LSE European Institute 'Perspectives on Europe' public lecture

Countering the crisis: fixing the monetary union and upgrading EU employment policy

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Ladies and Gentlemen,

You may have seen the Spring Economic Forecast which the European Commission published last Friday.

It contains very little in terms of good news.

GDP is forecast to remain negative in the EU27 throughout 2013, with a possible growth of around 1% in 2014.

There are also many downside risks, related especially to further development of the euro crisis, and you would be right in pointing out that over the past years, official economic forecasts concerning Europe have mostly proven over-optimistic.

In fact, the euro area has been in a double-dip recession for more than a year.

Of course, with such worrying outlook, the debate on how to achieve growth is intensifying.

In 2010-11, expectations were based on a safe exit from the crisis. Therefore, fiscal consolidation was given first priority in order to assure financial markets of governments' responsibility, on the assumption that investment and growth would then return thanks to increased confidence.

But in practice this was followed by a double-dip recession with rising unemployment as well as debt-to-GDP ratios. We have also seen a growing divergence between the 'core' and 'peripheral' countries within the euro zone, as I will show.

In March 2012, 25 European governments signed up to the so-called Fiscal Compact, committing themselves to strict limits on structural budget deficits and to a gradual reduction of debt levels to 60% of GDP while the current average is about 90%.

But then the focus started slowly shifting from the numerator to the denominator of the debt/GDP ratio.

In June, the European Council agreed on a Compact for Growth and Jobs, which included for instance a capital increase for the European Investment Bank.

A discussion has also re-emerged on giving a more favourable eye to investment expenditure when assessing excessive deficits.

And today we can see that the pace of deficit reduction is somewhat slowing down, while increasing emphasis is being put on ‘structural reform’ and there is growing sensitivity to the importance of aggregate demand.

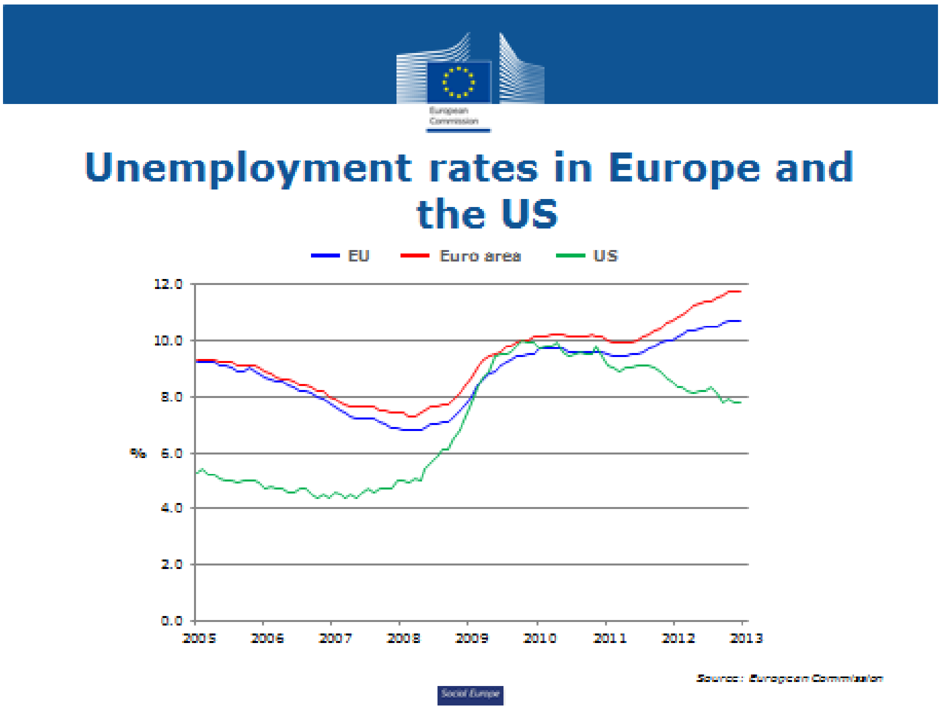
Europe has a very good strategy for smart, sustainable and inclusive growth by 2020.

I would not say that we have a convincing strategy for a recovery in the short term yet, but the debate is certainly shifting in the right direction.

Today I want to present to you how I see the right recovery strategy from the employment policy angle, building on three big policy initiatives the Commission has put forward over the past year: the Employment Package, the Youth Employment Package and the Social Investment Package.

But I also want to elaborate on the issue of reconstructing Europe’s monetary union. I will argue that developing a robust long-term architecture for the economic and monetary union (EMU) is of fundamental importance if we want to see a recovery during the coming years.

Crisis and divergence in Europe

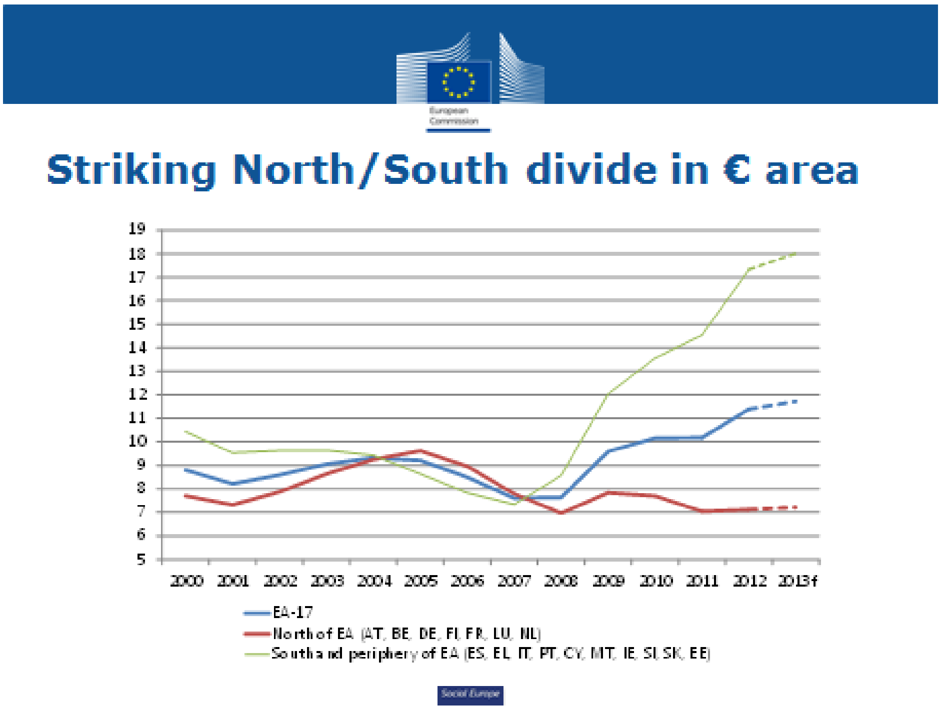


The unemployment rate in Europe has increased very significantly since 2008. As of March 2013, it is almost 11% in the EU-27, and exceeds 12% in the euro zone.

This means that 26.5 million people who are looking for a job across the EU cannot find one. More than 19 million of the unemployed are in the euro zone.

The double-dip character of our economic crisis is also obvious: after a mild recovery in 2010, unemployment has been rising steadily again since the middle of 2011.

Compare this with developments across the Atlantic: while unemployment rose faster in the US in the first phase of the crisis, the recovery has been much stronger and the US unemployment rate is now below 8%.



But perhaps the key observation about the current crisis is that there is an unprecedented divergence -- or polarisation -- in unemployment and other socio-economic outcomes among the 17 countries sharing the common currency.

This is very different from what we saw in the first years after the launch of the euro.

The period up to 2004 was marked by convergence in output and employment, in favour of southern and peripheral euro area countries that saw their economies catch up gradually with those of the core of the EU.

The weighted average unemployment rate of the group made up of Cyprus, Estonia, Greece, Ireland, Italy, Malta, Portugal, Slovakia, Slovenia and Spain then even became lower, by some 1 percentage point, than the average rate for Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands.

In 2005-07, both aggregate rates were decreasing in parallel.

Finally, the convergence stopped in 2008 and unemployment started rising much faster in the Southern and peripheral countries of the euro zone.

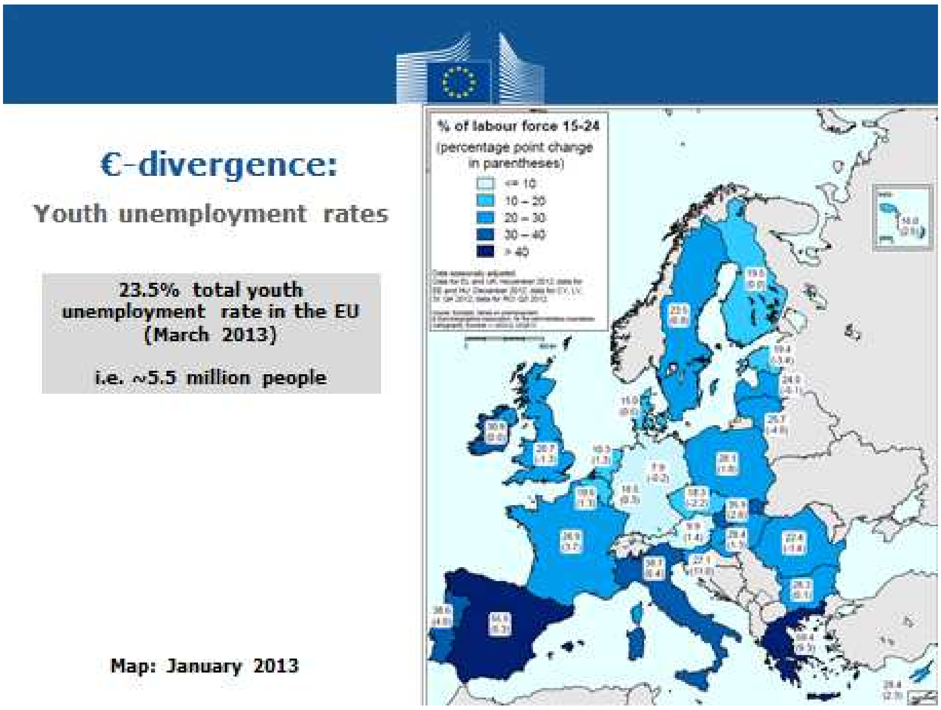
We have seen divergence ever since.

As a consequence, the core-periphery gap in unemployment rates reached an unprecedented 10 percentage points in 2012.

This gap had been ‘only’ 3.5 pps in 2000.

We can see that the convergence trend of the good years has been reversed – by far – during the crisis. This divergence is forecast to peak this year, but it is not certain at all whether and how it is going to be reduced in the coming years.

Much of this depends on policy and on the resolution of the euro crisis.

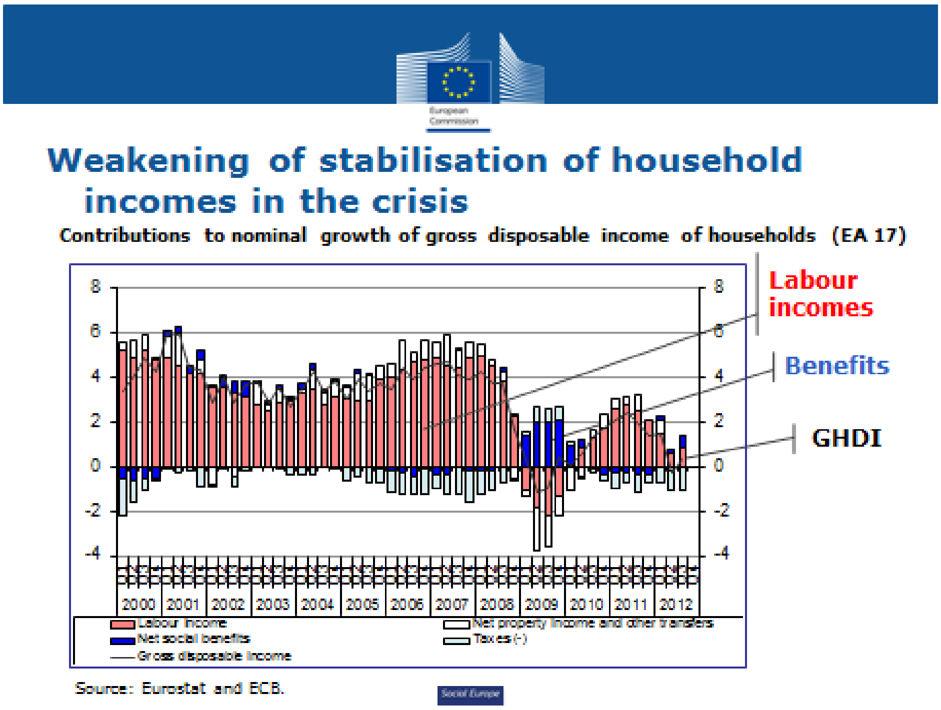


The socio-economic divergence within the monetary union can also be very well observed in terms of youth unemployment rates, which are at or below 10% in Germany, Austria and the Netherlands, but exceed 30% in many countries. In Spain and Greece, more than half of young jobseekers cannot find work.

Across Europe, we have over 14 million people aged 15-29 who are neither in employment nor education nor training (NEET). That's nearly 3% of the EU population, and these are people on whom the creation of prosperity in Europe will depend in the coming 40 or 50 years.

You can guess what such massive youth unemployment and inactivity mean in terms of these people's future employability and productivity.

You can also try to guess what such concentration of the employment and social crisis in the peripheral countries means for the economic and political future of the monetary union.



There is crisis and divergence also in terms of the *capacity* of national governments to counteract an economic crisis.

This capacity is heavily constrained within the Economic and Monetary Union, where countries cannot unilaterally influence their exchange rates as monetary policy is centralised, and where national fiscal space is constrained, especially if sovereign debt is already high.

Traditionally, since World War Two, welfare state systems in Europe shielded households against the effects of economic shocks. If you lost your job, you would receive unemployment benefits, plus you were entitled to a number of other benefits depending on your family situation and other needs.

During an economic crisis, benefit payments would increase and governments would also accept lower tax revenues. European countries have built these so-called 'automatic stabilisers' as countercyclical tools – instruments mitigating the boom and bust character of capitalism.

This is also what we observed in 2009 when GDP fell sharply: increased spending on benefits and lower tax collection largely offset the fall in household incomes from the labour market and property. This has helped keep up consumption and demand. Together with the discretionary stimulus in the form of the European Economic Recovery Programme, this contributed to the mild recovery in 2010.

But then came the sovereign debt crisis, closely linked to the systemic crisis of the currency union.

Peripheral countries were those hardest-hit by the slump, mainly due to the bursting of property bubbles. Restructuring and recapitalisation of troubled banks was in the interest of the whole of Europe, including creditors in the core, but there was no European capacity, no banking union, to take care of this.

Therefore countries like Ireland, Spain and Cyprus had to rescue their banks on their own, generating fears on the financial markets about the sovereigns' solvency.

But the Maastricht design of the EMU explicitly excluded any common liability for national debts: this has been known as the no-bailout clause.

It also did not foresee any fiscal transfers between countries, and so there are no European automatic stabilisers that could help restore recovery in countries undergoing an asymmetric shock.

Let me make a little diversion here: Two weeks ago, one of Europe's foremost political philosophers, Jürgen Habermas, gave a lecture in Leuven on "Democracy, Solidarity and the European Crisis". He reminded us that the concept of *solidarity* is essentially political: you help somebody who needs help in a process of economic change because you share the perspective of a common future within a polity.

A perspective of a common future is much better when the partners can trust in reciprocal help over time.

That is why a union needs solidarity between its members; otherwise it cannot last.

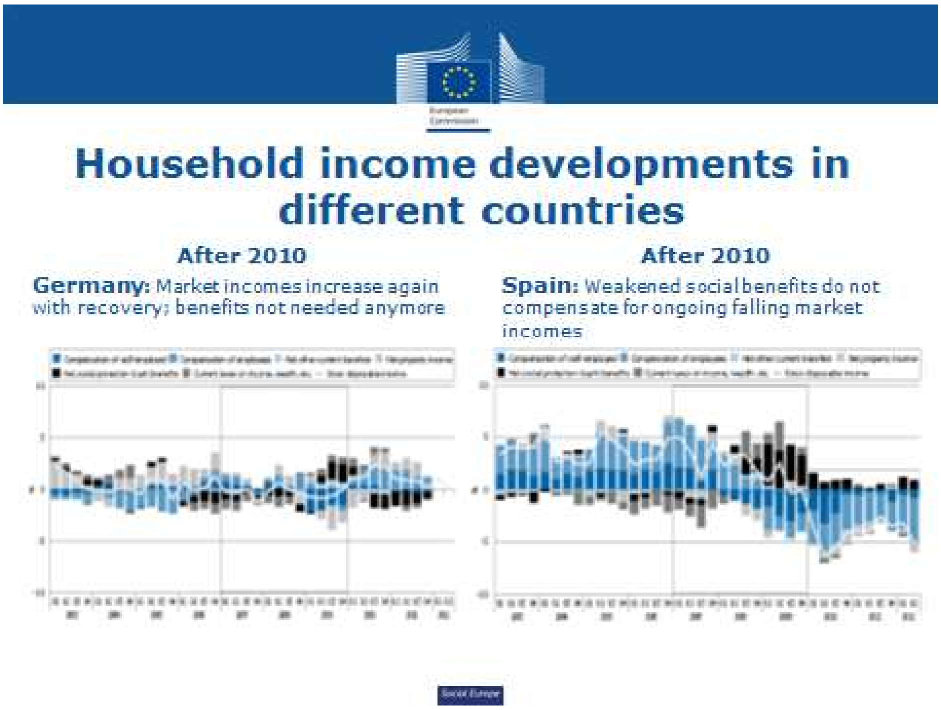
Unfortunately, the original design of the monetary union did not foresee solidarity between its members, and that it also why the Economic and Monetary Union – and by implication the European Union as a whole – is now undergoing a truly existential moment.

It still remains to be seen whether the Members will agree to sufficiently support each other in times of crisis so that they can maintain the perspective of a common future within a union.

But to come back to national automatic stabilisers: Because of the absence of a fiscal union, the troubled countries had to face the pressure of financial markets on their own, meaning that they had to increase taxes and reduce public spending in a very rapid way, and expenditure on social protection and public services has been heavily affected.

The automatic stabilisation function of social systems has weakened substantially after 2010 onwards, and in some countries it has basically disappeared.

Consequently, household incomes – and therefore domestic demand – have been less protected than before and this has aggravated the recession in the affected countries.



That is why I speak about divergence in the capacity of governments to counteract the economic crisis and its employment and social consequences.

The need for automatic stabilisers to work has of course varied between countries, depending on whether the country in question experienced a shock or was doing well.

In Germany, for example, market incomes increased and benefits declined after 2010.

Germany currently has the capacity to allow automatic stabilisers to work, but there is little need for them in Germany at the moment.

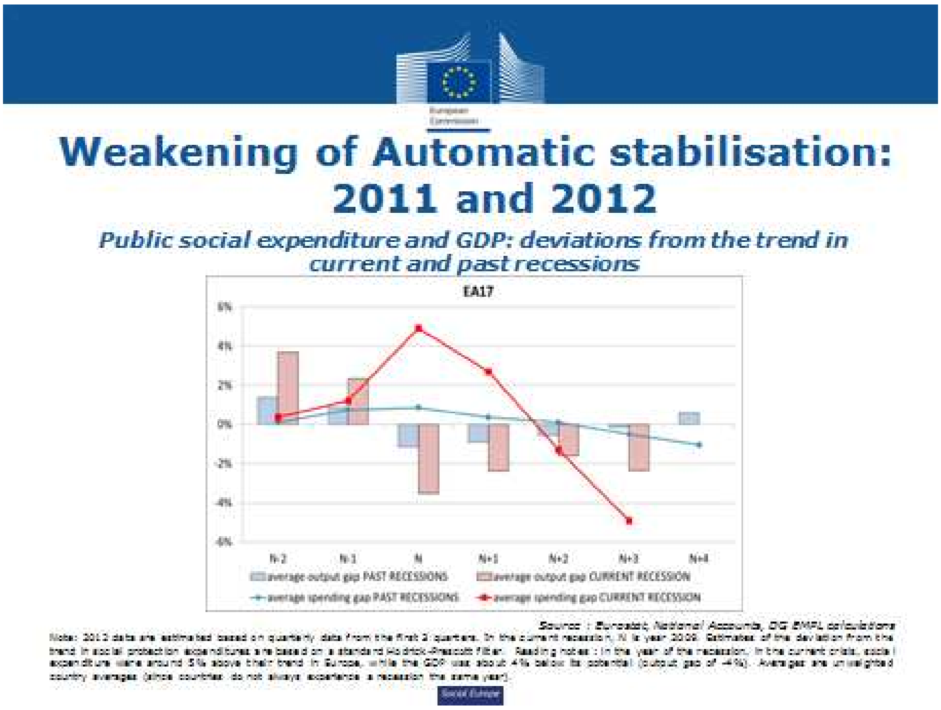
But in Spain, the situation is the opposite: market incomes continued to decline and benefits did not compensate for much of this decline after 2010 as Spain had to implement austerity.

The country is in serious recession and would need automatic stabilisers to help, but does not have the capacity.

So long as there are no fiscal transfers within the monetary union, this divergence is likely to continue.

In the end, everyone is worse off, because as we have seen since 2012, the recession in the periphery engulfs also the core as total demand falls.

Recovery would have been closer if the monetary union had transnational automatic stabilisers in place, for example a European unemployment benefit scheme.



If we make a historical comparison, we can see that in the present crisis, social protection expenditure was reduced even as the output gap continued to be negative, largely because of the sovereign debt crisis.

This is quite different from earlier downturns: there were about 40 instances in the 1990s and 2000s when the output gap was negative, but social protection expenditure used to remain much more stable.

My conclusion on the lessons to be learned from this crisis is therefore that austerity was perhaps a necessary short-term response in the absence of a better design of the monetary union and in the absence of greater solidarity, but that it has made the crisis worse.

Clearly, we need better solutions.

We need to enlarge our focus from fiscal discipline to the real economy, and we need to improve the design of the EMU.

Employment, Youth Employment and Social Investment Packages

Over the past year, the Commission has put forward a number of initiatives seeking to boost the real economy. Let me summarise three which fall under my responsibility.

The **Employment Package** of April 2012 broadened and strengthened the employment policy agenda.

Traditionally, the European Employment Strategy focused a lot on the supply-side of the labour market, such as on modernising employment protection legislation, skills development through lifelong learning etc.

But it is clear that if we are to move to a job-rich recovery, we need to also boost demand for labour.

We need to support job creation, and maintain employment that exists.

This can be done through a number of different measures, such as by shifting taxation away from labour, making more effective use of hiring subsidies, and by supporting entrepreneurship and the social economy.

But we must also ensure that we have enough adequately skilled and mobile people to meet the expected labour demand in areas that have a large job creation potential due to structural trends, in particular the green economy, the health and care sector and the digital economy.

The Employment Package also calls for a balanced approach to labour market reforms so that labour markets become more dynamic and inclusive.

A key element is to reduce segmentation of the labour market into groups with very different levels of employment protection: segmentation condemns many people to precarious economic existence and prevents them from properly developing and using their skills. At the same time, some groups are over-protected and the economy cannot meaningfully restructure without reducing their entitlements.

We also need to counter in-work poverty: we need to build competitiveness on high levels of productivity, not on squeezing the cost of labour and forcing people to move from one unstable contract to another.

The Employment Package also shows ways to better forecast labour market needs and identify the skills needed, so that investment is focussed on the right skills and that workers are better matched with the jobs that need them.

Finally, the Employment Package aims to create a genuine European labour market by removing remaining obstacles to the free movement of workers in Europe, and transforming the existing network of European Employment Services (EURES) into a true European placement and recruitment service that will match and place jobseekers across borders.

All these measures, on both the supply and demand sides of the labour market, are structural reforms that can contribute to a recovery and sustainable growth.

In December, the Commission adopted a **Youth Employment Package** to step up action against the continuously rising levels of youth unemployment and inactivity.

This package includes four initiatives:

First, it aims to decisively improve school-to-work transitions through **Youth Guarantee schemes.**

On 22 April, the Council adopted a recommendation – proposed by the Commission in this Youth Employment Package – that every Member State should ensure that every young person under 25 gets a quality offer of employment, education or training within four months of becoming unemployed or leaving formal education.

Such schemes are needed to ensure that every young person really gets a chance.

Introducing Youth Guarantees is a crucial structural reform that could help the economy work better, as the economic loss due to young people's disengagement from the labour market is much larger than the cost of intervention.

They can be set up with the help of EU funding, in particular the European Social Fund as well as the additional €3 billion that European leaders have agreed to set aside in the multiannual 2014-20 budget under a new Youth Employment Initiative.

Second, we will set up a quality European framework for traineeships, which should encourage companies to offer traineeships with good learning content and decent working conditions.

Third, we seek to improve the quality and the supply of apprenticeships by launching a European alliance for apprenticeships, promoting transfer of successful dual-learning models across Europe.

Dual learning (in-school and in-company) is very successful in countries like Germany and Austria, but nearly non-existent in many others. Apprenticeships can be a very good way to improve the quality of training and consequently to make young people more employable and productive.

Finally, we aim to reduce obstacles to labour mobility among young people within Europe, to open access to more job opportunities.

53% of young people are willing or keen to work in another Member State. To facilitate this, the Commission is modernising the EURES job mobility portal to offer increased possibilities for job-matching online, also for apprenticeship and traineeship placements. We are also running a pilot scheme for transnational job placements, called "Your First Eures Job".

Finally, in February 2013 we have put forward a **Social Investment Package**, setting out a policy vision for making European welfare states more effective in terms of reducing poverty and social exclusion and thereby in strengthening the economy.

Social investment is expenditure that helps develop the *stock* of human capital, like skills and competences, throughout the entire life, or expenditure that improves the *flow* of human capital into and within the labour market, helping everyone to make the best possible contribution.

Core social investment areas are active labour market policies, child-care, education, social rehabilitation and active ageing. The Youth Guarantee I mentioned earlier is a clear example of social investment.

Social investment means 'anticipating' and preventing social and economic exclusion rather than 'repairing' things *ex post*.

Social investment is needed now if we are to avoid large losses of human capital and an erosion of social cohesion.

If we do not undertake social investment now, the economic costs in the future will be much higher.

Reconstructing the Monetary Union

Ladies and Gentlemen,

I mentioned that to achieve a recovery in Europe, we need to put in place a robust long-term architecture for the economic and monetary union.

By ‘robust architecture’ I mean an arrangement that ensures an acceptable economic future for all Member States sharing the same currency, even during asymmetric shocks.

Without question, this requires common fiscal capacity.

But a sustainable monetary union also needs to be able to collectively detect and address employment and social problems: it needs to have a social dimension.

In December, the Commission put forward its *Blueprint for a Deep and Genuine EMU*.

It seeks to outline a path towards a more robust EMU architecture. In fact, just today, a conference is taking place in Brussels discussing the Blueprint’s proposals as regards strengthening economic governance, banking union and democratic legitimacy.

In the short term, the Blueprint focuses mainly on further strengthening economic policy coordination. This includes *ex ante* coordination of major national reforms, i.e. their discussion at European level before they are actually deployed. It is clear that in a currency union, national action – or inaction – can have spill over effects.

To incentivise national reforms, the Commission also proposed the creation of a small fund, called the Convergence and Competitiveness Instrument. This could become an embryo for a proper common fiscal capacity within the monetary union.

In the medium term, further steps are foreseen, such as the creation of a debt redemption fund and of short-term Eurobills. This would represent partial pooling of sovereign debt and would help alleviate the cost of refinancing for peripheral countries, helping them to recover. This would already require Treaty changes.

In the longer term, the EMU would have a proper fiscal capacity, including transnational automatic stabilisers helping to counter short-term asymmetric shocks. As I mentioned, an unemployment benefit scheme covering the whole currency union would be the most obvious mechanism.

To get there, we would of course need to further develop mechanisms of economic governance and control, ensuring that fiscal transfers are used in the right way, and we would need to see greater solidarity between countries.

To make such reinforced union legitimate, we also need to work on building real supranational democracy at the European level, and here I would again encourage you to read Jürgen Habermas.

All along, we also need to work on developing the social dimension of the monetary union, which is closely linked to both economic performance and political legitimacy.

A clear lesson from the past three years is that a systemic crisis of a currency union cannot be overcome if we rely predominantly on adjustment within the individual troubled countries – fixing budgets, rescuing national banks and trying to restore national competitiveness against other countries by cutting labour costs.

Internal devaluation is not the solution for a systemic crisis. The so-called ‘Baltic model’ of abrupt fiscal consolidation and wage cuts may have restored market confidence in these small economies, but this adjustment has taken a major social toll, with high unemployment and significant net emigration of young people.

Applying this simultaneously in much larger economies is certain to produce a disaster, also because of the effect on aggregate demand in Europe.

Rebalancing within the monetary union must be symmetrical, at least in the absence of fiscal union.

Fiscal consolidation and internal devaluation in the periphery need to be balanced by higher consumption and investment in the core.

This requires structural reforms within the surplus countries, such as adequate minimum wages and prevention of in-work poverty.

If the surplus countries were willing to help restore the periphery’s growth potential through large fiscal transfers, the need for expansion in the core would be smaller.

But without such fiscal transfers, we cannot have recovery – or even proper rebalancing – in Europe unless domestic demand in the core countries grows and they accept higher inflation than the periphery.

A genuine EMU also needs to be based on an understanding that employment and social crises in some of its parts have negative impact on other Member States and the currency union as a whole.

High unemployment, inactivity or poverty in parts of the monetary union depress demand in the short term, and in the medium-to-long term can reduce the employability of people and give rise to implicit fiscal costs.

Moreover, they undermine the legitimacy of national governments and of the EMU as a whole, reducing the ability for the currency union to be effectively governed.

That is why the Commission is working on developing a way to detect and diagnose employment and social imbalances in individual countries that can impact the EMU's proper functioning. High levels of youth unemployment and inactivity are perhaps the most straightforward example.

On this basis, the EMU Member States should collectively ensure that adequate employment and social policies are in place to reduce – and preferably prevent – these imbalances.

For this, we need to further strengthen the coordination and oversight of employment and social policies in the EMU. All countries should converge towards certain policy standards or benchmarks. As regards youth unemployment and inactivity, all countries should implement a Youth Guarantee, as proposed by the Commission in December 2012.

A monetary union is only sustainable if its Member States are able to collectively manage the economic fundamentals in a way that each country maintains opportunities to create prosperity and social progress.

If we are serious about coming forward with systemic solutions that would enable the economic and monetary union to prosper over the coming decades, we must base such solutions on a clear understanding of what the employment and social dynamics have been during the current crisis, and how the euro crisis and the social crisis are linked.

I hope I have succeeded in explaining this link and our vision of the solutions. I look forward to your questions.

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