Countering divergence through automatic stabilizers in EMU

László Andor
Mercator Senior Fellow at Hertie School of Governance (Berlin)
Former EU Commissioner for Employment, Social Affairs and Inclusion

1 Imbalanced and fragile euro area

Following the political agreement on the third bailout program for Greece, what else could Europeans wish for? Is there anything else left on the agenda after defeating the evil of Grexit?

Well, the next step should be to explore the forest behind the tree. The euro area has not been in a state of recession for some time, but it has not experienced a proper recovery either after the double dip.

Angel Gurria, head of the OECD, speaks about a vicious circle driven by falling investment and increasing imbalances, resulting in the erosion of human capital, economic competitiveness and fiscal health.

Arguably, this vicious circle cannot be broken without further reforming the Economic and Monetary Union (EMU). As long as core countries are allowed to accumulate ever greater surpluses, while periphery countries can only rely on internal devaluation in bad times, the euro area will remain wedded to low growth, deepening asymmetries and vulnerability.

The euro area has been diagnosed with serious divergence in the Five Presidents’ Report (FPR) in June. This document was noticed by too few at the time of the Greek storm, but Jean-Claude Juncker, Donald Tusk, Mario Draghi, Jeroen Dijsselbloem and Martin Schulz actually outlined the key arguments for revamping the EU’s economic and monetary structures.

Excessive focus on Greece – which sometimes was inevitable – never helped putting a proper analysis of the EMU on the agenda. But it is high time to ask why since 2011 the EU economy decoupled from the USA, why countries keeping their national currencies are more dynamic and stable than those in the euro area, and
why EMU remains so imbalanced and fragile despite investing so much political capital in stabilization and reforms.

No doubt, Greece has been and remains the weakest link in the euro area, and there are many internal reasons for that. However, the shortcomings of the whole EMU architecture also require attention, before continuing weak economic performance and future disturbances destabilize the system again, with an increasing likelihood of disintegration.

2 From diversity to divergence

Post-war European monetary cooperation disintegrated twice: once in the early 1970s, and then again in the early 1990s. We learned in the recent years that the abolition of national currencies in itself is not a sufficient guarantee against another disintegration.

At times of crisis and heightened speculation, a possible break-down, or dissolution of the euro has been mainly discussed in terms of a crash of one or several member states and the resulting need to introduce a new national currency. However, this is not the only way the single currency could die.

Just like the life of humans can end in various ways, a currency union can also be a victim of different diseases. Cancer does not kill the same way as a heart attack. Through reforms (notably the banking union) and one-off, discretionary measures (by the ECB mainly), the risk of a heart attack has been diminished. However, the risk of cancer is still there, and has probably increased in the meantime.

The EU is supposed to create unity out of diversity, but the minimalist monetary union turned diversity into divergence in the last two decades. Divergences between the core and the periphery of the euro area (or North-South imbalances) are more dangerous for the sustainability of the EMU and the stability of the EU than East-West imbalances. The latter are linked to the wide income gap between old and new Member States, which despite the crisis, continued to diminish in the last five years.

EMU membership for peripheral countries means that in periods of growth they enjoy greater confidence and consequently favorable pricing of finance, for private as well as public actors. At a time of recession, on the other hand, financial fragmentation increases the costs of borrowing and also the risk of insolvency. Capital flight usually aggravates this situation, also in connection with the lack of full confidence in the future of the euro area, or in its composition.

What I would like to highlight is that the sovereign debt crisis since 2010 and the fiscal consolidation strategies implemented in response to it have substantially weakened the power of the welfare state in countries of the euro area periphery.

In particular, they have weakened the effectiveness of so-called automatic fiscal stabilizers at the national level, which basically means the ability of a state to immediately act in a countercyclical way as tax revenues drop and social expenditure
increases. A dramatic cut in automatic stabilizers (e.g. unemployment benefits) due to tightened economic governance led to the euro area recession of 2012–13, which was actually more brutal in terms of household incomes than the first recession of 2008–09. Unemployment and inequalities soared in particular in more peripheral regions.

Divergence is indeed the main threat to the existence of the single currency and to the stability of the EU as a whole. Hence, there is a need for further strengthening of the EMU architecture, and in particular to strengthen its real economic performance and its social dimension.

This ambition should go beyond securing the short-term survival of the single currency. Without an improvement in real economic and social outcomes, rising nationalist sentiment will continue to turn against either the single currency, or the EU, or both.

3 The quest for risk sharing

Rebalancing the euro area is a key question. Various models of rule-based, though limited mechanism of solidarity have already been explored by think tanks, in order to strengthen people’s and markets’ confidence in the euro, and thus create a better institutional foundation for the recovery of investment.

Hostility around bailout programs and their conditionality have not created a good atmosphere in which more solidarity could be easily promoted, especially if it involves various forms of fiscal transfers. However, there is virtually no serious assessment of the functioning of the euro which would see a chance of long life without a fiscal capacity and risk sharing, ideally in some form of automatic stabilizers that can limit the damage from cyclical downturns.

In recent years, various forms of cross-border automatic stabilizers have been examined as one of the possible ways to improve the functioning of the EMU: output gap-based schemes, partial pooling of unemployment insurance systems and reinsurance for big shocks. Each of these options would have beneficial effects on economic growth and the most vulnerable euro area members, with each member state deriving benefits over the cycle. Among the options, a partial pooling of unemployment benefit schemes stands out as the model with continuous impact and direct connection with the citizens. However, each of the three models could contribute significantly to the effort to restore confidence in EMU.

Hence, before we get too close to national parliamentary elections in major countries again, and while the third Greek bailout agreement delivers a certain degree of tranquility, we should use the window of opportunity to discuss a substantial reconstruction of the EMU and make some crucial steps in practice. The work ahead should not only focus on avoiding another heart attack, but on changes needed for truly improving resilience, performance and cohesion.
Beyond occasional bailouts, there are several broader issues awaiting debate and answers. Should we see the IMF as a permanent participant of EMU stabilization? Or we will reach a point soon when the Fund is not needed any longer as a lender or an analyst of debt sustainability.

Can the ECB be defended from constant legal challenges when it acts in defense of the integrity of the single currency? Can we find the right balance between external support and national responsibility (and bankruptcy if needed) without the risk of contagion and disintegration?

There should also be a way to better articulate economic policy for the euro area as a whole, in order to optimize policy coordination for growth together. Member states should not be allowed to pursue arbitrary targets (e.g. “black zero”), or accumulate excessive current account surpluses, if those are detrimental to the growth prospects of the community as a whole.

Establishing a chief economist in the euro area has been considered for some time, but concrete steps have proven just too difficult, similarly to the external representation of the euro.

Better governance is necessary (e.g. joint action against excessive imbalances), but it is not obvious that Member States would hand over competences to a stronger EMU level governance structure without more risk sharing. This latter on the other hand would also help strengthening public acceptance of the EMU. Strengthening discipline, solidarity and legitimacy simultaneously would probably pay-off economically as well as politically.

4 Political capital for change

Perhaps a dramatic momentum is not here now for a sudden paradigm shift. But the time is right for a serious and deep reflection. In fact this might be the last time when the road forward towards a more perfect EMU is still open. If this chance is missed and divergence and asymmetries are not dealt with, continuing stagnation will turn even greater shares of the electorate against the euro, and in a few years the only choice will be between orderly or disorderly deconstruction.

The 2012 experience should serve with inspiration. Three years ago, the intervention of the ECB turned out to be a game changer. Without it, the euro area would probably have quickly disintegrated. However, the ECB only managed to change the game at the level of survival. Today this is not sufficient. What we need is significantly higher rates of growth and a return to real convergence.

The key question, however, is whether there is still sufficient political capital left among mainstream political forces to promote solutions that can counter the internal imbalances and divergence between the core and periphery within the euro area. Some would say a full solution to the euro area problem can only be delivered
by changing the Treaty of the EU, which is very hard. Still it is easier to change the
Treaties than the laws of economics.

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