocks (Buti and Turrini, 2012). The correction of the pre-existing imbalances is arguably what matters the most in the debate on contractual arrangements. Contracts would thus address immediate and important imbalances and be 'corrective' before being 'preventive'.

Labour market reforms

There is a widely-accepted fact in the history of economic theory on 'downward wage stickiness': while wages easily move upwards, they tend not to adjust downwards in a downturn (Leidler, 1992; Bewley, 1999). Labour market reforms seek to remove the (legal) factors leading to such wage stickiness, which prevents the downward adjustment of wages. More flexible labour markets

would allow for lower wages which in turn would allow for lower prices, thereby making the economy more competitive.

Failing to remove labour market rigidities would induce a pattern of adjustment to shocks that falls disproportionately on employment, reduce growth and make the adjustment more painful, particularly because the highest cost caused by this delay is borne by the most vulnerable members of society (Praet, 2013; Coeuré, 2013).

Measures adopted in several deficit countries – notably those under a troika-led adjustment programme (Greece, Ireland and Portugal) – provide some concrete examples of labour reforms seeking to introduce more flexibility in the wage-formation system (Buti and Turrini, 2012). The decentralization of wage bargaining at the firm level by reforming the mechanisms for collective agreements is favoured (Greece, Portugal, Spain, Italy). Other reforms typically seek to diminish the legal minimum wage (Greece) or how minimum wage is set (Greece, Ireland), to introduce measures favouring the renegotiation of collective clause (Greece, Portugal, Spain), in order to increase the flexibility of working-time arrangements (Greece, Portugal).

Product and service markets reforms

Other reforms aim to improve the country's competitiveness by increasing competition in some product and services markets. Product market reforms seeking to reduce excessive profit margins in monopolistic sectors sheltered by internal competition would also allow wage decline to translate into lower relative prices (Coeuré, 2013). These reforms have large scope and involve the deregulation of some professions, the promotion of a better business environment and the liberalization (including privatization) of some sectors.

In turn, better functioning markets would increase the country's overall competitiveness by lowering the costs of products and services used by exporting industries. Productivity would also increase indirectly as firms would become more efficient by being exposed to increased competition. Reforms seeking to improve the business environment can be seen as complementary as they promote entrepreneurship as well as investments from abroad.

3. FINANCIAL SUPPORT

The possible justifications for granting financial support to a country as part of the contractual arrangement will first be discussed (3.1), before considering the total funding for the instrument that would be required (3.2).

3.1. Incentive and solidarity rationale

The rationale of linking a financial incentive to the contract is twofold: the financial support represents a (positive) financial incentive for reform but also amounts to a solidarity mechanism. The need for a financial incentive relies on political economy considerations. Countries with a large external deficit might not be sufficiently willing to introduce the necessary reforms for adjustment. There would be a short term political and economic cost linked to these unpopular reforms. Political inaction in vulnerable countries would as a result impose a negative externality ('spillover') to the whole EMU. Negative spillovers could relate to financial contagion, notably in sovereign debt markets. But ultimately, negative spillover could be understood as the demise of the eurozone: as the insufficiently reforming country would fail to adjust, social and political forces would push for an exit from the euro. A contractual arrangement, by introducing a positive financial incentive would compensate for the short term economic and political cost and prompt the country to reform. The incentive would make the country 'internalize' this 'external cost'.

The second rationale is that financial support amounts to outright solidarity justified by the social and economic costs faced by the adjusting country. Financial transfers would help cushion the impact of the reforms, and more generally of the internal devaluation process. The contract thus opens the perspective of outright transfers within the eurozone, conditional on reforms. This form of solidarity differs from the existing solidarity via the EFSF/ESM where loans rather than grants are provided to vulnerable countries. One could hence imagine that a country would implement the reforms recommended by the EU institutions without the need for any incentive, but that creditor countries would nevertheless deem it necessary to alleviate their social and political impact.

All in all, both the incentive and solidarity reasoning point out to the very same economic and social costs inherent to any internal devaluation process. With this support, the adjustment would be speeded up and some of the short term pain lifted. Money would serve both as an incentive (ex-ante) making sure the country introduces these reforms with no further delay, and as a solidarity mechanism (ex-post), cushioning the political and social cost of the reforms and of the devaluation the reforms aim to facilitate. In the worst-case scenario, this would prevent the country from having to exit the eurozone.

3.2. How much money is needed?

Financial support would back the structural reforms and be conditional upon them. As mentioned above (see 1.2), the Commission suggested that the financial mechanism should provide quick, targeted, and limited in time support which would be financed via external assigned revenues to the EU budget. Money would be made available as a lump sum per contract. In practice though, it could as well be spent on specific spending items specified in the contract, like the financing of active labour market policies or of training programmes.

The funding question first comes down to the question of the potential beneficiaries: which countries should be able to engage into a contractual arrangement from an economic point of view? The number and size of the economies requiring support is indeed an important factor determining the size of the fund/financial instrument to set up. Eligible countries should in principle be those facing the greatest adjustment needs i.e. displaying the greatest imbalances, notably Greece, Portugal, Spain, Italy, Ireland and Cyprus.

The next question is how large should the available sum of money be for each of the affected countries most likely to benefit. A possible point of reference is the size of the transfers induced by more ambitious macroeconomic schemes. Such schemes have notably been proposed by EU institutions as a key element of a deeper budgetary union, notably the ‘shock absorption function’ (Van Rompuy, 2012) and the ‘stabilisation function’ (European Commission, 2012). The basic principle is that eurozone countries facing country-specific shock would benefit from automatic transfers from the common instrument. This would provide an insurance system whereby risks are pooled across Member States. Should the financial solidarity involved in the contracts try to even out the size of the transfers allowed by these macroeconomic schemes, an average southern country (Portugal, Spain, Italy and Greece) should be able to perceive about 1% of GDP per year¹. For this group of countries, this would require an annual funding budget of about €30bn.

Although this gives some indication, it is however clear that solidarity levels introduced by contracts will not match the solidarity involved in these larger solidarity mechanisms. A cap on the net maximum amount a country should receive per year would probably lie in the range of 0.2-0.5% of GDP: large enough to be a meaningful incentive but not as much as in a scheme requiring a genuine fiscal capacity. The upper range (0.5%) would still represent less than what Portugal, Greece or Cyprus perceive from cohesion policy funds; the lower

1. Based on transfers implied on average over 2009-2014 in schemes suggested by *Pisani-Ferry et al* (2012) where transfers represent 0.25% of the absolute output gap above a 2% threshold and *Enderlein et al* (2012) where transfers represents 0.5% of relative deviations of output gap relative to the euro-area output gap. See Annex III for data.

range (0.2%) less than what any likely beneficiaries perceive from cohesion policy funds².

Assuming Spain, Italy, Portugal, Greece, Ireland and Cyprus would be beneficiaries of a 5-year funding programme, the approximated total funding required would range between about €30bn and €75bn, for net transfers respectively amounting to 0.2% and 0.5% of the beneficiary's GDP (Table 1). This would require a yearly gross contribution of respectively 0.09% and 0.21% of GDP by each eurozone country. Not including the programme countries (Greece, Portugal, Ireland and Cyprus), on the sole ground that they have already signed a 'contract' under the form of a Memorandum of Understanding, does makes little difference as they are small compared with the much larger Spanish and Italian economies.

Table 1: Net transfers per year and over 5 years based on cap set at 0.2% or 0.5% of GDP (selected countries) (€ billions)

Potential beneficiaries	Cap at 0.2% GDP		Cap at 0.5% GDP	
	Yearly net transfers	Total over 5 years	Yearly net transfers	Total over 5 years
Spain	2.1	10.3	5.1	25.7
Italy	3.1	15.5	7.8	38.9
Greece	0.4	1.9	0.9	4.7
Portugal	0.3	1.6	0.8	4.0
Ireland	0.3	1.3	0.6	3.2
Cyprus	0.03	0.2	0.1	0.4
Total	6.2	30.8	15.4	76.9

Source: Own calculations based 2012 GDP figures (in Commission's AMECO database)

2. EU Cohesion policy funding committed under the 2007-2013 Multiannual Financial Framework, per year, as % of respective 2007 GDP: 1.79% (Portugal), 1.63% (Slovenia), 1.26% (Greece), 0.53% (Cyprus), 0.47% (Spain), 0.26% (Italy), source: Marzinotto (2011).

4. MAKING SENSE OF CONTRACTUAL ARRANGEMENTS

At this stage of the discussions, there are many possible designs for contractual arrangements. Each of the following subsections presents recommendations and considerations for sensible contractual arrangements.

4.1. Contracts on a voluntary basis only

Mutual consent is by definition inherent to a contractual arrangement. Although the ‘contracts’ were initially envisaged as being ‘mandatory’ (for all eurozone countries) in the Van Rompuy report and the December 2012 Council conclusions, these concepts are simply incompatible. There is no such thing as a ‘mandatory contract’³.

Should this be dismissed as a mere wording issue, in which case ‘contractual arrangements’ would actually mean ‘binding arrangements within the preventive arm of the MIP’, such arrangements would still alter the original design of the MIP. Current EU recommendations for structural reforms are not ‘binding’ in so far that no enforcement mechanism exists in the preventive arm of the MIP. Only in the corrective arm of the MIP do countries have to adopt a Corrective Action Plan and face the prospect of sanctions (see annex I for background information on the MIP).

With ‘mandatory’ contractual arrangement, recommendations would become binding for countries under the preventive arm of the MIP. This could concern all eurozone countries (as in the Van Rompuy proposal) or perhaps just those facing ‘non-excessive’ macroeconomic imbalances, i.e. the eurozone countries for which an in-depth review was conducted based on the Alert Mechanism Report. In the latter scenario, the Council recommendations for all eurozone countries displaying macroeconomic imbalances would therefore become binding. Applied to the 2013 EU Semester, they would concern Belgium, Spain, France, Italy, Malta, the Netherlands, Finland and Slovenia. The Council’s previously non-binding ‘recommendations’ would almost become ‘prescriptions’ as the concerned countries would be forced to address them by signing a contract.

Making the MIP preventive arm binding would go far beyond the original scope of contractual arrangement – offering money for reforms – and would imply larger sovereignty transfers from the national to the EU level. Consequently, the

3. This apparent contradiction inevitably led to diverging political statements. The French President, François Hollande, asserted that contracts “*can only be done on a voluntary basis*” (Hollande 2012), while the German Chancellor, Angela Merkel, said that “*we have not yet clarified the conditions under which the contract is mandatory or not*” (Merkel, 2012).

line adopted by the Commission where contracts are only mandatory for countries under the corrective arm of the MIP is sensible. This means that the preventive arm of the MIP would not become more constraining, but only integrate the possibility of financial support for countries choosing to abide by the EU recommendations and to commit to reform. Since, ‘contracts’ under the form of the CAP are already mandatory for countries under the corrective arm of the MIP, the only modification of the corrective arm would be the availability of financial support.

4.2. Prioritizing in Country-Specific Recommendations is required to determine potential beneficiaries

By design, contracts seek to address the lack of economic reforms in countries where it is the most urgent and necessary for the well-functioning of the EMU. However, under their current form, CSRs lack justification and prioritisation, and tend to follow in some cases a bureaucratic necessity rather than a genuine need for EU guidance on policies (Hallerberg et al, 2012). The Commission proposal to draft CSRs with ‘*greater focus and specificity*’, and with a timetable for specific policy actions, aims to address this issue. At the same time, it should refrain from being too prescriptive as legitimacy concerns would dictate leaving most of the initiative to the concerned Member States.

The Commission should explain and justify better why and how specific reforms included in their recommendations are necessary for the EMU as a whole, and not just for the country itself. In its proposal for Council recommendations, the Commission would prioritize recommendations for reforms across countries to make clear which reforms are the most necessary and urgent in the eurozone. This would also be a first step towards overcoming economic and political trade-offs of different reforms (Hallerberg et al, 2011). The ex-ante discussion and coordination of major reform plans, as envisaged in Article 11 of the TSCG, may serve to highlight where the lack of reforms pose a problem to the EMU⁴.

Better prioritization of the CSRs would in turn allow for a pre-selection of the countries that may engage in a contractual arrangement. If all countries can submit a contract, the financial support will lack focus and efficiency. This would clearly be an unacceptable proposition as available funding will be fairly limited. Instead the Commission should invite those countries where imbalances are the most severe to draft and propose the reforms in a contractual arrangement.

4. This is as envisaged by the Commission (2012) (see 1.2). It should however be noted that the ex-ante discussion and coordination of major reform plans, as envisaged in Article 11 of the TSCG, in principle concern *envisaged* national reforms plans and not the *lack thereof*. This further suggests the Commission should not be overly prescriptive but rather highlight how the lack of reforms impacts the EMU as a whole.

In other words, the Commission would highlight the recommendations for which a contractual arrangement is sought. At this stage, it should probably propose the lump sum that would be made available to support reforms as a clear incentive for the concerned countries. Following the Council's adoption of CSR, 'invited' countries would then voluntarily prepare a contract during their National semester.

4.3. Financial support required for incentive AND solidarity reasons

Financial support should systematically be made available to countries engaging into a contract. This directly follows from the fact that contracts should be made on a voluntary basis (see 4.1), and therefore require a form of incentive. With no perspective for a solidarity funding mechanism, it seems very unlikely that a country would voluntarily submit itself to the contract's binding nature in the preventive arm of the MIP. However, the financial support should not be presented *strictly* as a financial incentive: it is also required on solidarity grounds.

If presented strictly as an incentive, creditor countries would wonder whether the countries with imbalances are actually not facing enough incentives for adopting the reforms. Even if the Commission underlines that the reforms are *not only* necessary for the country itself *but also* for all its partners (the EMU), benefits will systematically overlap. Hence, the perception might be that countries would implement the reforms even without the additional financial incentive. In an economic perspective, this would present a 'deadweight loss': supporting financially reforms that would have been implemented anyway. Moreover, competitiveness is a relative concept and some countries may feel more directly exposed. In practice and for example, a country like France may be asked to pay for the reforms whose core purpose is to increase the cost competitiveness of Spanish firms.

It could also be argued that the readily available incentive structure of the MIP should be fully exploited. Instead of designing a new 'positive' incentive, the 'negative' financial incentive available under the corrective arm of the MIP i.e. sanctions under the form of an interest-bearing deposit and fine should be used (Art 3 of regulation 1174/2011). In other words, rather than creating a 'carrot', the existing 'stick' could be used. The Commission would therefore need to recommend the Council to open the Excessive Imbalance Procedure. This would oblige the country facing excessive imbalances to adopt a Corrective Action Plan, and to face the possibility of sanctions should it fail to sufficiently take into considerations. In short, the Commission may decide to use its full

powers, which it has refrained from doing so far⁵. Making the EU funding of cohesion policy conditional upon addressing CSRs will also reinforce the binding nature of the recommendations (Verhelst, 2012).

Finally, by overly focusing on its incentive aspect, the money involved could ultimately be perceived as a side payment from creditor countries to entice vulnerable countries to submit themselves to binding arrangements and surveillance by the Commission. It is difficult to see how national endorsement of reforms will increase if the government appears to be selling off to Brussels and Berlin.

Financial support is probably more justifiable on solidarity grounds. Countries face major social costs in their devaluation process. Reforms are intended to speed up the adjustment, bringing forward most of the costs, in order to reap benefits in the medium term. Solidarity under the form of outright transfer can cushion the process, offering some relief. Contracts would convey a strong signal that solidarity – under the form of conditional grants rather than conditional loans – from creditor to debtor countries is possible in the eurozone.

Moral hazard arguments that were systematically raised as insurance mechanism proposals were made in the course of the crisis (in particular ‘Eurobonds’ proposals) would not hold in the case of contracts. Financial support imbedded in the contract would – by definition – be conditional upon the implementation of structural reforms. The contract rationale is *to speed up*, not *slow down* the adjustment process.

4.4. Countries under a financial assistance programme should be able to benefit from the new solidarity mechanism

Since the Commission is presenting contracts mostly on the ‘incentive’ ground, it also suggests that contracts should not concern the ‘programme countries’ (currently: Greece, Ireland, Portugal and Cyprus) (Commission, 2012). As they are already under a ‘contract’ in the shape of a Memorandum of Understanding (MoU) and Financial Assistance Facility Agreement (FFA), there would indeed be no practical need for an additional binding arrangement.

However, from a solidarity perspective, Greece, Portugal and maybe Ireland are in principle perfectly eligible. Barring them from grant-based financial support, and restricting them to loan-based solidarity (by the EFSM, EFSF, ESM) would

5. In the 2012 Semester, the Commission did not recommend that the EIP should be opened for any country. In the 2013 Semester, it suggested it may do so for Spain and Slovenia but only after assessing their National Reform Programmes and Stability Programmes.

bear a contradicting signal. The fact that, contrary to other potential recipients, these countries have lost access to financial markets is not a valid argument to restrict them to loans. To the contrary, the issues they are facing in their attempts to tap financial markets on their own reveal their current unsustainable state and their need of assistance.

Moreover, barring these small countries from additional grant-based support would not make great differences in terms of the required resources. Spain and Italy, which would allegedly become the main recipients of financial support, would already take up the bulk of the financing needs (about 85%) irrespective of the fund size.

4.5. Appropriate funding is required for the solidarity mechanism

The size of the funding cannot be as large as the one that would be involved in bigger solidarity schemes. It would seem unrealistic to consider pooling large sums at the European level for contractual arrangements, in particular if these are mostly ‘ad hoc’ mechanisms, rather than a step towards a genuine ‘fiscal capacity’ at the eurozone level.

However, if too limited, the common resources would seem inadequate to serve both as an incentive to sign a contract and as sizable solidarity fund able to cushion some of the costs of the competitive disinflation⁶. The maximum total funding commitment by eurozone countries to be considered should be between €30bn and €75bn. This would allow all the countries facing the greatest imbalances to potentially benefit from yearly net transfers of respectively 0.2% and 0.5% of GDP for 5 years. Beyond the committed amounts, actual disbursement would depend on the number and size of the countries engaging into a contractual arrangement. In the current political context, these figures may seem unrealistic or too ambitious. But no unnecessary political and legislative effort should be spent on designing contracts whose insufficient funding would unavoidably jeopardize their effectiveness.

At the press conference following the European Council of December 2012, German Chancellor Merkel voiced an early opinion on the size of the funding, when she mentioned that ‘[the solidarity fund would have] *a very limited budget, which would not lie in the hundreds of billions of dollars, but rather at €10, 15 or 20 billions*’ (Merkel, 2012). This range seems appropriate as a *yearly*

6. Considering the financial support as being essentially an incentive – albeit more limited than the one suggested here –, Verhelst (2013) suggests an alternative to creating a dedicated budget for the contracts: increasing the European co-financing of cohesion policy projects under the macroeconomic conditionality.

gross budget, much less so as the total capacity of the fund over several years. A total capacity limited to €20bn would only amount to about 0.001% of the combined Italian and Spanish GDP over 5 years, certainly too little to serve either as an incentive or as a meaningful solidarity mechanism.

4.6. Contracting countries should benefit from ESM precautionary credit lines

The ECB's pledge to do 'whatever it takes to save the euro', and subsequent announcement of its 'Outright Monetary Transactions' (OMT) programme over the summer 2012, so far considerably eased pressure in sovereign bond markets. However, as the ECB made its interventions conditional upon the granting of an ESM precautionary credit line, it cannot intervene beyond the positive effect this announcement had so far.

When signing a contract, non-programme countries should systematically be granted a precautionary credit line from the ESM. The conditionality attached to the ESM support would largely reflect the contractual arrangement content. The Eurogroup would take its decision according to the ESM treaty in parallel with the MIP procedure. The opening of an ESM credit line would in practice allow for potentially unlimited intervention of the ECB in secondary sovereign bond markets of the contracting country. Such a provision would definitely shelter the beneficiary country from any risk of self-fulfilling liquidity crisis degenerating into a solvency crisis (De Grauwe, 2011).

If the solidarity linked to contracts can contribute to limit the risk of excessive pressure in sovereign bond markets and the associated risks of contagion effects, the activation of potential ESM and ECB interventions would constitute a much stronger insurance policy. For the time of its reforms, the country would benefit from the ECB acting as a genuine lender of last resort i.e. one which can act not only on an unlimited basis, but also unconditionally. The ECB will independently decide at any point in time whether actual purchases in secondary markets are required. Such activation would be particularly warranted for large countries such as Spain and Italy which are too big to be rescued due to the limited capacity of the ESM (Vanden Bosch, 2012).

4.7. Legitimacy of the European Semester will not radically increase

The fact that contractual arrangements were put forward by the Council and the Commission not only reflects concerns about the effectiveness, but also about the legitimacy of the EU Semester. So far, countries have generally ignored the

non-binding recommendations for structural reforms (Hallerberg et al, 2012). Reinforcing the currently limited legitimacy of the EU Semester could in turn entice greater ‘national ownership’ and compliance with the CSRs. However, the contracts as an ad hoc mechanism can help address *some* but *not all* of the EU Semester legitimacy issues.

Greater involvement of the contracting countries’ National Parliament will necessarily result from the binding nature of the contract. The draft contract should in principle be backed by a parliamentary vote so that the government can benefit from a clear mandate to engage in negotiations with EU institutions. At the very least, National Parliament’s endorsement of reforms should be insured prior to the Council decision to grant support. This could promote a greater sense of legitimacy in so far as the government is willingly proposing the reforms and signing a contract rather than feeling coerced into doing it. It could also be envisaged for the Commission to directly address the National Parliament of the contracting country to expose its position. However, in non contracting countries, National Parliament ownership of non-binding EU policy recommendations would still essentially depend on how national procedures have adapted to the European semester.

At the EU level, contracts may offer the opportunity of a greater involvement of the European Parliament. However, in so far as its prerogative would not be extended beyond those foreseen by the ‘Economic dialogue’, the European Parliament would not increase the legitimacy of the decisions taken by the Council. Currently, the European Parliament is limited to a right of information on economic policies by the Treaty (under Art 121 (2) (5) TFEU). With no formal vote that could alter or overrule any of the decisions taken, the European Parliament will remain ‘*restricted to creating public awareness of decisions and requesting information on the decisions*’ (Hallerberg et al, 2012). Extending the European Parliament prerogatives would require a Treaty change which has not been envisaged for the introduction of contracts. In the current set-up, it may nonetheless adopt (non-binding) resolutions regarding the Council’s major decisions in the contract procedure in order to influence outcomes (adoption of the CSR, adoption of the contract, etc).

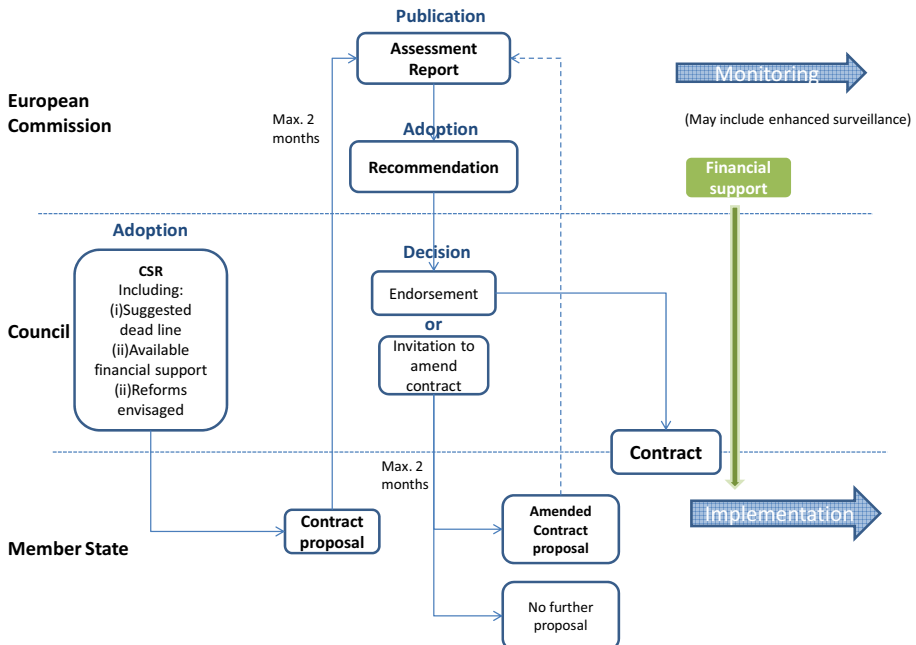
5. POSSIBLE CONTRACT PROCEDURE

This section briefly illustrates how, following the publication of the Country-Specific Recommendation, the contract negotiation phase and the ensuing monitoring phase could possibly occur. The exposed procedures largely rely on the existing ones under the corrective arm of the Macroeconomic Imbalance Procedure (MIP). This approach follows what the Commission suggested in its early proposal. The exposed procedures also integrate the recommendations made in the previous section.

Contract negotiation phase

Once a country submits a contract, it would follow a procedure similar to the one following the submission of a Corrective Action Plan under the corrective arm of the MIP, except that no sanctions would apply (as defined in art. 8 to 12 of regulation 1176/2011 on the prevention and correction of macroeconomic imbalances). Figure 1 illustrates how the ensuing negotiation steps would look like.

Figure 1: Contract procedure similar to the Excessive Imbalance Procedure (art 8-12 of regulation 1176/2011)



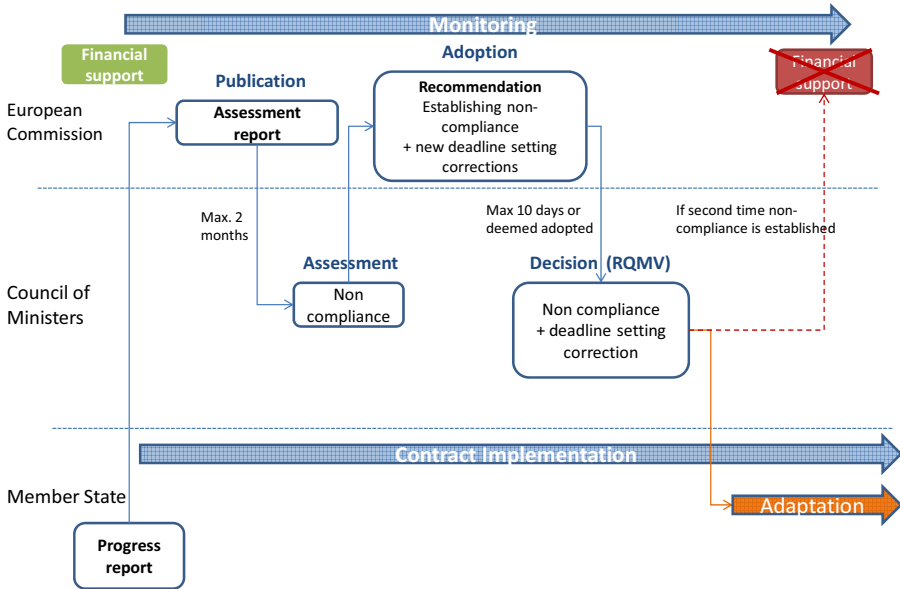
Source: Own compilation.

Following the Commission recommendation, the Council would adopt a CSR (i) highlighting which recommendation the Member State should address in priority and suggesting reforms, (ii) indicating how much funding can be made available and (iii) proposing a deadline. The addressed Member State would propose a contract following a national debate, notably involving its National Parliament. The Commission would have a maximum of two months to assess whether the reforms proposed by the Member State are sufficient, and recommend the Council to accept or request amendments accordingly. In the latter case, the Member would as a rule have up to two months to adapt its initial contract proposal. Once submitted to the Commission, it would be reassessed following the same procedure. After the Council endorsed the contract, notably by setting the detailed reform planning and the financial support made available, the contract would be 'validated'. Implementation of reforms by the Member State would start and a first tranche of financial support released. In parallel, monitoring by the Commission would ensure compliance.

Monitoring phase: withholding of financial support in case of non compliance

Figure 2 illustrates the main step of the monitoring phase that could lead to the withholding of the financial support. It follows on the existing steps under the Excessive Imbalance Procedure that can lead to sanctions (Art 10 regulation 1176/2011 and Art 3 regulation 1174/2011). The Member State regularly submits progress reports on the actions taken. Based on them, and possibly based on on-site missions ('enhanced surveillance'), the Commission publishes its assessment report. Then, the Council assesses whether the Member State complies with the contract. In case of non compliance, the Commission would adopt a recommendation establishing non-compliance and setting a new deadline for making corrections. The Council would be expected to endorse it, unless it decides, by qualified majority, to reject the recommendation within 10 days (i.e. reverse qualified majority would apply). The Member State would in turn be required to act. Should non compliance be established once more, the next financial support tranche would be withheld.

Figure 2: Withholding of financial support under the monitoring by the Commission



Source: Own compilation.

Note: Follows similar steps than under (Art 10 reg. 1176/2011 and Art 3 reg. 1174/2011). RQMV – Reverse Qualified Majority Voting.

CONCLUSION

In this paper, I essentially argued that contractual arrangements can make sense if they are undertaken on a voluntary basis by most eligible countries – those displaying the largest external adjustment needs – and that some sizable financial support is made available to them.

This last point – the necessity to associate money with commitment to structural reforms – will be a key point in the debate on these ‘contracts’. Contracts will only be possible if eurozone countries agree to commit sufficient funding, something of an unpalatable prospect in a period of fiscal consolidation. The money will serve as an incentive for the country to voluntarily engage in a contract, but is actually mostly justified on solidarity grounds. The targeted financial support will help cushion social and economic costs in countries adopting the reforms that should facilitate the recovery of their cost and price competitiveness. In the short to medium term, contracts would introduce net fiscal transfers between eurozone Member States – an unprecedented form of solidarity mechanism since the start of the eurozone crisis. The eurozone as a whole would thereby share some of the adjustment burden of the countries most affected by the crisis.

Although the discussions may convey signals on the degree of solidarity envisaged in the EMU in a longer-term perspective, discussions should stay focused on what contracts can deliver in the short term. As such, contracts may be perfectly designed as temporary ad hoc mechanisms that only aim to facilitate the correction of present imbalances of countries most afflicted by an exceptional crisis. Financial support will imply only targeted, limited and temporary transfers. It could possibly help address youth unemployment concerns. By definition, financial support will be made conditional upon structural reforms that intend to speed up not slow down the adjustment process. Moral hazard arguments that dominated previous debates on solidarity mechanisms will thus not hold this time.

However, agreeing on such mechanisms will be difficult. Some political and fiscal resources trade-offs may also be at play. The most obvious one is related to the banking union. Credit supply in several southern eurozone countries is increasingly becoming a problem, and the ECB’s link between its policy rate and borrowing in the real economy is broken. Restoring normal lending conditions and reversing financial fragmentation in the eurozone for capital to flow ‘downhill’ again from creditor to debtor countries must remain a priority. This would have a much larger impact than any form of fiscal transfers between countries. An effective and genuine banking union is therefore needed. This would in particular require common fiscal resources as a backstop for the resolution mecha-

nism i.e. a form of solidarity potentially competing with the financial support linked to contracts.

However, efforts on the banking union front should not undermine the rationale for contracts. Although not a “game-changer” on their own, the contracts can be very effective in supporting adjusting countries with targeted transfers. By promoting the restoration of competitiveness in the most vulnerable countries – a precondition for cross-border financial flows to resume in Europe – contracts complement the banking union initiative. They also share the longer-term objective of ‘smoothening the functioning of the EMU’. Finally, contracts may also convey an important signal that countries sharing the euro are committed to preserve their union, by increasing the scope of solidarity mechanisms within the eurozone.

ANNEX I

EU economic policy guidance on structural reforms – The European semester and the Macroeconomic Imbalance Procedure

A. How binding are structural reforms recommendations issued by the EU?

The European Semester provides an integrated framework for reviewing fiscal and macro-economic policies of EU Member States. Next to the Stability and Growth Pact (SGP) pillar which focuses on fiscal policies, two pillars define EU macroeconomic policy guidance: (i) the Macroeconomic Imbalance Procedure (MIP) and (ii) the EU2020 Integrated guidelines which merge the Broad Economic Policy Guidelines and Employment Guidelines. The final output of the European Semester are the Country-Specific Recommendations (CSRs) addressed to each Member State by the Council following a Commission proposal (draft CSR). Next to the strictly ‘fiscal’ recommendation issued under the SGP, a CSR thus includes several (about 5) recommendations concerning economic policies and reforms. Contracts would concern the MIP-related recommendations, i.e. those concerning the correction of economic imbalances, notably competitiveness imbalances.

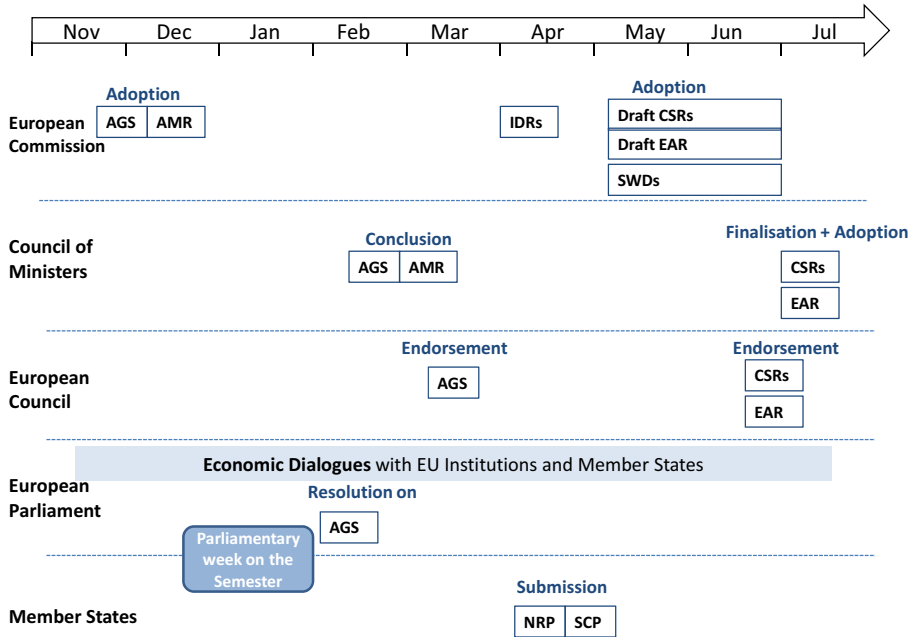
Under the **preventive arm of the MIP**, these recommendations are essentially **non-binding**, in so far that non-compliance does not lead to sanctions. They concern structural reforms which Member States may or may not abide by. The rationale for following them is enshrined in Art 121 TFEU, according to which Member States should treat their ‘economic policies as a matter of common concern’.

However, non-compliance may lead to the launch of the **corrective arm of the MIP**, where recommendations become **binding** for euro area countries as failure to obey leads to sanction (under regulation 1174/2011). The Excessive Imbalances Procedure (EIP) can be opened, if following its In-Depth Review, the Commission comes to the conclusion that a member State is affected by ‘excessive’ imbalances (Art 6.1 regulation 1176/2011). (Although in practice, the Commission waits for the country to state in its National Reform Programme how it intends to address the issue). In this case, the Council can decide at a qualified majority to require the country to take corrective action and submit a CAP. In the first two EU semester exercises (2011 and 2012), the Excessive Deficit Procedure was not opened for any countries.

B. What are the main steps of EU economic policy guidance under the European Semester?

Figure 3 provides the major steps of the time-table that characterizes the European Semester (based on the 2012/2013 process).

Figure 3: EU semester and the MIP: main steps towards the adoption of Country-specific recommendations



Note: AGS: Annual Growth Survey; CSRs: Country-Specific Recommendations; SCP: Stability or Convergence Programme; NRP: National Reform Programme; AMR: Alert Mechanism Report; IDRs: In-Depth Reviews; EAR: Euro Area Recommendation; SWDs: Staff Working Documents (assessing the NRP and SCPs); Source: own compilation.

Major policy orientations are prepared by the Commission in the Annual Growth Survey (AGS) which is based on the EU2020 Integrated guidelines. Published in November of the preceding year, this document sets a short list of policy priorities and a longer list of policy objectives for the EU as a whole, in terms of economic, budgetary and labour policies and other reforms to boost growth and employment. It is presented and simultaneously discussed in the Council of Ministers and in the European Parliament in January-February. In March, the Council of Ministers adopts these policy orientations which are subsequently endorsed by the European Council.

In parallel, the MIP also starts in November with the publication of the Alert Mechanism Report (AMR) by the Commission, which comprises a scoreboard of indicators on macroeconomic imbalances. These allow for the identification of the Member States warranting further analysis in In-Depth Reviews (IDRs). These are published in spring (March-April) on the basis of which any imbalances and their severity may be identified. If this qualitative analysis leads to the conclusion that a Member State is experiencing ‘imbalances’, the Commission



will propose for the Council to issue a (non-binding) recommendation (under Art 121(2) TFEU). These are integrated in the (draft) Country Specific Recommendations (CSRs), next to fiscal recommendations under the SGP. If instead the Commission considers a Member State is affected by ‘excessive imbalances’, it may recommend (under art 121(4) TFEU) the Council to adopt a recommendation establishing the existence of an ‘excessive imbalance’ and thereby to open the Excessive Imbalance Procedure (EIP). The EIP – the corrective arm of the MIP – requires the concerned country to submit a Corrective Action Plan (CAP). If the corrective action taken is deemed insufficient, the Commission may recommend the Council to adopt sanctions (Art.3 of regulation 1174/2011).

In the mean time, taking into account the AGS, Member States jointly submit their National Reform Programme (NRP) and their Stability or Convergence Programmes (SCP) in April. Reforms and measures presented in these programmes take into account the AGS priorities but also typically refer to CSRs issued in the EU Semester of the previous year. These are then assessed by the Commission in Staff Working Documents (SWDs) which accompany the draft Country Specific Recommendation for the Council. These are discussed in the Council and the European Parliament. The European semester ends with the endorsement of CSRs by the European Council and their formal adoption by the Council of ministers.

ANNEX II

Comparison of ‘Contractual Arrangement’ (Van Rompuy, 2012), and the ‘Convergence and Competitiveness instrument’ (European Commission, 2012)

	Contractual arrangement	Convergence and Competitiveness instrument
Contract		
Coverage	<ul style="list-style-type: none"> - Mandatory for all eurozone countries. - Voluntary for non eurozone countries. 	<ul style="list-style-type: none"> - Voluntary for countries under the preventive arm of the MIP. - Mandatory for countries under the preventive arm of the MIP.
Build-up to contract	In-depth reviews generalized to all EMU countries (based on thorough and on-the-ground dialogue with each country)	<ul style="list-style-type: none"> - Earlier publication of Staff Working Documents assessing the NRP and CSP allowing for ‘<i>informal dialogue on the analysis</i>’ - Coordination of major economic reforms: publication of an ‘<i>horizontal appraisal of the proposed major economic reforms</i>’ which would be discussed by Eurogroup and ECOFIN
Basis	Country Specific Recommendations	Country Specific Recommendations <ul style="list-style-type: none"> - <i>More detailed, policy-specific, and time bound – setting out specific policy measures and a timeframe for their implementation.</i> - CSRs focus on a small number of key elements related to weaknesses in the Member State concerned.
Initiative for proposing contract	Not explicit: would arise from ‘dialogue’ between Commission and each country.	Member States submit the contractual arrangement proposal.
Contract content	Specific, detailed and measurable reform agenda. With concrete timelines and specific modalities for monitoring and access to information.	<ul style="list-style-type: none"> - Voluntary contract: Similar to Corrective Action Plan under the corrective arm of the MIP. - Mandatory contract: the CAP is the basis for the contract.
Negotiation phase		<ul style="list-style-type: none"> - Countries under the corrective arm: Articles 8 to 12 of Regulation 1176/2011 apply. - Countries under preventive arm: similar procedure and deadlines should apply, including monitoring and assessment but without possible sanctions.
Ownership/ Accountability	Commission to report to European Parliament and National government to report to National Parliament on progress achieved.	Not specified for the CCI as such (broader discussion in the Blueprint). Accountability to European Parliament in the context of the ‘Economic Dialogue’
Flexibility	Significant economic change or altering political circumstances could lead to renegotiation.	

	Contractual arrangement	Convergence and Competitiveness instrument
Financial support		
Legal basis		Secondary legislation as part of the MIP based on art 136 TFEU or alternatively 352 TFEU (if necessary with enhanced cooperation).
Link with contractual arrangement	Optional	Systematically coupled with/embedded in the contract.
Link with reforms		<ul style="list-style-type: none"> - Only for reform packages important for both the MS and the EMU. - Lump sum not earmarked to specific reforms/overall allocation for financing measures flanking reforms (ex. Training programmes)
Instrument		Special fund/financial instrument Decision pursuant to Art 352 TFEU on expenditure being included in the EU Budget.
Resources	'Specific resources'. Treated separately from the Multiannual Financial Framework.	MS contribution based on contribution key dependent on GNI. Included in EU budget as assigned revenues (not under ceiling of MFF regulation)
Monitoring		Commission to issue warning (use of 121.4 TFEU) including call to correct deviation and timeline. Financing withheld when call not met.

ANNEX III

Size of financial support under two counter-cyclical mechanism proposals

Table 2: Yearly transfers under Pisani-Ferry et al (2012) proposition* over 2009-2014 for selected countries.

Year	Greece	Spain	Italy	Portugal	Southern country
2009	0.31%	1.03%	0.92%	0.69%	0.74%
2010	1.21%	1.17%	0.46%	–	0.71%
2011	2.34%	1.01%	–	–	0.84%
2012	3.10%	1.13%	0.76%	0.89%	1.47%
2013	3.42%	1.13%	0.93%	1.07%	1.64%
2014	2.63%	0.60%	0.72%	0.78%	1.18%
Average	2.17%	1.01%	0.63%	0.57%	1.10%

Source: AMECO database, output gaps as provided in its fall 2012 forecast version, including forecasts for 2012-2014.

Note: * calculated as 0.25% of output gap when above a 2% threshold (noted by “–” otherwise). ‘Southern country’ represents the average of the selected countries.

Table 3: Yearly transfers as percentage of GDP under Enderlein et al (2012) proposition* over 2009-2014 for selected countries.

Year	Greece	Spain	Italy	Portugal	Southern country
2009	-0.97%	0.22%	0.15%	-0.43%	-0.26%
2010	1.96%	1.25%	-0.15%	-0.24%	0.71%
2011	4.08%	1%	0.15%	0.68%	1.48%
2012	4.52%	0.81%	0.41%	0.85%	1.65%
2013	4.81%	0.77%	0.23%	0.59%	1.60%
2014	3.43%	0.13%	0.22%	0.54%	1.08%
Average	2.97%	0.70%	0.17%	0.33%	1.04%

Source: Enderlein et al. (2012) based on AMECO database, output gaps as provided in its fall 2012 forecast version, including forecasts for 2012-2014.

Note: * calculated as $T_i = a * ((y_{EZ} - y_{EZ}^*) / y_{EZ} - (y_i - y_i^*) / y_i^*) * y_i^*$ where T_i , is the yearly transfer reported in table, y denotes actual and y^* denotes potential output and a denotes the share of the difference between individual and eurozone output gap to be offset. a is set at 0.5. ‘Southern country’ represents the average of the selected countries.

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