THE MISSING PIECE IN THE EMU PUZZLE: ECONOMIC POLICY COORDINATION

PORTUGAL DISCUSSION PAPER

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Introduction

• Europe stands for an integrated space where borders tend to disappear and ideas, people, goods, services, and capital are allowed to move freely. If this is what a close union means, then it resonates deeply with what European citizens want.

• Ideas, people, goods, services, and capital. One crucial piece of the puzzle is still missing. Even those who have no interest in creating a European superstate must wish that this free space of communication includes political choices. We need to break the dynamic of political fragmentation by which public policy in each member state is conducted in isolation. If entrepreneurs, students, and bankers work within a common European space, so should policymakers. If economic policies are not made to converge in some fundamental respects, then a true European space will never exist, because those policies will themselves work as barriers.

• As we painfully discovered over the last five years, financial markets need a common institutional structure in the Union and particularly in the euro area. A financial union is a structure that allows agents to act freely while creating centripetal forces at a deeper level. But fragmentation can just as easily be found in labor markets, energy markets, as well as the education or social security systems.

• There is an economic reason why a framework for policy coordination is needed. Since important markets like finance, energy, technology, and transport are heavily dependent on public policy choices, we will not have a fully integrated internal market until we have some level of integration in economic policy as well. Additionally, there are positive spill overs from structural reform and economic policy that can be captured through better coordination. If reforms implemented by each country in isolation produce positive results, cross-border coordination produces larger and more evenly distributed benefits.

• There is also a political reason. This has to do with legitimacy. It is odd that small interest groups within a member state that are affected by a national decision can participate in the policy process, while the interests and concerns of other member states that are just as affected are not taken into account or are only very poorly taken into account.

• There is a case for some form of common governance over economic policy, just as there is a case for a common fiscal framework in the EU. The question is how to design this form of common governance in a way that makes sense and that can avoid the problems we ran into in the past, for example when discussing the idea of contractual arrangements a year ago.
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• Indeed, this is a matter of common responsibility. The European Union has made huge strides in bringing national economies closer together. Economic integration is a matter of both efficiency and equity. It ensures that resources flow to where they can be more efficiently used and it creates a level playing field for economic agents all over the common market. This common market will only flourish and prosper if we are able to create policy instruments that are just as integrated. Member states need to recognize that cross-border coordination creates positive spillover effects and that in the case of structural reform and other large-scale economic policies a valid constituency exists beyond their borders.

• We see three main paths forward, which should form the basis of a constructive debate over the next year. Even if there is no agreement right now on the right instruments, we cannot continue to ignore the problem.
MECHANISMS FOR STRONGER ECONOMIC POLICY COORDINATION, CONVERGENCE AND SOLIDARITY

1. The Flexibility Clause

Flexibility is already built into the existing rules of the Stability and Growth Pact and additional guidance on how to make the best use of this flexibility was recently provided. Nevertheless, the question still suffers from a number of ambiguities. From the moment when fiscal guidance is set in structural terms, that is cyclically adjusted and net of temporary measures, fiscal guidance should be able to track the structural deficit, without much need for additional considerations. Adequate fiscal policy should be dynamic rather than static. What matters is almost always the medium and long term fiscal trajectory and the need to make it sustainable. The static point may in some cases be less favorable if it corresponds to more favorable dynamics.

There is another, entirely different set of considerations and those remain unaddressed. The Commission proposal for an Investment Plan for Europe adopted a favorable treatment of national financial contributions from member States to the European Fund for Strategic Investments (EFSI) on the understanding that such contributions would not go into separate national silos and would thus be clearly marked as being in the interest of the Union as a whole. The crucial element here is not the need for a dynamic analysis of fiscal policy, but rather the need for an aggregate analysis. In other words, in some cases it may not make sense to look at the fiscal stance of each Member State in isolation. This is one of the cases where it may be useful and even necessary to have a discussion on the overall fiscal stance of the EU and the euro area in particular.

The idea could be further developed in order to address the need for closer coordination and convergence in economic policymaking. If a Member State implements reforms that help it converge with the rest of the Union, then it should be possible for the costs or investments associated with these reforms to receive adequate treatment in terms of the overall fiscal stance of the Union. Otherwise, there is little incentive for those reforms and the SGP will work as an engine of policy divergence and fragmentation (“If investment is considered only in terms of my own fiscal position, then I should decide without taking into consideration the interests and policy goals of other Member States”).

1 COM/2015/0012.
2 “Unemployment in the euro area.” Speech by Mario Draghi, President of the ECB, Annual central bank symposium in Jackson Hole, 22 August 2014.
MECHANISMS FOR STRONGER ECONOMIC POLICY COORDINATION, CONVERGENCE AND SOLIDARITY

1. The Flexibility Clause

In practice, economic policies and structural reforms with significant economic spillover or a “coordination dividend” or, more generally, which promote greater policy convergence could benefit from adequate incentives from fiscal guidance at the EU level. **Those incentives would be able to incorporate the overall fiscal stance.** In other words, the Commission could be more or less flexible depending on the fiscal stance of the Union or the euro area as a whole. **In periods when fiscal policy is constrained by concerns over debt sustainability, the critical test on the “coordination dividend” of proposed reforms would have to be more stringent.**

For the flexibility clause to provide an effective basis for economic policy convergence, an intense dialogue between each Member State and the EU institutions, both at technical and political levels, would have to be envisioned and developed so as to properly identify the best opportunities for coordination and convergence.
MECHANISMS FOR STRONGER ECONOMIC POLICY COORDINATION, CONVERGENCE AND SOLIDARITY

2. Economic Partnerships

In this case the mechanism would be designed from a different template: a banking union as the framework for financial integration. Free movement of capital and even a single currency were not able by themselves to create integrated markets. It may have seemed at some point that financial integration had been or was in the process of being achieved, but such illusion did not survive the global financial crisis. Why was it not enough? Because fundamental public policies and structures dealing with bank regulation, supervision and resolution remained national and pushed for growing fragmentation.

The lesson learned while building the blocks of a functioning banking union could be used elsewhere. In a number of markets it is simply not sufficient to eliminate barriers. It is necessary to bring policies closer together. Negative integration is not enough. We need a certain level of positive integration.

It is useful, when discussing economic policy coordination, to remember that the intergovernmental logic cannot simply be abandoned. It is possible to reach better results if we are able to combine the interests and views of different countries without excessive centralization and without questioning the basis of their own policy space.

While the mechanism of the flexibility clause described above is a logical conclusion of the communitarian method and relies on the intermediary role of the Commission, our second proposal is based on the intergovernmental method. It would be possible to create policy convergence areas, either with geographic or sectoral configurations, taking full advantage of the possibilities offered by the enhanced cooperation framework. The template is in many respects the creation of a banking union, which could in the future be extended to other sectors where to all evidence negative integration is not sufficient: energy, digital, labor markets, and education. In the digital area, for example, an intergovernmental agreement could decide the bases for regulating digital markets in participating Member States or, alternatively, set the right procedures for economic policy coordination for specific policies: privacy and data protection, mobile spectrum policy, value shift from network renters to network builders, ultrafast 5G mobile technology, etc.
The Investment Plan for Europe or other similar schemes could make the necessary funds available so that every member State would be in a position to join such a digital union if and when it so desired. The mechanism would consist in something like an economic Schengen agreement, in the words of a recent report commissioned by the French and German governments. More exactly: a certain number of economic Schengen agreements, with variable geographic and sectoral configurations.

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3. A Convergence Process

The most ambitious mechanism takes as a template the creation of the euro and the Maastricht criteria. In that case a certain level of policy convergence was obtained at the end of a long process. The ability to participate in the single currency was simultaneously the final goal of the process and the motivating reason for member States to implement the necessary reforms, which were mostly macroeconomic convergence reforms.

The same mechanism could now be extended to micro convergence. Just as the creation of a common currency was the final point in a process of macro convergence, one could envision that the creation of a genuine EU employment and social policy, including an euro area wide unemployment insurance scheme, would culminate a process of policy convergence consisting essentially of those labor market reforms which form the precondition for further integration efforts in this area. The mechanism would provide political backing for difficult but necessary reforms.

It should be noted that the mechanism solves the incentive problem much more adequately than the mechanism of mutually agreed contractual arrangements discussed in the past. There can be no better incentive for economic policy convergence than a process of progressive integration, a process developed over time and firmly anchored in the appropriate rules and institutions.

The establishment of a fiscal capacity to facilitate adjustment to economic shocks was defended in the Four Presidents Report of 2012 as a further and crucial element in strengthening our crisis management framework, but no such shock absorption mechanism could work without greater convergence and coordination between economic structures and policies of the Member States.

Convergence is essential also in order to avoid the risk of moral hazard inherent to every risk insurance mechanism.

From this perspective, the two goals can reinforce each other and the long-term objective of building a fiscal capacity in the euro area can help further greater economic policy convergence.4

4 “Towards a Genuine Economic and Monetary Union.” 5 December 2012.