Which economic and financial governance tools to overcome low growth – A European Unemployment Insurance? – A European Investment Plan?

- The EU needs deep structural reforms and public investment

Speech by Guntram B. Wolff, Bruegel, 29 September 2014

- Let me start by thanking the Italian presidency and in particular the Italian Senate and the Chamber of Deputies for their invitation to come and speak today. It is a great honour and pleasure to speak to you.
- In my remarks today, I want to focus on the economic situation in Europe and on the lessons we can draw from it for the governance of the euro area in particular.
- As I am sure you all are well aware of, economic performance in the euro area has been unsatisfactory and job creation has been absent. Since the beginning of the crisis in 2008, unemployment has increased from 7.6% to 11.6% in 2014. Real euro area GDP has been flat. Bank credit has been falling since mid 2012. The recent recovery has been weak and interrupted in 2014Q2. While it is often argued that our determined policy response has prevented a new great depression, the economic indicators show that we are close to getting an entire lost decade.
- Also, headline inflation in the euro area has been falling since late 2011 and has been below one percent since October 2013. Currently, inflation stands at 0.4%, well below the ECB's target, and inflation expectations are falling too. This makes the relative price adjustment in the euro area more difficult, complicates debt deleveraging and puts the sustainability of debt at risk.
- Looking ahead, the latest economic sentiment indicators decreased in the euro area, bringing it back to its December 2013 levels. Worsened sentiment resulted from of a drop in retail trade, industry and consumer confidence and was particularly pronounced in Italy and in Germany. (http://ec.europa.eu/economy_finance/db_indicators/surveys/documents/2014/esi_2014_08_en.pdf)

- Many reasons can be given for the weak EU performance. Certainly, the magnitude of the imbalances was very large at the beginning of the crisis. Adjusting to the high debt levels and the strong divergence in the EU was bound to be difficult. The European policy system was not

prepared to deal with the challenges and therefore slow to react to some developments.

- Many deep structural policy changes are needed at the national level and mechanisms to foster such reforms remain weak. Let me add that I fully agree with Jean Pisani-Ferry in that we have a lot of catching-up growth to do. In fact, we know that our education system is not everywhere up to the task of giving the skills for the 21st century. We also know that our innovation policy is lagging behind and when we look at the digital agenda, we see that national protectionism prevents our economies from changing and reaching a new growth model. National structural reforms remain crucial and need to be speeded up. Yet, the ability to influence these national reform agendas from the EU level is quite limited.

- To address these failures, the EU has created a number of new and significant tools. The most important ones are certainly the European Stability Mechanism, the European Central Bank's OMT programme, the fiscal compact, the macroeconomic imbalances procedure, and the still unfinished banking union.
- Yet, despite these significant measures, we have not reached an institutional set-up that can be considered to complete monetary union.
- Given the high levels of unemployment and low growth, a debate on additional policy instruments to address the situation is rightly ongoing.
- One of the instruments that discussed is the creation of a European Unemployment Insurance. At the invitation of the Italian presidency, I prepared a policy brief for the ECOFIN meeting this month and I thought I dedicate most of my presentation today to this topic as it discusses both, substantial structural/labour market reforms and also fiscal measures.
- European Unemployment Insurance (**EUI**) has been proposed as one solution to improve the functioning of fiscal policy in Europe's monetary union and as a way of fostering improvements in Europe's labour markets.
- Before discussing the benefits, the drawbacks and also the complexity of EUI, let me give you a short description of what EUI means. The basic idea of EUI is to replace parts or all of the national unemployment insurances with a European insurance. Depending on the design,

insurance could cover either the basic level of insurance or it could only be activated in case of exceptional circumstance such as a rapid increase in unemployment. Simple mechanical simulations suggest countries that were severely hit by the economic crisis could have received financial flows of 0.5-1% of GDP if EUI had been in place.

- But is EUI desirable? Is it necessary for a monetary union? Is it feasible? In the paper, we carefully assess the arguments that speak in favour and against such a major reform and highlight central policy questions that would need to be answered. It is, of course, obvious that introducing EUI would mean that you would have to agree on some limited fiscal risk sharing.
- Two big questions are of central importance:
    - How can EUI contribute to fiscal stabilisation and is there a need for a new fiscal instrument?
    - How differently are labour markets organised? What implications does this have for EUI and is EUI an opportunity to reform those labour markets?
- Turning first to the fiscal question, the idea of Maastricht was to give the role of fiscal stabilisation to national budgets. This idea basically worked as countries were able to use their automatic stabilisers. However, two important problems arose:
    - First of all, the sum of the national fiscal policies did not add up to a fiscal stance that can be considered adequate for the euro area as a whole. In fact, during 2011-13, fiscal policy for the area as a whole was procyclical. This does not mean that country-specific fiscal policy decisions were necessarily wrong but it shows that an instrument is missing to influence fiscal policy for the area as a whole.
- EUI cannot meaningfully contribute to a euro area-wide fiscal stance. In fact, replacing a national automatic stabiliser with a European automatic stabiliser leaves the area-wide fiscal stance basically unchanged.

    - Second, some countries were hit so severely by the crisis, that they had to consolidate much faster than desirable. They ran out of fiscal space and the European framework did not warn those countries before the crisis of the underlying fragilities in the private and public sector.

- For this second problem, EUI can provide a small and temporary relief depending on its design. The financial support of perhaps 1% of GDP would allow the national government to run smaller deficits and thereby reduce financial risk or allow additional fiscal stimulus to reduce the impact of the shock.

- Turning next to the issue of the labour markets, the introduction of EUI represents an opportunity but also a challenge. At the core of the issue is the question of how much labour market institutions need to converge in order to make EUI function properly. This is a multidimensional issue involving questions of the design of the insurance, the desired ability of the scheme to provide fiscal stabilisation as well as the acceptability of moral hazard at the level of the individual and among countries.

- As is the case with any insurance, the effect of the insurance on incentives of policy makers and individuals needs to be taken seriously. As some of the costs of unemployment would be borne by contributors outside of the country, incentives for national policy makers to address the variety of causes of unemployment are somewhat reduced. An important trade-off emerges: measures to reduce moral hazard such as limiting the replacement rate reduce the stabilisation properties of the scheme. In fact, there is a trade-off between moral hazard and stabilisation similar to national unemployment insurances but the problem is compounded by the decentralisation of labour market policies.

- But labour market institutions matter also for a variety of other reasons. For example, we show that in several countries social partners are involved in the setting of the parameters of unemployment insurance. Some countries have low replacement rates and low contribution rates while others prefer higher contributions to fund higher replacement rates.

- Such differences in levels of protection are no accident but the result of long standing traditions, histories and deeply rooted believes about how labour markets shall operate.

- But such differences in the way labour markets operate are also one of the central problems of Europe's monetary union. Not only is labour mobility low, but also wage setting mechanisms are not always adapted to the needs of the euro. In some countries, wage growth has been persistently deviating from the area average leading to sustained losses or gains in competitiveness that are now one of the cause of substantial economic disequilibria and sustained unemployment levels.

- Introduction of EUI is therefore both, an opportunity and a challenge. It is an opportunity to fundamentally reform inefficient labour markets and to have European states converge towards an optimal model. It could be a way of improving wage-setting mechanisms and increasing the involvement of social partners at the European level. But it is clear that such reforms would come at the expense of subsidiarity that now guarantees that labour market are organised at the national level according to national preferences.

- Overall, while a debate about additional fiscal stabilisation instruments is warranted for the euro area, EUI can hardly contribute to the area wide fiscal stance. Instead, it is an insurance mechanism for individual countries thanks to risk sharing. Perhaps more important is the potential of EUI to trigger deep structural change in the labour markets. This could help substantially improve national labour markets, render them more European and ensure that wage and social policies are in line with requirements of monetary union. Such a reform, however, would impose constraints on long-standing national traditions and preferences. It would therefore be a long-term project

- So what can be done by policy makers now to improve the economic situation while respecting the current constitutionality of the EU?

- Turning to public investment, since 2010 public investment has been falling in the Euro area, as it was cut back in stressed countries implementing fiscal consolidation (i.e. from 2009 to 2013 Greece, Ireland, Spain and Portugal reduced public capital expenditure by 51% on average, Italy by 24%). However, even in countries such as Germany public investment has hardly moved over the last three years, putting

into question the appropriateness of the fiscal stance in the Euro area. The problem is that even if the share of public investment is small compared to total investment, studies and anecdotal evidence suggest that it could be one of the factors behind the private investment slump. Companies' investment decisions are affected by the quality of infrastructure in transport or energy. Overall, the public investment gap is substantial. This gap should be closed by a pan-European public investment plan. It would influence the area-wide fiscal stance and push some of the burden of addressing the situation away from the ECB. Given the low current interest rates, it would be worthwhile to develop useful projects as soon as possible. We should achieve an increase of at least €300bn in 3 years from public and private sources.

- Beyond a European investment plan, I believe we should reduce taxes on low-income households in countries that have the fiscal space to afford this. It seems to me that my home country would have the fiscal space to do so. I would also want to emphasize the importance of reducing regulatory fragmentation and regulatory burdens that weigh on growth and private investment.

- Overall, the euro area still needs a deal that on the one hand achieves substantial structural reforms while on the other hand it triggers substantial pan-European investments and easy monetary policy. Such measures need to be implemented quickly to concretely improve the economic situation and create employment. A European Unemployemnt insurance could be a long-term reform agenda that will help to foster the right labour market reforms for monetary union while achieving better risk sharing.

Thank you very much.