EUROPEAN POLICY CENTRE

POLICY BRIEF

13 September 2013

Developing the social dimension of a deep and genuine Economic and Monetary Union

László Andor

BACKGROUND

The double-dip recession in the euro area, the on-going sovereign debt crisis and the intensifying social emergency in many of the euro zone's 'peripheral' countries have put under the political spotlight systemic flaws in the design of Europe's Economic and Monetary Union (EMU). The project of a currency union of structurally diverse countries without a common budget[1] and without collective economic policy decision-making based on supranational democracy had already been criticised by many economists in the early 1990s, but it took a protracted economic and social crisis for the **existential questions of the EMU** to begin to be re-examined at a high political level.

The first phase of the euro crisis has up to now been managed through emergency bailout mechanisms and innovative actions of the European Central Bank (ECB). However, the euro area is experiencing an **unprecedented socio-economic polarisation**. Deeper reform of the EMU rules and instruments is needed in order to safeguard the nascent recovery and make the EMU work towards balanced economic development and sustainable growth - objectives set out in the Treaty on European Union.

The introduction of the euro has removed exchange rates as an adjustment mechanism among members of the currency union and implies a uniform base interest rate for all euro-area countries, despite **differences in economic fundamentals** such as sector structure, productivity and labour market characteristics. Such differences, however, decrease the likelihood of Member States finding themselves at a similar point of the economic cycle at any given time, and consequently make one-size-fits-all monetary policy less suitable.

The **unusual mandate of the ECB** – designating price stability as the bank's primary objective, with growth and employment as secondary – means that it is difficult to alleviate accumulated imbalances between creditors and debtors in the EMU through somewhat heightened inflation.

National fiscal policies are (logically) subject to rules and oversight that aim to prevent individual governments from becoming insolvent and undermining the euro's stability. However, these rules can lead to pro-cyclical fiscal consolidation, and there is unfortunately **no shared fiscal capacity** that would enable collectively agreed fiscal expansion in times of massive cyclical downturn or in the case of strong asymmetries between different parts of the currency union.

The EMU is **ill-equipped to deal with asymmetric shocks** (such as excessive capital inflows or the bursting of construction or finance bubbles in some member economies) due to the absence of fiscal transfers of a cross-national nature that could help synchronise economic cycles by channelling disposable income from momentarily stronger to momentarily weaker countries (where they could fuel the economy faster).

In its present form, the EMU (and particularly its third stage, i.e. currency union) excludes unilateral adjustment of its member economies through the exchange rate or interest rate (by definition), as well as by inflation or fiscal expansion (by design). The only remaining adjustment mechanism is so-called **internal devaluation**, which involves social damage: it is an effort to restore price competitiveness by reducing costs, including through layoffs and wage cuts in both the public and private sectors.

The King Baudouin Foundation and Compagnia di San Paolo are strategic partners of the European Policy Centre

Such measures can destroy the social compact in a given country, often have a disproportionate impact on lower-income groups and negatively affect aggregate demand. Internal devaluation can produce results under certain specific circumstances, i.e. in small open economies enjoying sustained demand from trading partners, but it certainly cannot represent a general model for a large union whose overall exports and imports are balanced.

The absence of any other adjustment mechanism is one reason why the EMU is sometimes criticised for **lacking a social dimension**: unless countries undergoing an asymmetric shock have low debt/GDP ratios and can thus afford individual fiscal expansion (which will most likely not be the case in the next few decades), the only possible adjustment in the EMU is through cost-cutting and ever-greater flexibility in the labour market. Transnationally mobile labour represents only 3-4% of the euro zone's population, meaning that l**abour mobility cannot be expected to significantly alleviate high unemployment** in 'peripheral' countries, while the absence of transnational fiscal transfers implies that individual Member States need to be concerned about outflows of the qualified workforce and the consequent worsening of economic dependency ratios.

The social dimension of the EMU must be a set of **rules, procedures and capacities** at European level that can sustain the potential for real economic convergence and social progress for all Member States. Governments and EU institutions must ensure that the EU's fundamental characteristics as a highly competitive social market economy are maintained at the stage of currency union, by being able to **reconcile economic efficiency and social equity** in EMU-level decision-making. Such a social dimension cannot be achieved without a mechanism for collectively monitoring and preventing **employment and social imbalances** – and for collectively detecting and tackling them when they arise.

Converging socio-economic outcomes and territorially-balanced economic development have been long-standing concerns of the European Community. At the very start, such considerations led to the establishment of the European Social Fund (1958). In the context of the development of the Single Market, the commitment to convergence resulted in the emergence of the Cohesion Policy, which today amounts to about 0.4% of EU GDP. However, **socio-economic convergence** is of even greater concern inside a monetary union than in a Single Market, precisely because of the missing possibility of exchange rate adjustment and the constraints resulting from the jointly agreed fiscal framework.

The so-called Four Presidents' report "Towards a Genuine Economic and Monetary Union", outlined in June and further developed in October and December 2012, provided a basis for focused discussions among EU leaders on how to overcome the EMU's initial design flaws and **complete the monetary union with a real economic union**. It envisaged *inter alia* developing a common capacity to address banking crises, further strengthening coordination of national policies, and creating a common budget able to help absorb asymmetric shocks, all underpinned by greater democratic legitimacy and accountability, i.e. greater political union. The European Parliament adopted a comprehensive resolution on the same subject – the 'Thyssen report' – in November 2012.

The European Commission contributed to this discussion with its "Blueprint for a Deep and Genuine EMU". The December 2012 European Council decided to examine several issues in greater detail during 2013, among which the "social dimension of the EMU, including social dialogue". The Commission has subsequently made proposals on *ex ante* coordination of major economic reforms and the establishment of an embryonic fiscal capacity for the EMU where transfers of funds would be conditional upon implementation of various reforms. A Commission communication on the social dimension of the EMU is planned for 2 October 2013.

STATE OF PLAY

The first focused debate on the EMU's social dimension in the Council took place on 28 February 2013 with the participation of President Herman Van Rompuy. This meeting saw considerable consensus on the need to **systematically detect and address key employment and social challenges** in the monetary union, although views differed on the extent to which monetary union membership constrains (or not) the ability of individual governments to mitigate asymmetric employment and social crises on their own.

These differences are – understandably – related to Member States' varying socio-economic situations, and also to the predominantly national competences in the field of employment and social policies in the EU. Nonetheless, it has been broadly accepted that due to the limited availability of adjustment mechanisms for national economies within the EMU, **unemployment and social crises risk developing to a greater extent in a currency union** than in a more flexible exchange rate regime, unless they are anticipated and addressed by the currency union on a collective basis.

It is increasingly recognised that **severe employment and social problems in individual countries generate 'spill-over' effects** beyond national borders, notably through four channels: trade with other Member States, competitiveness, cross-border migration, and financial markets.

Higher unemployment, declining household incomes or rising poverty in any Member State imply **weaker demand** for the products of other Member States. Moreover, unemployment and poverty are eroding the workforce's skills, thereby undermining the long-term growth potential and competitiveness of the given Member State (making people less employable and less productive), and through trade they erode the growth potential of the others as well. This lasting output effect of deterioration in human and physical capital caused by cyclical downturns is known as **hysteresis**.

Reductions in public budgets for education, active labour market policies or other 'social investments' have similar negative effects and can mean that an asymmetric cyclical shock, which should normally be temporary, can **unleash longer-lasting economic divergence** within the monetary union, in turn decreasing the advantages and increasing the disadvantages of the common currency. Lack of opportunities and inadequate social protection systems in the affected Member States can also trigger **emigration**, often of the most qualified workforce, to other Member States or to the rest of the world.

Finally, high unemployment rates and severe social problems can also lead to pressures on current and/or future public budgets and to **social unrest**, which may trigger contagion in financial markets as **higher risk premia** are demanded on the sovereign debt of countries perceived as unstable, driving up the cost of credit for companies and households in these countries to prohibitive levels.

For all these reasons, it is important to step up **surveillance of employment and social problems** in the EMU and to ensure a **timely and effective policy response**. The June 2013 European Council concluded clearly that the social dimension of the EMU should be strengthened, highlighting three elements:

- Better monitoring and taking into account of the social and labour market situations within the EMU, notably through appropriate social and employment indicators within the European Semester;
- better coordination of employment and social policies (while respecting national competences), and;
- the important role played by social partners and social dialogue, including at national level, in addressing key employment and social challenges.

The importance of this debate lies in the fact that while budgetary policies or price developments in individual Member States have long been recognised as relevant factors for the currency union's functioning, employment and social developments have often been understood as matters that are of *common concern* but fall under national responsibility and do not represent core issues for the euro zone's stability or growth performance. Today, this perception is beginning to change and we are moving towards **systematic monitoring** of key employment and social developments as one of the bases for shaping economic policies at EMU level.

At their informal meeting in Vilnius in July 2013, EU Employment and Social Affairs Ministers had a first discussion on the **key indicators relevant for a well-functioning EMU**. The debate focused on five main issues – unemployment, youth unemployment and inactivity, household income, poverty and inequalities.

The EMU has been experiencing growing disparities in all these areas over the past five years, notably when comparing the performance of the 'core' (or 'Northern') countries on the one hand, and the 'peripheral' (or 'Southern') countries on the other. This **core-periphery divergence** during the crisis years has been stronger within the currency union than among countries not using the euro. Particularly visible is the divergence in the rates of **unemployment** and of young people neither in employment, education or training (**NEETs**).

Greater divergence within the euro area than outside of it is also apparent in the cases of **household income and inequalities**, which is a bad sign regarding the ability of tax and expenditure policies to stabilise the social situation and aggregate demand in cases of economic shocks. **Poverty** rates have also grown in the euro zone 'periphery' while remaining steady in the 'core'. All these developments indicate possible further economic, social and political problems ahead for the euro zone.

Ministers have also discussed ways in which the coordination of employment and social policies could be strengthened on the basis of the existing EU Treaties. The recently adopted Council recommendation on establishing a **Youth Guarantee** provides a good example of a *policy benchmark* (or non-binding standard) established at European level to address the growing problem of youth unemployment and inactivity, which is particularly serious in certain 'peripheral' countries and has negative economic spill-over effects on the EMU as a whole.

The European Council agreed in February 2013 to earmark €6bn within the EU's 2014-20 budget to a Youth Employment Initiative supporting the implementation of the Youth Guarantee. This **combination of a clear policy benchmark and dedicated fiscal capacity** at European level could provide an example for tackling other key employment and social challenges that negatively affect the performance of the EMU.

In parallel, the Commission and social partner organisations have been reflecting on ways in which the **involvement of European and national social partners in EMU governance** could be strengthened, in order to keep pace with the growing importance of EMU-level decisions for national labour markets and social protection systems. EU-level social partners had an exchange of views with the College of Commissioners in May 2013, and have worked towards bipartite consensus on this issue.

The Commission has also made progress in its technical work exploring the feasibility of a **European unemployment benefit scheme** potentially acting as an automatic fiscal stabiliser *at EMU level*, helping to offset the weakening (if not the disappearance) of national automatic stabilisers resulting from the sovereign debt crisis. This idea, debated since the late 1970s, was also mentioned in the Commission's Blueprint and the Four Presidents' report of 2012, and the European Parliament's Employment and Social Affairs Committee held a hearing on it in July 2013.

PROSPECTS

The June 2013 European Council decided to return to the issue of the EMU's social dimension at the October and December summits. The discussion on key employment and social indicators will continue in the Employment Committee (EMCO) and the Social Protection Committee (SPC), and subsequently in the Council of Employment and Social Affairs Ministers, in order to feed into these summits.

The Commission is working towards a specific proposal for a **scoreboard of key employment and social indicators** in its upcoming communication on the social dimension of the EMU. The scoreboard and its analysis would then form part of the Commission's draft Joint Employment Report, to be published in mid-November alongside the Annual Growth Survey. We are organising a conference on *Restoring socio-economic convergence in Europe* on 10 October 2013, and the issue of a possible EMU-level unemployment benefit scheme will be addressed at an expert conference organised by Bertelsmann Stiftung on 11 October.

Of course, the introduction of systematic monitoring of key employment and social challenges in the EMU and the strengthening of employment and social policy coordination would – while necessary – not represent magic solutions to rapidly overcome socio-economic divergence in the currency union. What they would facilitate is **stronger consideration of key employment and social problems within the European Semester** process and the country-specific recommendations that result from it, helping to ensure that adequate resources are allocated to tackling these problems in the interest of the currency union as a whole. It would also be useful in this respect to further strengthen cooperation between the Finance and the Employment and Social Affairs Ministers, and to step up the involvement of social partners in economic policymaking at both EMU and national levels.

Looking further ahead, a key next step would be to deepen the discussion on the possible design of an **EMU-level fiscal capacity** that would be flexible enough to support recovery from cyclical downturns, without setting up permanent transfers. In parallel, it would also be useful to develop a focused debate on ways to define possibly binding **employment and social standards** in the EMU, helping to prevent a social race-to-the-bottom during adjustment processes.

To the extent that Treaty changes would be necessary to provide a basis for some of the measures under discussion, notably stronger coordination or binding standards in the field of employment and social policies or an EMU-level fiscal capacity with an automatic stabilisation function, these would be likely addressed by the Commission together with other such elements of EMU reform, contributing to a thorough debate in the context of the upcoming European elections.

László Andor is the EU Commissioner for Employment, Social Affairs and Inclusion.

This paper was prepared on the occasion of a seminar in honour of Hans Martens, the EPC's outgoing Chief Executive.

1. The EU budget is too small (about 1% of EU GDP), serves the whole EU28 rather than the currency union of 17 (soon 18) countries, and its 7-year programming cycle and focus on investment imply that it is not flexible enough to absorb asymmetric shocks.

European Policy Centre ■ Résidence Palace, 155 rue de la Loi, 1040 Brussels, Belgium
Tel: +32 (0)2 231 03 40 ■ Fax: +32 (0)2 231 07 04 ■ Email: info@epc.eu ■ Twitter: @epc_eu ■ Website: www.epc.eu

Europe for Citizens
Programme

With the support of the Europe for Citizens Programme of the European Union.