EUROPEAN COMMISSION

[CHECK AGAINST DELIVERY]

László Andor
European Commissioner for Employment, Social Affairs and Inclusion

Basic European unemployment insurance: Countering divergences within the Economic and Monetary Union

Vienna University of Economics and Business
Vienna, 29 September 2014

Professor Badelt,

Governor Nowotny,

Distinguished Guests,

Ladies and Gentlemen,

It is an honour and a pleasure to be with you today to discuss the future of Europe's Economic and Monetary Union.

I am grateful to Governor Nowotny for helping to organise this lecture and to the University for the excellent preparation of the event.

Spokespersons' Service
Service des Porte-parole

SPEECH/14/635

I am also happy to have here four discussants, not only from Austria but also from Slovakia, all of whom are involved in economic policy-making.

I believe that reflecting on the possibilities and options for introducing an automatic fiscal stabilisation scheme at EMU level is a task which is both important and urgent, and I am very much looking forward to discussing this with all of you.

I have argued in favour of introducing a basic European unemployment insurance scheme for about two years now.

Initially, in 2012, these were mainly internal reflections and deliberations within the European Commission in the context of the *Four Presidents' report* and the *Blueprint on a deep and genuine EMU*.

But the number of experts, think-tanks and policy-makers interested in the subject has gradually grown, and I was very happy to see this idea debated at the informal meeting of EU employment ministers in July and at the informal meeting of finance ministers earlier this month.

In exploring the possibilities of cross-country fiscal stabilisation within the EMU, the Commission has benefitted from excellent cooperation particularly with the Bertelsmann Stiftung in Germany. It is safe to say that an epistemic community has developed in Europe over the past two years, focusing on the reconstruction of the EMU with a shared fiscal capacity as one of the key elements.

But I believe that this debate has already passed the stage of an epistemic community: it is an open, public debate.

Thinking about a shock-absorbing fiscal capacity at the EMU level is of course related to broader considerations about the role of fiscal policy in supporting an economic recovery.

But it is about more than that: the unprecedented divergence in economic and social outcomes across the euro zone has called into question the ability of the European Union to achieve its core objectives as agreed within the Treaties, in particular balanced economic growth, full employment, social progress and the well-being of its peoples.

The European elections in May showed very clearly that mainstream parties of the centre-right, and to a lesser extent of the centre-left, are losing people's trust when it comes to ensuring broadly shared prosperity.

The Economic and Monetary Union was created two decades ago not just as a financial, but most of all as a political project. At the time of German reunification, its mission was to unify the entire continent while at the same time strengthening its economic prosperity.

However, in its current form, the euro has failed to fulfil either its economic or political role.

Since the euro crisis broke out in 2010, the EU has entered a different path compared to other developed regions in the world. Unemployment and poverty have grown further and bitter political and social divisions have emerged, with nationalism and welfare chauvinism on the rise.

The main reason for these worrying developments is in my view not the lack of structural reforms, excessive red tape or insufficient global competitiveness of European economies.

What has made Europe so vulnerable in both the economic and political sense is the incomplete structure of the monetary union. In other words, Europe suffered from absence of financial instruments that would have supported countries without access to market financing and enabled a continuation of the economic recovery that began in 2010.

Since the sovereign debt crisis started, some of the missing elements have been added to the incomplete EMU structure.

We will be entering the second half of this decade with a European Stability Mechanism as a permanent instrument for emergency lending, and with a banking union being put into place.

In other words, we have a framework for better resolving financial crises at the EMU level and reducing the risk of further bank bailouts with taxpayer money.

However, Europe has not yet developed macroeconomic policies enabling a lasting recovery, and we are far from ensuring that the next financial or economic shock to occur within the monetary union will not once again take a heavy toll in terms of rising unemployment, falling household incomes and rising poverty.

The new intake of policy-makers taking office in Brussels appears to be aware of these problems to some extent, although the sense of urgency differs.

Representatives of the emerging new Commission explicitly speak about a 29th Member State consisting of unemployed people who need to be given new hope and reintegrated to the economy.

Some of these colleagues have also pointed at the risk of Europe repeating the Japanese experience of prolonged deflation or very low inflation, with disastrous consequences for growth, employment, debt sustainability and therefore social cohesion.

High expectations are being attached to a major new investment plan for Europe, which could indeed help remedy the shortage of public and private investment over the past years and could strengthen our still fragile recovery from the euro crisis.

But a one-off investment plan should not be seen as a substitute for further reform of the Economic and Monetary Union and for eliminating the vulnerabilities which brought us to the present crisis.

It remains to be seen to what extent the new Commission, together with the European Council, the ECB and the Eurogroup will take forward the recommendations made in 2012 in the Four Presidents' report "Towards a genuine Economic and Monetary Union".

My main argument today, and one of my main messages to the next European Commission, is that the resilience of the EMU needs to be further strengthened with a well-designed mechanism of automatic, countercyclical fiscal transfers between Member States using the euro.

Through such a scheme, it would be possible to create a European safety net for the welfare safety nets of individual Member States, and thereby to uphold aggregate demand in the EMU at a time when it is most needed.

The earlier such a mechanism is agreed and launched, the better for everybody, including those countries which today enjoy higher levels of employment and may consider themselves to be safe from the impact of financial crises.

Based on the expert work available to date, I consider that the best form of such a countercyclical fiscal capacity at the EMU level would be a scheme where the participating countries share part of the costs of short-term unemployment insurance.

A basic European unemployment insurance scheme would provide a limited and predictable short-term stimulus to economies undergoing a downturn in the economic cycle. It would therefore boost market confidence in the EMU's growth prospects.

Consequently, it would help to avoid a vicious circle of downgrades, austerity, internal devaluation, economic contraction and anti-EU resentment across the euro zone.

I will focus on three points today:

First, I will highlight the social consequences of Europe's double-dip recession and remind you that these are without precedent since the EMU was launched in the early 1990s.

Second, I will show that Europe's weakness in confronting the crisis is a systemic problem, rooted in the incomplete character of the EMU as designed 25 years ago.

And third, I will elaborate on my proposal for a basic European unemployment insurance scheme. I will explain why the advantages would far outweigh its costs and I will tackle some of the misconceptions that sometimes arise in this context. I will be then happy to further discuss the details of the proposal or its context during our discussion, and I would also like to refer you to the hand-outs which provide answers to some frequently asked questions.

The dangerous divergence resulting from the second euro zone recession

Ladies and Gentlemen,

In 2010, Europe was on the path of recovery from the deep downturn of 2008-09 thanks to the countercyclical fiscal stimulus also known as the European Economic Recovery Package.

But while the United States continued to experience a robust and job-rich recovery, the EU nose-dived into a second recession in 2011.

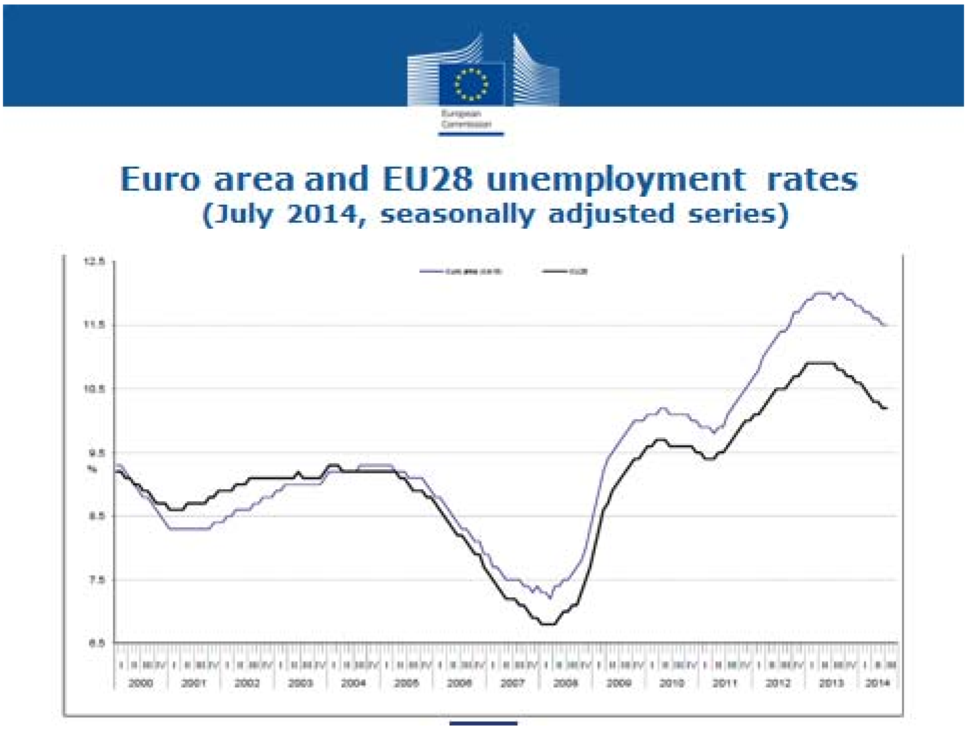
The reason for this decoupling was that the EMU had been unprepared to handle a sovereign debt crisis of some smaller Member States. It had no lender of last resort, no collective framework for resolving bad debt, and no mechanism for managing aggregate demand in the economy.

Speculation about the solvency of the Greek state was followed by many months of hesitation. The emergency loan announced on 9 May 2010 was much larger than would have been the case if Europe had taken collective action more promptly (without waiting for the regional elections in North Rhine-Westphalia). A few months later Ireland was effectively forced to bail out its banks and the crisis quickly spread to other countries too.

Debts from financial markets were replaced by debts from official sources, which turned the euro zone into a club of debtors and creditors, set against each other.

We entered a double-dip recession in 2011, accompanied by capital flight from less stable countries towards more stable ones, causing further financial and economic polarisation.

The euro zone crisis produced a dramatic rise in unemployment. And although we have experienced some improvement in the last 12 months, unemployment in Europe remains still much higher today than at the peak of the first recession in early 2010.



When the financial crisis began, the euro provided some shelter for its Member States. Austria, for example, was challenged by capital markets but its membership in the euro zone helped to calm down the speculators.

But in the horizon of several years, the euro has also proven to be a trap, because Member States suffering from capital outflows could no longer support their economies through tailor-made monetary policies and devaluation in their exchange rate, while at the same time being subject to strict rules on fiscal policy.

In the absence of a budgetary or wage stimulus from countries in the core, adjustment to the economic shock in the periphery had to operate mainly through so-called internal devaluation, resulting in falling domestic demand and rising unemployment and poverty.

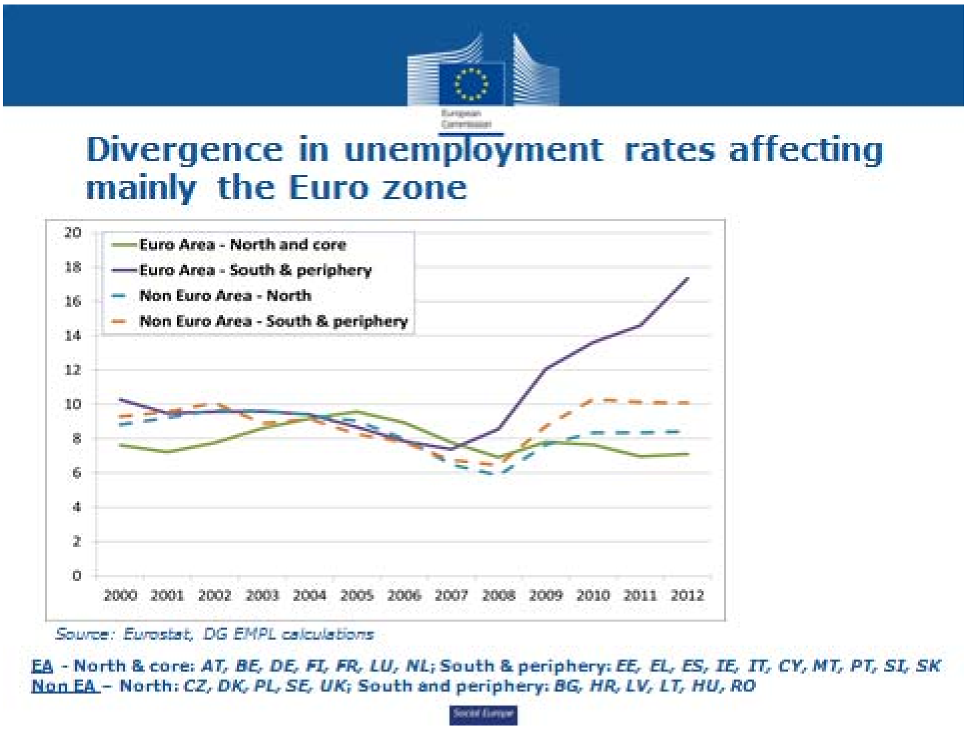
To make matters even worse, this internal devaluation was coupled with fiscal consolidation required by the official creditors as assurance that the emergency loans would be repaid.

The contractionary effects of these strategies have put the EU at a competitive disadvantage in global terms. Furthermore, the euro zone crisis has led to social consequences that cannot be acceptable in the European Union.

While the EU employment rate was over 70% in 2010, it fell to 68.3% in 2013. More than 25 million people are unemployed across Europe today.

The number of people in or at risk of poverty or social exclusion was 118 million in 2010, but 124 million in 2012.

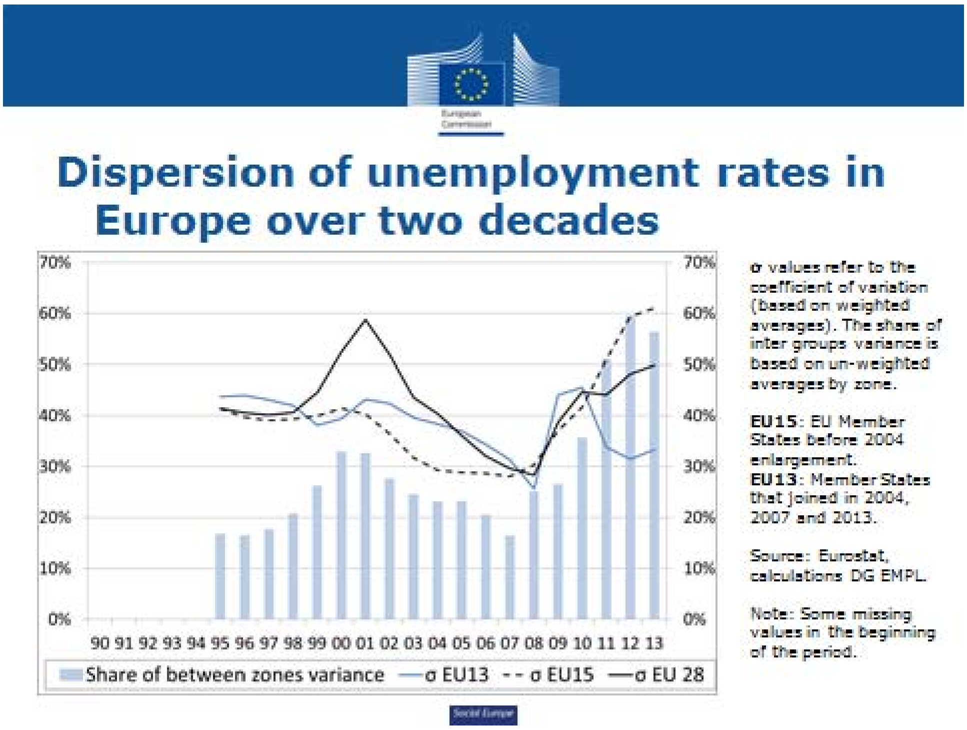
Crucially, these aggregate figures hide enormous disparities between Member States.



While some countries like Austria are enjoying economic growth and high employment, many other Member States are struggling with economic stagnation or continued contraction, with unemployment rates near or over 20% and with declining household incomes and rising levels of poverty.

This graph shows the recent divergence in unemployment rates, to give just the most obvious example.

But in adjusting countries, the second recession also meant rising long-term unemployment, poverty, social inequalities and emigration of many young people, often to other continents.



What we should keep in mind that this socio-economic divergence within the EMU is without precedent since the monetary union was agreed in the Maastricht Treaty of 1992.

This graph shows the dispersion of unemployment rates among the 28 Member States of today's EU over the past two decades (the thick black line). It also shows the dispersion of unemployment rates within the group of the 15 so-called 'old' Member States (the dashed line), and within the EU13, the newer Member States that joined in 2004 or later (the blue line). All these lines are based on weighted averages, reflecting country sizes.

We can observe in this graph a high dispersion of unemployment rates within Europe at around 2000.

This reflects mainly the period of higher unemployment in Poland, Slovakia and the Czech Republic at that time, when these countries were not Member States yet and they were certainly very far from adopting the euro.

But what is really striking in this graph is the divergence of unemployment rates within the EU-15 group since 2010. While the new Member States have followed a roughly similar path and gradually recovered, the old Member States have experienced a major polarisation between the core and the periphery.

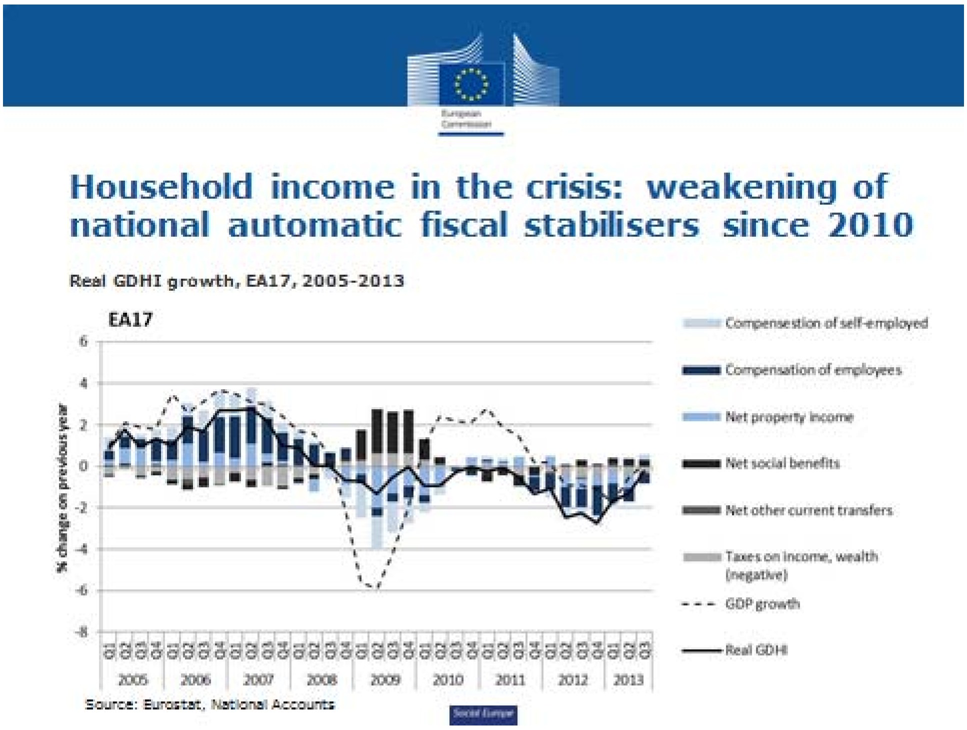
The key drivers of this development are of course Spain, Greece and Portugal on the one hand, and Germany, Austria and the Netherlands on the other.

The EU15 and EU13 categorisation is of course not the same as the euro zone versus non-euro-zone categorisation in the previous graph, but we can clearly see that a huge divergence has occurred within 'old' Europe, and indeed inside the euro zone, which has significantly changed Europe's economic geography.

But why did Europe become so divided in terms of economic and social outcomes?

The sovereign debt crisis since 2010 and the policies undertaken in response have substantially weakened the power of the welfare state.

In particular, they have weakened the effectiveness of so-called automatic fiscal stabilisers 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.



Until 2010, national budgets were able to counter the economic downturn by running deficits. Since 2010, many national governments have lost this ability and austerity policies in many cases actually aggravated the economic crisis.

This means that instruments that were historically used to limit the social impact of crises were not available any more, while there has been nothing newly introduced to replace them.

Over several years, internal devaluation was undertaken in an attempt to stabilise the troubled economies and to boost their economic competitiveness. It has certainly not borne any good fruit in terms of improving the employment and social situation.

Moreover, internal devaluation is a recipe that cannot be applied in many countries at the same time because it undermines overall demand. If many countries cut their wages and lay off workers, nobody wins in terms of relative competitiveness but everybody loses. If, in exceptional circumstances, internal devaluation helps a country to return to growth, it does so at a very high price.

You may therefore ask: Why and how was this peculiar and vulnerable system of an incomplete EMU established?

The construction of the EMU and its design flaws

The possibility of a single European currency was first considered when the Bretton Woods system was coming to an end.

The first actual attempt at monetary policy coordination, the so-called 'snake in the tunnel', lasted only from 1971 till 1973.

Subsequently, two high-level reports prepared for the European Commission warned that a common budget as well as stronger political union would be needed for a monetary union to work.

The Marjolin Report of 1975 actually proposed a "Community Unemployment Benefit Fund".

The MacDougall report of 1977 estimated that a monetary union between EEC Member States would need a shared budget to the tune of 5 or 7% of Community GDP in order to function well.

The proposal was in fact that regions with a current account surplus should contribute and that deficit regions should draw down funding, as normally happens within nation states, so that social cohesion and aggregate demand could be maintained within a monetary union.

However, in the European Community of the 1970s, agreement on such a large budget was impossible. The European Monetary System launched in 1979 then collapsed in September 1992 under the weight of speculative attacks.

The Economic and Monetary Union was enshrined in the Maastricht Treaty of February 1992, foreseeing the creation of a European Central Bank and launch of a single currency at the end of a convergence process. It did not foresee a central budget: it was assumed or hoped that individual national governments would always be able to conduct the right fiscal policy for their country, by tightening budgets in good times and accumulating debt in bad times.

The social implications of the EMU's rules on national deficits and debts were not expected to be negative. After two decades of monetary instability in Europe, it was assumed in the early 1990s that political stability and better economic performance and social outcomes in Europe require first and foremost monetary stability.

However, we know now that the price for monetary stability has been fiscal and social instability.

Political leaders in the early 1990s believed that social cohesion could be essentially achieved through legislation and social dialogue.

For Jacques Delors and other leading politicians at the time, the social dimension of the Single Market and of the EMU was predominantly about preventing a race to the bottom in employment and working conditions. A body of labour law was therefore negotiated for the Single Market, based on dialogue between management and labour.

However, there is little we could achieve today through further employment and social legislation at the European level, particularly when it comes to dealing with asymmetric cyclical shocks that by definition affect only part of the monetary union.

I call this 'the Delors paradox'. On the one hand, we introduce social legislation to improve labour standards and create fair competition in the EU. On the other hand, we settle with a monetary union which, in the long run, deepens asymmetries in the community and erodes the fiscal base for national welfare states.

Social legislation cannot make up for the absence of a euro zone budget or a genuine lender of last resort. Delors' idea of Social Europe is unfortunately offset by Delors' model of the EMU.

Due to the absence of a lender of last resort or a common countercyclical budget, financial market panic can force EMU countries to adopt austerity and internal devaluation policies.

We know that such developments have a particularly negative impact on workers, the unemployed and everyone whose quality of life depends on public services.

With such asymmetric allocation of costs and benefits, the EMU is not functioning well and its sustainability cannot be taken for granted.

In the history of the European Communities, two attempts at monetary cooperation have already broken down because the system was not resilient enough. The existence of a single currency in itself should not be seen as a sufficient guarantee against such a breakdown to happen again.

New pillars, new stabilising mechanisms are therefore needed in the architecture of the EMU.

Basic European unemployment insurance as part of the EMU's reconstruction

The euro zone crisis triggered more coordination and more solidarity from the very start. First the EFSM and EFSF were put together and then a permanent European Stability Mechanism was established as a permanent tool able to bail out various smaller euro zone countries.

A banking union has recently been agreed, as I have already mentioned.

But does this mean that the core weaknesses of the EMU have been addressed? I do not think so. The main design flaws, namely the absence of a lender of last resort and of common fiscal capacity are still present.

Even with strong policy coordination and banking union, the EMU is not resilient enough to cope with economic shocks in a way that would be acceptable from the viewpoint of the EU's treaty objectives such as balanced economic growth, full employment and social progress.

The recently introduced instruments may be able to restore financial stability in the short term, but are not sufficient for stabilising aggregate demand, output and employment.

When I advocate fiscal transfers between euro zone countries, I do not do it only out of concern for the employment and social situation. The current functioning of the EMU is suboptimal first of all for economic growth – for all Member States without exception.

The creation of a fiscal capacity at the level of the EMU is therefore clearly foreseen in the *Blueprint for a deep and genuine EMU* and in the *Four Presidents' report* of 2012.

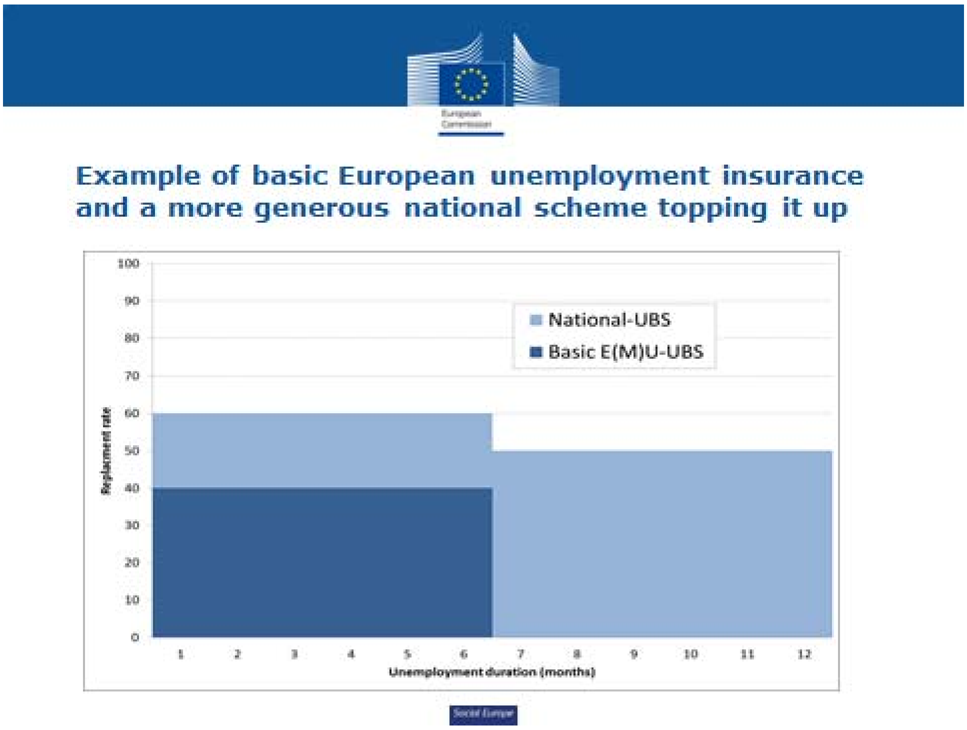
A number of options for automatic fiscal stabilisers at the level of the monetary union have been proposed in the expert literature over the past few years. What most of them have in common is their focus on mitigating short-term cyclical downturns occurring in parts of the EMU as opposed to compensating for structural differences among the EMU economies.

Focusing fiscal risk-sharing mechanisms on mitigation of asymmetrically distributed cyclical shocks means that over 1-2 decades, all participating Member States are likely to be both contributors and beneficiaries of the scheme.

But even if the balance is not exactly zero after a certain period of time, the effect that economic crises would be less deep and last less long would be good for all countries.

The best idea for an EMU-level automatic fiscal stabiliser is in my view a scheme where fiscal stimulus is provided to countries of the monetary union based on developments in their short-term unemployment.

Unemployment is an indicator whose big advantages are that it very closely follows developments in the economic cycle, it is easily understandable, and it is easily and promptly measurable.



Basic European unemployment insurance could replace the corresponding part of national schemes. The levels of the contribution and of the benefit should represent a relatively low common denominator between the rules of the various national schemes.

The scheme should clearly focus on cyclical unemployment caused by a drop in aggregate demand, as opposed to structural unemployment caused by skills mismatches, less efficient labour market institutions and the like.

For example, the basic European unemployment benefit would be paid only for the first 6 months of unemployment and the amount would represent 40% of the previous reference wage. These exact parameters would of course need to be discussed, depending on the desired macroeconomic stabilisation effect.

The eligibility conditions should not be too strict, so that also workers in short-term or part-time jobs could contribute and qualify for corresponding support. But in any case there would be clear conditionality in terms of the job-search and training effort.

Each Member State would be free to levy an additional contribution and pay out a higher or longer unemployment benefit on top of this European unemployment insurance. What the European scheme would do is to ensure a fairly basic standard of support during short-term unemployment.

Citizens would directly benefit from EU solidarity at times of hardship, and Member States would be required to upgrade their employment services and labour market institutions to the best EU standards.

The jobseekers would continue to interact with national authorities (public employment services). However, every month these national authorities would send to the European fund the basic contribution from all their employed workers.

Likewise, every month the European fund would pay to the national authorities an amount corresponding to the sum of all the basic European unemployment benefit payments to be made that month in the country.

In principle, each country would therefore make every month an overall contribution and receive an overall payment from the European scheme. In practice, these two could of course be offset and only the net balance would be paid.

The overall volume of such a basic European unemployment insurance scheme would be around 1% of GDP, mainly depending on the exact parameters such as duration and level of the benefit or the eligibility conditions. Of course, the net transfers from or into any particular country would be smaller, because drawdowns would be offset by contributions and vice versa.

The question who is a net contributor and a net beneficiary at any given point in time should be to some extent secondary. Sharing a currency really in many ways means sharing a destiny, and the euro is meant to be irreversible.

However, it would be of course important to mitigate the risk of possible 'moral hazard', namely to ensure that there are no free-riders in the scheme, i.e. countries that would be net beneficiaries most of the time.

It would be also important to ensure that countries with successful active labour market policies and internal flexibility are not unfairly penalised for having lower unemployment rates than countries where external flexibility is more common and labour market institutions less efficient.

The risk of ‘lasting transfers’ could be minimised through two mechanisms, which already exist elsewhere in the world, namely *experience rating* and *clawbacks*.

Experience rating means that the contributor vs. beneficiary profile of each Member State in the scheme is monitored, and the contribution or drawdown parameters can be adjusted at the beginning of each period so as to bring the Member State closer to a projected balance with the scheme over the medium term.

Clawbacks, on the other hand, enable to neutralise net transfers *ex post*, meaning that Member States are allowed to be net beneficiaries for several years, but then their contribution and/or drawdown rates are modified so as to compensate for the net transfers that had occurred.

Similar safeguards feature for instance in the US federal unemployment insurance system.

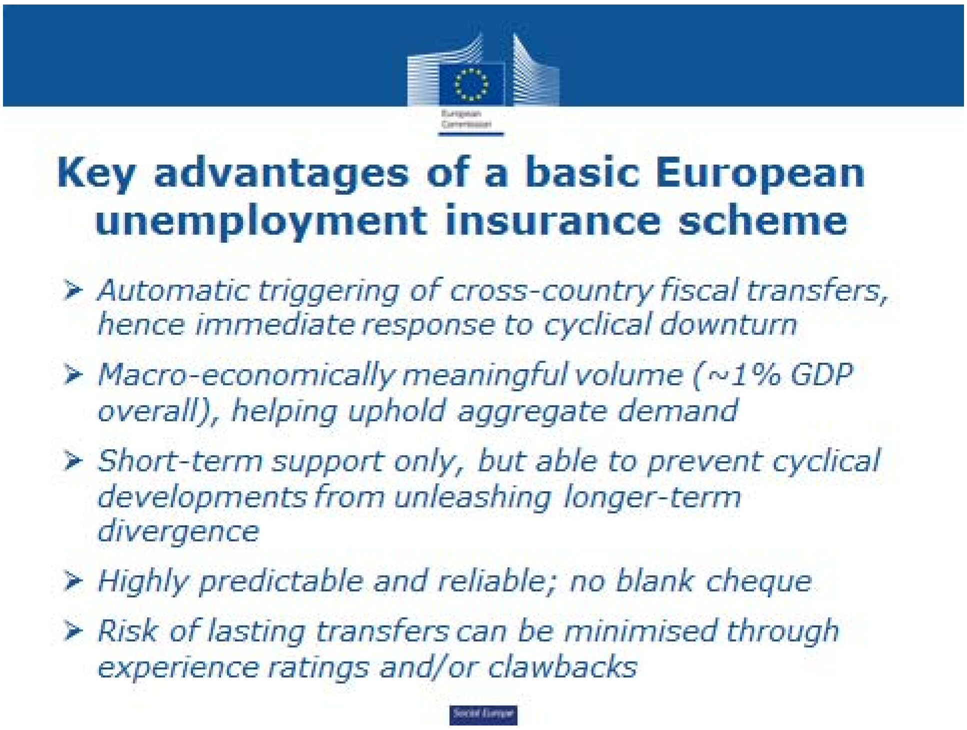
As part of its exploratory technical work on EMU-fiscal stabilisers, the European Commission is in the process of launching a major study where econometric modelling would be undertaken to analyse the possible functioning of a basic European unemployment insurance scheme. Mechanisms preventing lasting transfers will be one of the key issues studied.

But for those interested in estimating how such a scheme would work and which countries would be net beneficiaries and contributors at various points in time, there is already today a number of interesting analyses available, for example the "do it yourself" tool developed by the Bruegel think-tank, which allows anyone to play with key parameters of a European unemployment insurance scheme directly on the website and see what implications they would have.

Conclusion

Ladies and Gentlemen,

Allow me to conclude by re-capping the key advantages which an automatic fiscal stabiliser in the form of basic European unemployment insurance would have.



First of all, with automatically triggered and rapidly implemented transfers of a few tenths of a per cent of GDP, the scheme could have a meaningful macroeconomic effect in counteracting a cyclical downturn exactly at the right time.

Secondly, the functioning of the scheme would be entirely predictable and calculable in advance on the basis of clear rules.

The parameters could be adjusted in response to actual experience, but governments, citizens as well as financial markets would be able to rely on the principle that an EMU country undergoing a cyclical downturn receives a limited fiscal transfer to support the cost of short-term unemployment.

At the same time, the basic European unemployment insurance scheme would certainly not be a blank cheque. Given the still limited trust between national treasuries and parliaments in the euro zone, this scheme would be a much safer option than various scenarios for the mutualisation of sovereign debt.

Thirdly, the fact that the scheme would trigger countercyclical transfers automatically and immediately is a major advantage compared to bailout programmes or bank rescues. These are always surrounded by uncertainty which pushes up their cost. The basic European unemployment insurance would be relatively cheap precisely because of its automaticity.

Fourth, as an automatic fiscal stabiliser focused on the short-term, basic European unemployment insurance would help to prevent cyclical shocks from turning into longer-lasting divergences which undermine the functioning of the entire monetary union.

Cyclical shocks will always occur. Members of a monetary union can either insure themselves through a short-term automatic fiscal stabilisation scheme, or they can choose to remain uninsured and therefore to risk the repetition of a dangerous and damaging economic and political crisis every time.

For me the key question is: can we learn from the experience of abrupt fiscal consolidation and internal devaluation that caused the second euro zone crisis (from which we still have not recovered), or will we maintain a system that will force us to repeat the same mistakes at the next occasion and lock Europe into low growth and high uncertainty?

In my view the EU cannot live together for too long with the risk of monetary breakdown, which also would bring with itself social and political breakdown.

Our political union is not so strong as to survive 20 years of anaemic growth, very low inflation and high unemployment. We are not a homogeneous country like Japan, and in any case it would be a bad idea to repeat Japan's lost decades when Japan itself is finally emerging from them.

If our Economic and Monetary Union is meant to be irreversible, it must also be fair and it must be based on solidarity. We must pay attention to the employment and social outcomes, and try to prevent lasting divergence.

For that, an automatic fiscal stabiliser is needed at the euro zone level.

I have presented to you what I consider to be a workable option, and I very much I look forward to your views.

Thank you.