# What is the appropriate role of structural reforms in E(M)U deepening?

Kurt Bayer,
Andreas Breitenfellner[1]

*Can flexibility-enhancing "structural" reforms at the national level substitute institutional reforms at the EU level, or are they rather complementary? In this article, we first look at more broadly defined structural reforms of both institutions and product and factor markets through the lens of economic theory – and also review empirical evidence. In particular, we discuss if and how reforms depend on macroeconomic conditions and policies. We then analyze the role that reforms play for the proper functioning of Economic and Monetary Union (EMU) and for fostering the well-being of EU citizens. In a nutshell, there is no one-size policy framework that fits all. The optimal set of structural policies for an economy depends on the quality of its institutions as well as its factor endowment, level of development and/or geographical location. We argue for extending the structural reform paradigm beyond "defensive" (flexibility-enhancing) toward "upgrading" (productivity-enhancing) instruments. Design, packaging, timing and sequencing will make or break such reforms. In general, reform ownership based on broad consensus is essential at the national level. EU involvement, however, would only be justified in the case of cross-border spillovers.*

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This article explores the following questions: First, in what way are structural reforms necessary for the functioning of the European Union (EU) and its Economic and Monetary Union (EMU)? Second, should traditional, mainly flexibility-enhancing reforms aimed at making prices and wages more reactive to shocks be complemented by reforms that enhance growth and well-being more directly? Third, should structural reforms originate from the EU or the national level?

Structural reform is one of the buzzwords in the EU's jargon. Reforms that "tackle obstacles to the fundamental drivers of growth" (European Commission, 2018a) figure importantly in the EU's regular country-specific recommendations presented to each EU country during the so-called European Semester. More tangibly, they form part of the strict conditionality of official financial assistance made available to stressed euro area countries monitored by European institutions and the IMF. The Commission's roadmap for completing Europe's Economic and Monetary Union holds that structural reforms strengthen the resilience of the euro area (European Commission, 2017a), a view shared by many economists, e.g. in a recent joint French-German paper (Bénassy-Quéré et al., 2018). Already back in 1958, however, the Austrian economist Fritz Machlup (1958) denounced the pervasively arbitrary use of the terms "structure" and "structural change" as "weasel words," maintaining that everyone was applying these terms to fit their predilection. Taking up Machlup's criticism, in what follows we define more clearly what we mean by structural reforms, while paying attention to their appropriateness, functioning and context.

[1] *Vienna Institute for International Economic Studies – wiiw, Austrian Institute of Economic Research – WIFO, kurtbayer15@gmail.com, Oesterreichische Nationalbank, Foreign Research Division, andreas.breitenfellner@oenb.at (corresponding author).* *Opinions expressed by the authors of studies do not necessarily reflect the official viewpoint of the Oesterreichische Nationalbank (OeNB), the wiiw or the Eurosystem.* *The authors would like to thank Vladimir Gligorov (wiiw), Edith Kitzmantel (Fiscal Advisory Council) and Michael Landesmann (wiiw) as well as Peter Backé and Julia Wörz (both OeNB) and an anonymous referee for very helpful comments and valuable suggestions.*

Typically, in economics one contrasts cyclical developments with structural ones. Structural policies target the fundamental supply side of an economy with a view to producing long-term effects[2]. In that sense, "structure" comprises many elements of the policy framework of an economy, including the rule of law, the level of technological development and capabilities, factor endowments, sectoral composition, employment and wage bargaining institutions, competition policy framework, education, welfare state institutions or infrastructure. Structural reforms are hence intended to change one or some of these elements.[3] Depending on one's objectives, one could distinguish between flexibility-enhancing and well-being-enhancing reforms. The latter foster inclusiveness and sustainability and boost economic potential and productivity. Quite comprehensively, the recent European Commission's Structural Reform Support Programme (SRSP) lists 34 areas of potential intervention, grouped into five sectors: (1) governance and public administration, (2) tax revenue and public financial management, (3) growth and business environment, (4) labor market, health and social services, and (5) financial sector and access to finance.[4] Still, some well-being-enhancing areas are underrepresented there, such as innovation policy, industrial policy, infrastructure or income and wealth distribution.

In section 1 of this article, we analyze varying theoretical views and evidence on structural reforms. Section 2 deals with the interaction of structural and macroeconomic policies. In section 3, we describe structural reforms as they pertain to the functioning of the European Union and of Economic and Monetary Union. We conclude in section 4, trying to answer the question whether and to what extent the EU needs to be involved in individual Member States' "structural reforms."

## 1 Shifts in the meaning of structural reforms and related evidence

The meaning of structural reforms has been subject to ever-changing interpretations. Before the global financial crisis that started in 2008, the term structural reform was mainly used to describe free market policies, such as cost cutting, deregulation, liberalization and privatization. In connection with advanced economies, it has been associated in particular with supply-side strategies to overcome stagflation and the Keynesian consensus of the post-war period (Klein, 2007). The OECD and the IMF were major international institutions propagating and imposing such policies (see e.g. Lall, 1995). Applied to emerging and developing economies, these policies constituted the Washington Consensus that guided the structural adjustment programs incorporating export-led development strategies (Rodrik, 2016).

Descriptive evidence shows that some structural convergence (European Commission, 2018b) within the EU and the euro area has been taking place[5]. Many EU Member States, particularly those heavily affected by the financial crisis

[2] *These supply-side conditions interact with demand conditions to form the overall performance of an economy.*

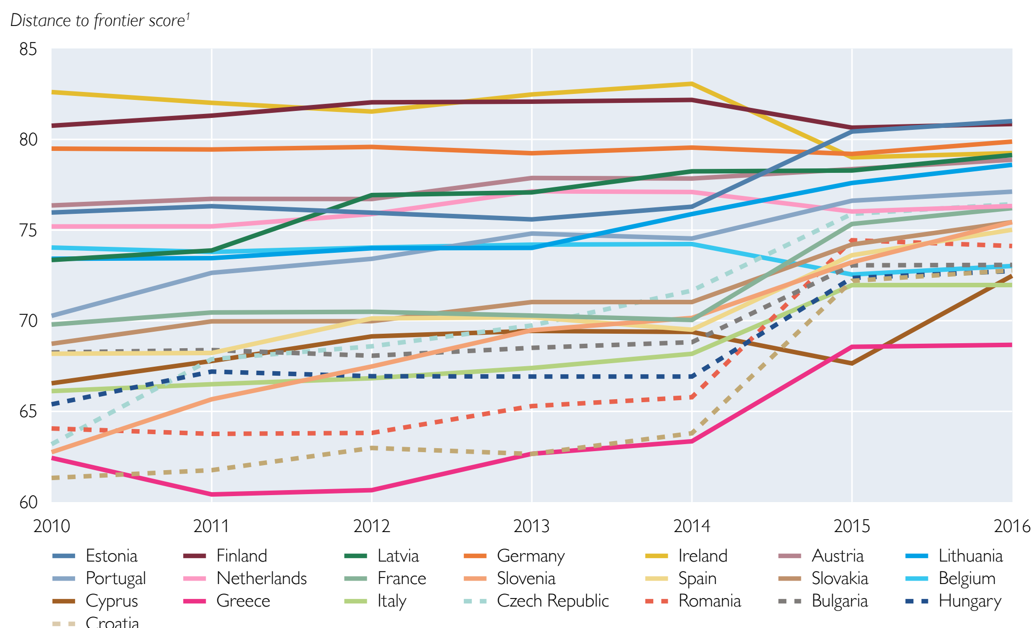
[3] *In the 1950s, the IMF and the World Bank introduced the term "structural adjustments" as preconditions for emergency loans, to denote measures like liberalizing trade, balancing budgets (which rather belongs to the realm of macroeconomic policies), removing price controls, encouraging foreign direct investment (FDI) and fighting corruption.*

[4] *See https://ec.europa.eu/info/sites/info/files/srsp-policy-areas_en_0.pdf.*

[5] *By "structural convergence," we mean greater similarity with respect to regulatory and institutional conditions; this may result in more cyclical alignment and even in more similar compositions of output.*

Chart 1

**Doing Business indicator – distance to frontier, for selected euro area and EU countries (2010–2016)**




*Source: World Bank.*

*[1] The "distance to frontier" score measures the distance of each economy to the best performance observed for each of the regulatory environment indicators across all economies in the Doing Business sample on a scale from 0 (lowest performance) to 100 (the frontier).*

and the subsequent sovereign debt crisis, have registered an improvement. This is reflected by indicators developed by the OECD, such as the Product Market Regulation (PMR) index and Employment Protection Legislation (EPL) index (Fischer and Stiglbauer, 2018). Indices developed by the European Commission (2018b) on labor market reforms and by the World Bank on the ease of Doing Business (chart 1) give a similar account of reform activities. Analysis built on these data suggests that both the euro area and the EU as a whole have achieved progress with (i.e. convergence in) business regulation and institutional quality over recent years, even though substantial differences remain (Canton and Petrucci, 2017).

There is good reason to assume that the structural convergence observed among the euro area countries will lead to business cycle convergence, which in turn facilitates conducting a common monetary policy for the euro area (Lukmanova and Tondl, 2016). Economic activity in EU countries has, indeed, become increasingly synchronized, particularly among euro area countries (Campos et al., 2017). In terms of per capita income levels, however, the post-crisis period has shown real divergence among the "old" EU Member States (EU-15), most of which are part of the euro area, despite substantial EU transfers via regional and structural funds (Janekalne, 2016). Meanwhile, the "new" Member States (EU-12) continued to successfully converge to the EU-15 group – with generally higher per capita income levels –, albeit at a slower pace than before the global financial crisis (Astrov et al., 2017).

## 2 The link between structural and macroeconomic policies

The financial crisis brought about a major shift in the policy prescription of international institutions. Most prominently, the OECD – a key advocate of structural reforms, and motivated by a self-reflective initiative called New Approaches to Economic Challenges (NAEC) – started to zero in on inequality and well-being (OECD, 2015). Going beyond the narrow concept of economic growth, the latter encompasses material conditions, quality of life and sustainability. The IMF has recently highlighted the importance of supportive macroeconomic conditions and policies, the careful prioritization and sequencing of reforms, targeting inclusive growth and even accepting a reversal of market-oriented pension system reforms or compromising on capital market liberalization. The European Commission (2017b), for its part, has elevated egalitarian considerations to the same level as efficiency and acknowledged the need for supporting macro policies.

The debate about the interaction of structural and macroeconomic policies ties in with the very origins of macroeconomic theory. The most commonly used approach is the so-called New Keynesian Model. This workhorse of micro-founded macroeconomics is actually a neoclassical model that incorporates imperfect competition in labor and product markets, which hampers wages and prices from swiftly adjusting to shocks. Only those rigidities justify countercyclical stabilization as conducted by fiscal authorities and central banks. Ideally, those institutions would complement their macroeconomic policies with structural reforms to strengthen the economy's long-run growth potential.

More recent analyses based on New Keynesian dynamic stochastic general equilibrium (DSGE) models reveal, however, that the issue is more complex, particularly in a monetary union and during a recession. Following the intuition of these models, reforms that boost competition in product and labor markets lead to a reduction of markups. While this implies an initially deflationary impact, the expansionary effects fade in only gradually via reallocated resources, at least in good times or given sufficient fiscal or monetary policy space. Galí (2012) challenges the widespread appraisal of the virtues of reform-induced wage flexibility in individual countries of a monetary union. Given constrained monetary policy, flexible wages cannot fulfill their assigned role of offsetting the negative impact of an adverse aggregate shock on employment and output. In a similar vein, Eggertsson et al. (2014) show that structural reforms, which the authors left unspecified, can even be contractionary in the short run amid economic slack that limits the monetary policy interest rate to its zero lower bound (ZLB). Using larger euro area models, Vogel (2014) finds only small and short-lived deflationary effects, while Fernández Villaverde et al. (2014) suggest a wealth effect even boosting consumption and labor supply. Cacciatore et al. (2017) reject the proposition that a binding ZLB generally matters. Empirical evidence in OECD countries from 1980 onward, however, substantiates the uncertainty about whether monetary policy can improve the growth impact of labor market reforms when the economy is in a recession or close to the ZLB, especially in the case of a euro area country (McAdam and Stracca, 2015).

In the policy-oriented debate on macrostructural interdependence, the focus, erstwhile on price stability and fiscal sustainability, has shifted to an explicit endorsement of a "two-handed" approach where monetary and fiscal policies accommodate structural reforms. Before the global financial crisis, Van Riet (2006)

stressed that structural reforms render the conduct of monetary policy more effective and efficient by dampening the medium-term outlook for inflation and smoothing the monetary transmission mechanism, respectively. In turn, stability-oriented monetary policy generates price transparency revealing the need for, as well as the welfare-enhancing benefits of, pro-competitive reforms. In the course of the crisis, however, the task of monetary policy was extended to "support economic activity," and policy makers are urged to raise the effectiveness of monetary accommodation by swiftly implementing structural reforms (Draghi, 2017).

Similarly, before the crisis, fiscal policy makers were keen on stabilizing public finances. This was seen both as a precondition for successful growth-enhancing reforms and as a financial stabilization instrument in itself. According to the OECD (2006), for instance, limited scope for fiscal expansion would leave only structural reforms to exert beneficial effects on employment and potential output. Beetsma and Debrun (2004), however, demonstrate that fiscal rules erode incentives for structural reforms requiring temporary fiscal deficits, thereby sacrificing future growth for present stability. Conversely, Buti et al. (2009) point out that structural reforms and fiscal discipline may either complement or substitute each other, depending on the short-term costs of the reform at hand – as demand might shrink due to labor shedding and income losses – and the time horizon of the respective government.

As the crisis progressed, though, emphasis shifted to an explicitly supportive role of fiscal expansion to help revive the economy while remaining in compliance with the EU's fiscal rules (Draghi, 2017). Additionally, in the context of the endeavors to deepen EMU, it was recently proposed to use EU budget funds to support structural reform efforts (European Commission, 2017a).

On balance, the economic policy literature recognizes the need for carefully designed, packaged and sequenced structural reforms coupled with complementary macroeconomic policies that mitigate transitory adjustment costs (IMF, 2016). However, analysis of the political economy of structural reforms reveals that governments tend to carry out reforms in dire economic times, exactly when fiscal space is lacking (Masuch et al., 2018). Furthermore, governments frequently restrict themselves to reforms for which they have political and public backing, even if the latter no longer reflect their more ambitious initial intentions.

## 3 Structural reform and E(M)U reform

How do national structural reforms relate to institutional reforms in terms of improving the functioning of the EU and EMU[6]? Here, we want to consider three views, according to which the two levels substitute, complement or even reinforce each other. First, to paraphrase an "ordoliberal" view widely held by German academics (see survey of De Ville and Berckvens, 2015), it suffices that every country does its "homework" in following principles and rules. As reforms at the country level substitute those at the EU level, the latter becomes superfluous. Second, implying a complementary role for both levels, in contrast, EU institutions tend to hold a "Brussels-Frankfurt consensus" view, according to which E(M)U deepening is useful and feasible only when the country-specific homework

[6] *In line with Article 3 of the Treaty of Lisbon, the ultimate aim of both EMU and the EU as a whole is to enhance the well-being of the EU's citizens.*

is completed (Cœuré, 2016). Third, many economists claim that EMU institutional reform is itself the most important structural reform; it is the precondition for local reforms to succeed (Baldwin and Giavazzi, 2016). In line with this "integral" view, a successful currency union requires a unified state or state-like political framework.

It is easy to detect which principal EU policy actors champion which view. At one end of the spectrum, the northern, core and Baltic Member States prioritize structural reforms and fiscal responsibility at the national level (Government of Sweden, 2018). By contrast, the French position attests to greater European solidarity rather than more responsibility – a view essentially shared by most southern Member States (Macron, 2017). To be sure, different interests do not rule out compromise, as exemplified by the French-German roadmap for the euro area, which – while not explicitly mentioning structural reforms – stresses the need for economic coordination and integration in a currency union (German Federal Government, 2018).

The theoretical discussion of the role of structural reforms in contributing to resilience in a currency union harks back to the theory of the optimal currency area (OCA) pioneered by Mundell, Kenen and McKinnon in the 1960s. According to this approach, in the case of an asymmetric shock, flexible costs and prices would replace the no longer available exchange rate mechanism. However, the postulated flexibility does not necessarily imply a decentralized structure, as in the case of bargaining systems. For instance, both employment growth and wage restraint in the wake of the Great Recession were higher in centralized and multi-level collective bargaining systems than in countries with firm-level or individual bargaining (OECD, 2017). This is because workers' and employers' umbrella organizations assume sector- or nation-wide responsibility – as opposed to small special interest groups in critical industries that free ride by excessively exploiting their bargaining power. Furthermore, the consensual practice of social partnership extends beyond wage bargaining and provides the ownership needed for balanced and sustainable structural reforms. Moreover, labor market regimes with very little employment protection tend to promote less long-run accumulation of firm-specific knowledge. Yet, corporate investment in human capital is vital for productivity-enhancing innovation. This may be why Nordic and Central European high-wage economies with rather rigid labor market regimes were more successful in securing the survival of their industrial sectors than several Anglo-Saxon economies that tend to emphasize individualism in their industrial relations (Kleinknecht et al., 2014).

The significant Five Presidents' Report on completing EMU (Juncker et al., 2015) states that "the ultimate aim is to achieve similarly resilient economic structures throughout the euro area" (p. 7) and "convergence towards similarly resilient national economic structures would be a condition to access (...)" proposed fiscal capacities for the euro area (p. 21). Providing further specifications, the European Commission's Roadmap (2017a) holds that reform-related funds should be included in the post-2021 Multiannual Financial Framework (i.e. the EU's long-term budget plan). Concretely, the European Commission proposed a new Reform Support Programme with an overall budget of EUR 25 billion (with a duration of seven years). This program is intended to provide financial and technical support for

reforms in Member States identified in the context of the European Semester, or in preparation for euro area membership (European Commission, 2018c).[7]

This raises several questions: Why incentivize something that should be in the Member States' own interest anyway? What justifies extending the EU's competences into domains of national sovereignty? Do asserted spillovers calling for EU involvement exist in areas other than capital markets, product market competition and tax policy? Will the funds provided suffice to mitigate the short-term costs of structural reforms? We maintain that EU involvement in national structural reforms is defensible if (1) excessive external or internal imbalances – mainly in current account and fiscal positions – create negative spillovers to other Member States, (2) reforms create positive externalities for productivity growth but possibly also negative ones for the competitiveness of other Member States, (3) they improve the functioning of the Single Market, (4) they prevent regulatory arbitrage ("race to the bottom"), and (5) they promote risk sharing (solidarity).

Proposals for reordering EU economic policies must take into consideration that many policy instruments are already in place, although they may deliver inadequate results (see e.g. Müller et al., 2015).[8] The main tool for encouraging EU and euro area members to carry out structural reforms is the European Semester. To be sure, it tends to prioritize budget consolidation over structural reforms, given binding procedures. After all, the purpose of compensating for the short-term costs of structural reforms is embedded in the Commission's changes to the way it applies the Stability and Growth Pact ("structural reform clause"). Apart from the above-mentioned proposals for positive reform incentives from the EU budget, another idea is to promote reforms through EU budget conditionality, i.e. to tie reflows of structural and cohesion funds to the respect of the rule of law (Halmai, 2018). Unanimity requirements in EU decision making, however, cast doubt on the feasibility of this proposal.

A couple of issues deserve further discussion: First, policies could focus more on citizens' overall socioeconomic well-being through upgrading structural reforms. This would imply a correction of the EU's policy recommendations in which it tended to lean toward budget consolidation and internal devaluation during the euro area crisis. Upgrading reforms include revenue-securing tax coordination, productivity-oriented collective bargaining, skills upgrading, industrial policy promoting research and innovation, effective anti-monopoly policy, as well as strategies fostering decarbonization and inclusiveness and limiting financialization. On a positive note, the current Commission under President Juncker has acknowledged the centrifugal threat stemming from income divergence within the euro area, and consequently changed the structural reform agenda. One result was the Proclamation on the Pillar of Social Rights (Council of the European Union, 2017) that, albeit not binding, has considerably influenced the country-specific recommendations in the latest European Semester.

[7] *Additionally, a European Investment Stabilisation Function would complement efforts to absorb large asymmetric macroeconomic shocks in the euro area and its (potential) members, guaranteeing back-to-back loans of up to EUR 30 billion. Such loans would be available to Member States with "sound fiscal and macroeconomic policies"; no explicit reference is made to any structural conditionality.*

[8] *One could go even further and argue that business-friendly reforms over the last decades led to declining labor shares and rising returns on investment in many OECD countries – without triggering higher investment (Janssen, 2018).*

Second, the relationship between macroeconomic imbalances and structural reforms is unclear (Gros, 2016). For instance, is Germany's current account surplus the result of its restrained budget and wage policies, or does it rather result from a structurally determined lack of German demand? While the first explanation entails mere quantitative adjustment, the latter implies a blurred line between demand-side and supply-side issues. The European Commission (2018d, p. 16) recommends both "fiscal and structural policies to support potential growth and domestic demand." How contradictory this strategy is becomes visible when we compare the emphasis to "boost competition in the service sector" (ibid., p. 12) with the statement that "service sector wages are the lowest in the EU relative to manufacturing wages" (ibid., p. 28).

Third, one could ask what the "optimal level of rigidity" of a market economy should be. The optimality of minimal or even zero rigidity implied by EU policy recommendations would require structural convergence to a "one-size-fits-all" model. Of course, the country-specific recommendations in the European Semester do not adhere to such a model, although the EU has advised completely diverse countries to carry out the same type of reforms, e.g. in the service sector, to solve either their supply or demand problem. More essentially, in a managed market economy some "rigidities" are justifiable on economic grounds – creating a level playing field that constitutes markets – and by noneconomic factors: cultural, social, historical, territorial identity traits (e.g. customs and citizens' preferences) which safeguard the public's support for policy measures. In other words, some degree of market imperfection might be well warranted by political economy considerations – conditioning the very existence of the market itself.

Fourth, should the EU apply rather "restrictive" instruments, such as negative sanctions in the Stability and Growth Pact, or rather "positive and enabling incentives," as proposed in the new Reform Support Programme? Insights from modern pedagogy seem to support the European Commission in pursuing the latter approach.

Finally, we would like to briefly touch on the principle of subsidiarity in EU law, according to which political issues should be dealt with at the most local level consistent with their resolution: What is the optimal division of labor between E(M)U institutions and Member States with regard to national reforms? One approach could be that the EU level should be responsible for diagnostics, macro objectives and safeguarding the functioning of EMU, while the Member States should be responsible for implementing their own path toward these objectives. Nevertheless, subsidiarity may even imply centralization of critical tasks and sharing sovereignty beyond loose and slow policy coordination – a concept that is, in fact, reflected in the institutional reform envisaged in the Five Presidents' report to accomplish a genuine EMU.

## 4 Concluding remarks

There is consensus in the literature that macroeconomic policy effectiveness interacts with structural conditions and vice versa. The latter are vaguely defined as the fundamental institutions and regulations of an economy and society, having evolved over time. There is also widespread agreement that structural reforms, while on balance positive for medium-term growth and employment, may cause short-term costs to society, the economy and the environment. Public acceptance will depend on how governments manage these costs. Governments may either ignore the costs

altogether, compensate the losers, and/or engage in a mix of compensation and proactive policies in order to lessen the negative impacts of reform. Conventional economic policy advice mostly centers on "defensive" structural reforms. In other words, labor market and product market rigidities are considered to be mainly cost factors that influence competitiveness negatively (and hence reforming them away leads to internal devaluation[9]). In contrast, a number of "upgrading" structural reforms, which enable the economy to progress toward the technological frontier, still attract less attention. There are, however, signs of the European Semester procedure moving in this direction.

National preferences (e.g. for more ecology-oriented production and consumption or for publicly provided health care) will determine the "optimal" structural conditions for each country or each region. Not all such preferences are "rigidities" to be reformed away, but rather help create markets and/or safeguard political and social cohesion. Thus, there is no single optimal policy framework across all Member States and societies, but a variety of appropriate sets of policies based on historical, social and cultural diversities. Whether structural reforms may contribute to sustainable and inclusive growth depends on their actual design and timing. While international institutions are prone to recommend comprehensive packages that combine, for instance, carefully sequenced product and labor market reforms with macroeconomic incentives, other policy advisors suggest that merely the most binding constraints to prosperity be fixed (Rodrik, 2016). At the same time, several institutional conditions must exist for market economies to flourish: the rule of law, property rights, effective tax collection and budgeting, regulation of industries, level playing field competition, adequate education, social security, regard for the environment and social cohesion, and freedom of firms entering and leaving the product market.

In line with the subsidiarity principle, we conclude that most of these policies should be implemented at the Member State level, not least to meet diverse national preferences. However, where (negative and positive) spillovers exist, and where the smooth functioning of the Single Market and of Europe's monetary union is at stake, the initiative for devising appropriate structural reforms should come from the EU and be supported by local consensus building.

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[9] *With regard to the controversial debate about internal devaluation and its extent and conditions, e.g. Wyplosz and Sgherri (2016) show that internal devaluation strategies might have failed in the past, for instance, due to underestimated fiscal and external multipliers.*

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