



Economic Policy in the EU: An Introduction

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Outline

- 1. International Unions**
- 2. The EU: A snapshot**
- 3. European governance**
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 1. The EU and globalisation
 2. The EU budget
 3. EMU and the crisis

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1. International Unions

- 40% of world population lives in federations or confederations (e.g. Australia, Brazil, Germany, India, US)
- Rise of regional groupings in Europe and elsewhere (Asia, Latin America..)
- Multi-level government raises many questions:
 - Costs and benefits of joining / leaving
 - Criteria for joining / leaving
 - Competence assignment
 - Vertical / horizontal coordination

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Basics: varieties of international unions

- Free trade area (e.g. NAFTA)
 - Trade and trade-related dimensions only, preserves national autonomy (different tariffs)
- Customs union (e.g. early EU)
 - Trade and trade-related only, but common tariff
- Single market (EU 1980s)
 - Free mobility of products and factors implies more demanding harmonised rules (services directive)
- Monetary union (euro area)
 - Major increase in interdependence, implication for other policies
- Economic and Monetary Union (EMU)
 - Single market + common policies + budgetary rules + monetary union

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Basics: theory

Early approaches

- Olson's 'budgetary equivalence': pay where you consume
- Oates: decentralisation principle
- Tiebout, Weingast et al.: decentralisation as a protection against the state

Modern approaches

- Why centralise? externalities / economies of scale
- So unions result from trade-off between diversity of preferences and externalities / economies of scale
- Alesina, Angeloni and Etro (2005) formalise this trade-off

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The AAE model

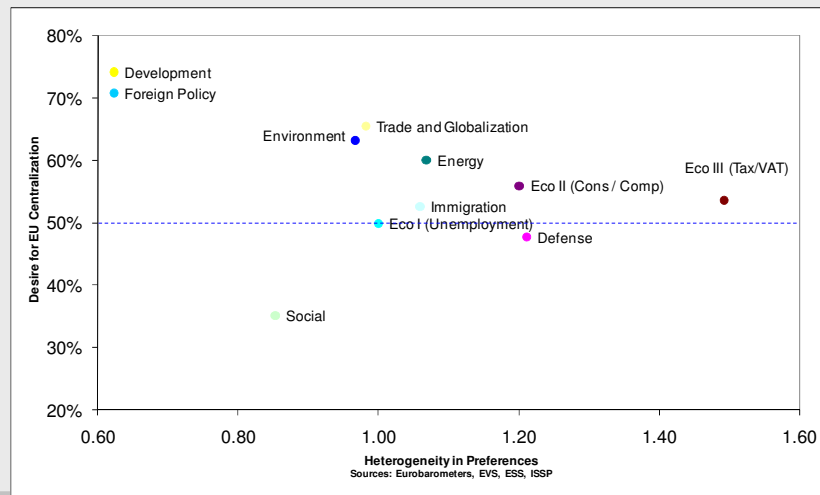
- N countries each have income Y_i , contribute G_i to provision of common public good. Utility is
 $U_i = Y_i - G_i + \alpha_i H(G_i)$ if country i does not belong to the union,
but $U_i = Y_i - G_i + \alpha_i H(G_i + \beta \sum_{j \neq i} G_j)$ if it belongs to the union
- In the union decision on production of public good is taken by majority, so corresponds to preference of median voter m (in case of simple majority voting). Therefore,

$$\alpha_m H((1 + \beta(N-1))\tilde{G}_N) = \frac{1}{1 + \beta(N-1)}$$

- After the union has been formed, enlargement to a new member has two effects:
 - a) Increases positive externalities (thus increases G_N)
 - b) May change political equilibrium (α_m)
- Thus current members may lose from enlargement or countries may be better off remaining outside (because of (b))

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Centralisation and preferences in the EU



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2. The EU: A snapshot

- 1950: learning of
 - Coordination with *European Payments Union* (ended 1958)
 - Delegation with *European Coal and Steel Community* (ended 1967)
- 1957: European Community. Limited scope, but full-fledged legal and institutional framework
 - Supremacy of Community law, Court of justice
 - Supranational body
 - Complete delegation of trade, competition policies
 - Irreversibility through *Acquis communautaire*
- 1992: Maastricht treaty
 - Delegation of monetary authority to common central bank
 - Coordination / surveillance of budgetary policies
- 1997-2005: (failed) attempts at political union

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The EU's evolving principles

- **Early days: broad end-goal (ever closer union), small steps, powerful integration lock-in mechanisms (*acquis*)**
- **Post-Maastricht introduced principles to limit centralisation**
 - Attribution: all competence not attributed to the EU belongs to MS
 - Subsidiarity: except in areas of exclusive competence, the EU only intervenes when action by MS is not « sufficient »
- **Constitution / Lisbon treaty: attempt at clarification**
 - Clearer competence assignment
- **However limited effectiveness**
 - De facto move into increasing overlap between EU and national competence

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What the EU does (for dummies)

	Member States	EU
Micro	Labour	Goods Capital
Macro	Budget	Money

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What the EU does (for scholars)

	Member States	EU
Allocation		
Labour	XX	X
Products	X	XX
Capital	X	XX
CO2	X	XX
Infrastructure, research, education	XX	X
Agriculture		XXX
Stabilisation		
Money and exchange rate		XXX
Financial stability	XX	X
Budgetary policy	XX	X
Redistribution		
Across individuals	XXX	
Across regions	XX	X
Across countries		XXX

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A sui generis construct

- **Less centralised than the US for:**
 - Budgetary policy (US federal budget amounts to 20% of GDP, EU budget is 1% of GDP)
 - Redistribution (redistribution in the US is mainly of the responsibility of the federal budget)
 - Labour market
- **More centralised than the US for:**
 - Indirect taxation
 - State aid control

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Why? An attempt at rationalisation

Economic assumptions

1. Products and capital are mobile cross-border, but labour isn't
2. The EU manages the single market, other allocation policies are of the responsibility of the MS (with loose coordination)
3. The single market implies a single currency
4. The single currency does not imply a common budget but the surveillance of national budgetary policies
5. The Union does not engage into redistribution across individual but across regions and countries

(This ignores the CAP)

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Are these hypotheses correct?

- **Market integration: yes, but**
 - Border effects still matter considerably (1/3 of manufacturing firms do not export; among exporters 1/3 exports only one product to one country)
 - Labour mobility has increased markedly in recent years (Ireland: from 0 in 1993 to almost 2% of population in 2006, possibly negative in 2009)
- **One market, one money: not for all**
 - No overriding economic argument in favour of the euro (UK, Sweden, NMS)
 - Political economy?
- **Small budget: political reality, not economic logic**
 - Larger budget would be desirable from a macro standpoint
- **Coordination of budgetary policies: enduring controversy**
 - Various views of EMU requirement
- **Redistribution: why regions?**
 - Economics or European pork barrel politics?

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3. European governance

- **Lisbon treaty (not in force) attempted at clarifying competences, distinguishing:**
 - Exclusive EU competences [competition]
 - Shared competences (MS exercise competence if EU does not) [regional policy]
 - Coordination [employment policy]
 - Supporting EU competence (but MS in the driving seat) [education]
- **Rise of shared competence and coordination**
 - Budgetary policies (post-Maastricht)
 - Lisbon (post-2000)
 - External dimensions
- **Increasing messiness of competences, complexity of governance**

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Governance technologies Three models

Model	Principle	Examples
Unconditional delegation	Delegation to EU institution, non-binding monitoring by states / parliament	Competition Monetary policy
Supervised delegation	Delegation to EU institution on the basis of specific mandate, supervision by states / parliament	Trade
Coordination	No delegation but commitment to coordinate policies	CO2 Lisbon matters Budgetary policies Int'l finance



What works and what doesn't

- **Delegation: issues are policy strategy, accountability**
 - Monetary policy
 - Competition
 - Trade
- **Coordination: low effectiveness**
 - [Budgetary policy](#) (rules-based coordination)
 - [Lisbon](#) (open method of coordination)

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4.1 The EU and globalisation

A view:

"For decades the assumption has been that Europe's nations would move from economic integration at a national level to economic integration at a European level. Instead of national flows of capital there would be European flows of capital; instead of national companies, European companies; instead of national brands, European brands. Yet today it is global, not European, flows of capital that we chart every day. We talk of the global company, rather than just the European company. [...] So it is the global and not just European sourcing of goods and services – as well as of capital and, importantly, labour - that is now driving economic change."

Gordon Brown (2005)



..A reply..

"[...] the EU needs a new core purpose. One which looks forward, recognises new realities, that draws inspiration from, but does not depend upon, the achievements of the past. Our purpose is staring us in the face. In 1950 the challenge was securing a lasting peace. Today it is climate change, growing competition from China and India. Mass migration. International terrorism. These challenges are shared by all Europeans, from London to Lisbon. They are challenges which no nation state can tackle successfully alone. [...] And surely this is the EU's raison d'être for the 21st century: to help Europeans prosper in a globalised world."

José Manuel Barroso (2006)



..The new consensus

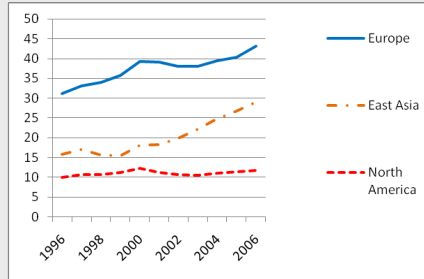
"Globalisation is increasingly shaping our lives by fostering the exchange of peoples, goods, services and ideas and by offering new opportunities to citizens and business. Greater trade flows and economic growth have increased prosperity, transforming the lifestyles of Europe's citizens and lifting millions worldwide out of poverty. But globalisation also confronts us with new economic, social, environmental, energy and security challenges. We aim at shaping globalisation in the interests of all our citizens, based on our common values and principles. For this even the enlarged Union cannot act alone."

European Council (2007)

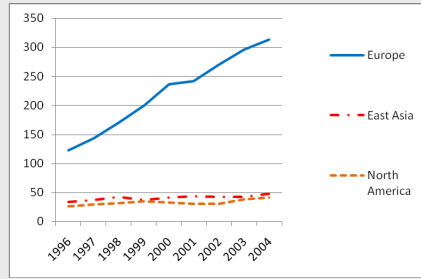


Is the EU still relevant? Facts

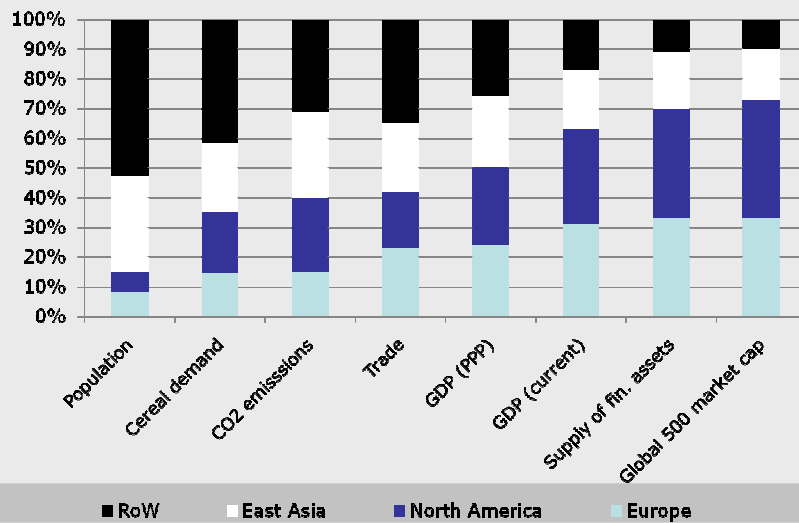
Internal trade as a percentage of GDP



Cross-border financial holdings as a percentage of GDP



Shaping globalisation? Europe's economic weight (2006)





Competence: Who does what on international issues

	Competence	Legal basis for EU competence
International trade	Goods: EU exclusive Services : shared	Explicit
Development	Specific EU alongside MS	Explicit
Intl. money and finance	Xrate: EU exclusive Other fields: MS	Explicit for Xrate Otherwise implied
Competition policy	Exclusive EU above threshold	Explicit
Financial markets regulation	Shared	Implied (single market)
Migrations	Mostly MS, EU initiative	Explicit
Energy	Shared	Implied, explicit for nuclear energy
Environment	Exclusive for maritime resources, otherwise shared	Implied



The fragmented representation of the euro area

Table 8.1: External representation of the euro area: an overview

	European Central Bank	Eurogroup Presidency	EU Presidency	European Commission	EU member states
OECD	Participates in Economic and Development Review Committee, Economic Policy Committee, and Committee on Financial Markets	Participates in Economic and Development Review Committee examination of the euro area		Quasi-membership (no voting rights and does not contribute to OECD budget but participates in all meetings)	19
IMF Executive Board	Observer status		Euro-area position represented by Executive Director holding EU/euro area Presidency		27
Financial Stability Forum	Full participation				5
International Monetary and Financial Committee	Observer status		Full participation depending on the constituency agreement	Observer status	27
IMF Multilateral Consultations	Full participation	Full participation	No	Full participation	
G7 Finance Ministers	Nearly full attendance	Nearly full attendance		Partial attendance (not involved in preparatory work)	4
G20	Full participation		Full participation	Attends meetings as part of the EU Presidency delegation	5



4.2 The EU budget

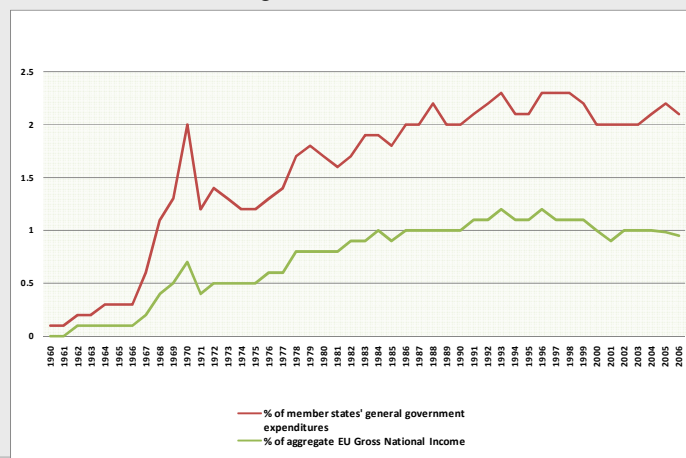
- **EU budget « an historical relic »**
 - Size
 - Composition (CAP and structural funds)
 - Financing (roughly GDP-based)
 - National rebates (*juste retour*)
 - Inflexibility
- **2005 agreement for budget review**
 - Should take place in 2009-S2

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A small and stable budget

The budget of the EU, 1960-2006

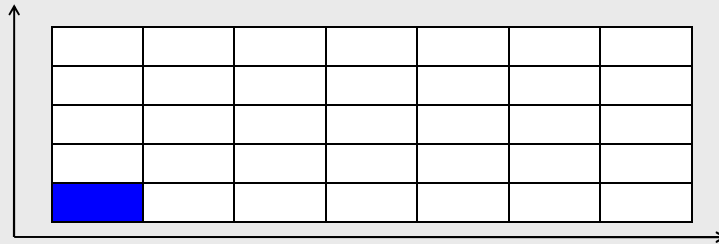


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Where the EU budget fits in

- **EU budget vs. other instruments: two dimensions**
 - Vertical: other public spending (EU spending 1/40th of total)
 - Horizontal: At EU level budget is only one of several *instrument* (alongside regulation, coordination), often not the main one



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What role for the EU budget?

The Musgravian trinity

- **Macroeconomic stabilisation – no role**
 - Dominated by monetary policy, coordination of national budgetary policies
- **Allocation – specific policies**
 - Main instruments are regulation, trade policy, competition policy
 - Room for complementary instrument
- **Redistribution – inter-country and inter-region**
 - No interpersonal redistribution
 - Significant international and interregional dimensions

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What criteria for deciding on spending?

Subsidiarity criterion applies, but

- Treaty clearly states it applies to competences, thus policies
- Impact of EU policies on national spending more significant than on EU spending
 - R&D, higher education
 - Infrastructure
 - Climate
 - Development assistance
- **EU budget cannot be looked at in isolation**
 - However large disconnect between EU budget and EU policies

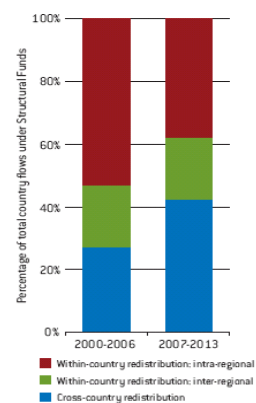
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Redistribution to regions or to countries?

- Most EU-led redistribution takes place within countries, even within regions
- Regional policy is a strange mix, disputable from allocative and distributional viewpoints
- Enlargement implies lesser focus on regions

Fig 1: Redistribution through Structural Funds, country average EU15



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Economics vs. politics

- **Two views**

- Standard normative economics
 - European public goods
 - Degree of redistribution
- Political approach (on both revenue and spending sides)
 - Citizenship through taxation
 - Redress domestic political failures through EU policies

- **Don't overplay political arguments**

- EU legitimacy still primarily rests on economic criteria
- Political argument should have limited role only
- Fate of referendum is reason for caution

- **Case for incentive role in accordance with EU priorities**

- Lisbon: EU as (weak) incentive framework

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How flexible should the EU budget be?

- **EU priorities variable over time**

- 1980's: Single market
- 1990's: EMU
- 2000's: Enlargement
- 2010's: Climate, external action

- **Calls for dynamic subsidiarity principle**

- **Yet most of EU budget is an entitlement budget**

- PAC and structural funds
- Lisbonisation of spending items is window dressing

- **Support to EU priorities calls for much more flexibility in the budget**

- Reason to separate out discussion on net balances
- Reason for sunset clauses

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The Sapir budget blueprint

Financial period 2007-2011	
<u>Expenditure</u>	<u>% of EU GDP</u>
Growth	0.45
(R&D)	(0.25)
(Education & Training)	(0.075)
(Infrastructure)	(0.125)
Convergence	0.35
(For new Member States)	(0.20)
(For old Member States)	(0.10)
(Phasing out for macro-regions)	(0.05)
Restructuring	0.20
(For displaced workers)	(0.05)
(For agriculture)	(0.05)
(Phasing out of agricultural expenditure)	(0.10)
Total economic and social activities	1.00

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4.3 EMU and the crisis

- **Euro area policy system challenged by crisis**
 - Early response to liquidity crisis
 - However belated / inadequate responses to:
 - Bank solvency concerns
 - Coordination of stimulus packages
 - Crisis across the border (Central Europe)
 - Threats of funding crisis within the euro area (Greece, Ireland)

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The problem: fair vs. stormy weather governance

What is expected from a policy system is very different in crisis times and in normal times

Normal times	Crisis times
Stability Predictability Incentive properties -Budgetary discipline -Pro-growth reforms	Initiative Flexibility Centralisation

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Summing up

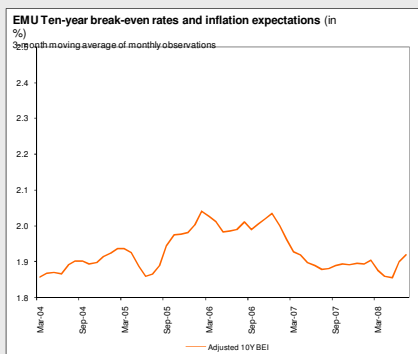
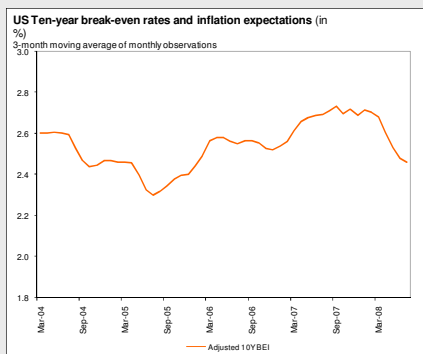
- **Excellent**
 - Transition to euro
 - Price stability
 - Predictability
- **Fair**
 - Budget discipline (but Greece, France, Portugal)
- **Poor**
 - Sustainability
 - Non-fiscal instability risks
 - Divergence within euro area
 - Financial supervision

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EMU in normal times: Inflation expectations

US 2004-2008

Euro area 2004-2008



Source: BIS and Bruegel calculations

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EMU in normal times: Monetary policy transparency

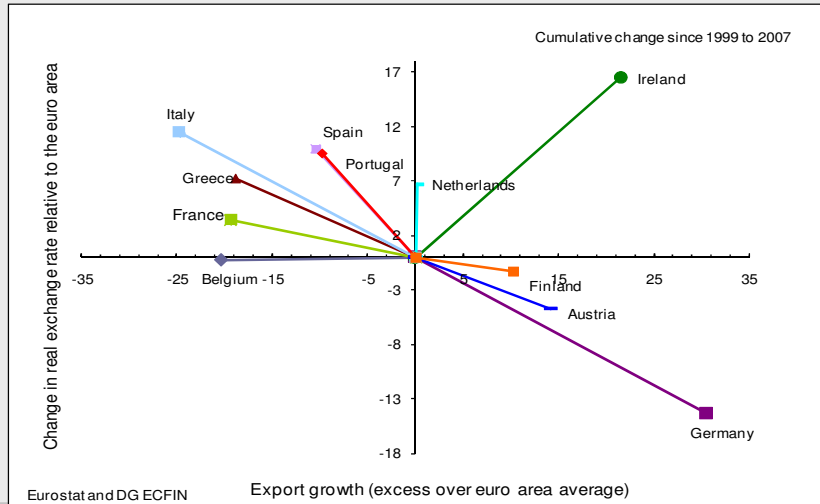
Little difference between the ECB and the Fed overall

	Australia	Canada	Euro zone	Japan	New-Zealand	Sweden	Switzerland	UK	USA
Political	3	3	3	1.5	3	3	2.5	3	1
Economic	2	2.5	2.5	1.5	3	2	1.5	3	2.5
Procedural	1	1	1	2	3	3	1	3	2
Policy	1.5	2	2	1.5	3	3	2	1.5	3
Operational	1.5	2	2	1.5	2	3	0.5	2.5	1.5
TOTAL	9	10.5	10.5	8	14	14	7.5	13	10

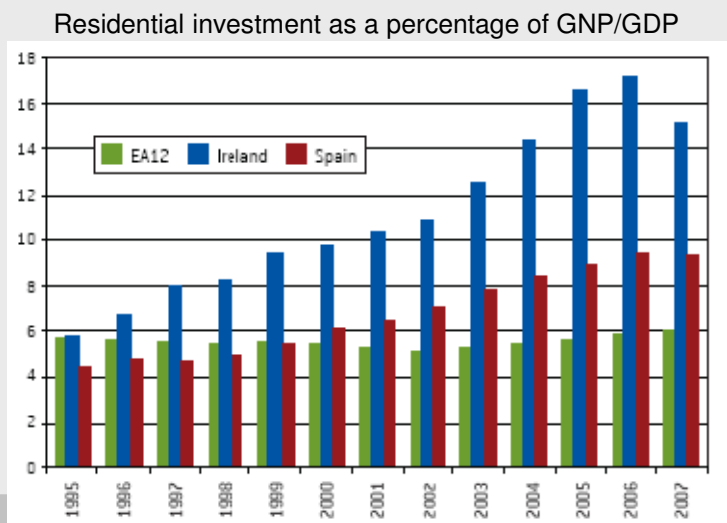
Source: Eijfinger and Geraats (2005)

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EMU in normal times: Competitiveness divergence



EMU in normal times: It's not always fiscal..



Source: Ahearne et al. 2008



Governance in crisis times: early lessons

- **Not a rigid system after all**
 - Considerable ECB flexibility in liquidity provision
 - Real-time response
 - Learning and pragmatism (monetary policy reversal Oct 08)
 - Commission demonstrated flexibility on state aid, SGP
- **Coordination outside institutional framework**
 - Ad-hoc cooperation on cross-border banking crises
 - Fortis, Dexia
 - Effective coordination on design of crisis management blueprint
 - Oct 12/15 success
 - Stimulus packages
- **Global leadership**
 - G20

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However major policy issues remain unsolved

- **Ad-hoc treatment of pan-European banks**
 - Weak supervisory structure, reliance on coordination neglects incentives to use information strategically
 - Case-by-case treatment of near-bankruptcies
 - No common chest
 - No template for burdensharing
- **« Too small to provide help » risk**
 - Big banks vs. small states (Austria, Ireland, Belgium)
- **Spillovers from national decisions**
 - Cross-border lending
 - Guarantees
 - Capital flows from « weak » to « strong » countries (issue for the NMS)

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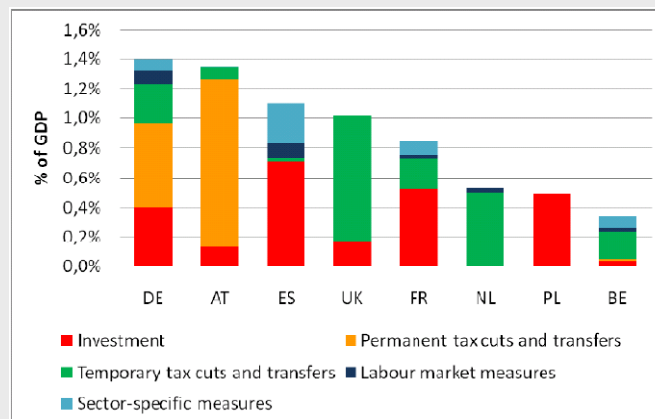
Coming challenges

- **Uneven implementation of joint decisions**
 - Devil in details: possibility of regulatory arbitrage
 - e.g. strings attached to funding
 - Return of « national champions »
 - Recapitalisation as a way to fund acquisitions?
 - Potential distortions to competition
- **Exit from crisis solution regime**
- **Fragmentation**
 - Fortis break-up
 - Lasting effects of national responses (new institutions and procedures)
 - Politics (especially in new member states)
- **Fiscal policy**
 - Effects of slowdown, drop in tax receipts
 - Further stimulus likely to be necessary
 - Beyond limits SGP provides little guidance, MTO has low credibility

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Loose coordination of national stimulus packages (size and content)



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Implication for governance reform

- **Questions: prevention**
 - Ex-ante centralisation vs. decentralisation in crisis prevention (do we need a European supervisor?)
 - Breadth of fiscal surveillance
 - Non-fiscal surveillance
- **Questions: crisis management**
 - Rules vs. discretion (replace Fortis by Unicredit and replay)
 - Institutions vs. leadership (replace Sarkozy by Klaus and replay)
 - Euro area vs. EU (is Gordon Brown an honorary member of the euro area?)
 - Money vs. rules (do we need an EU chest after all?)

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Thank You For Your Attention

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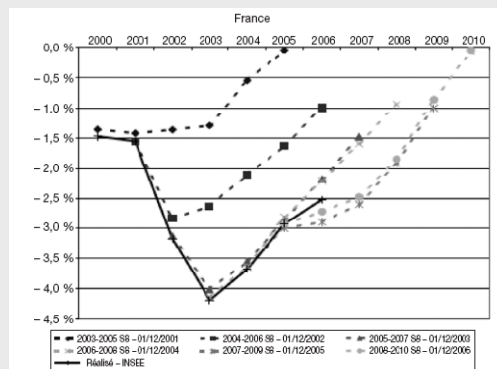


Annexes

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Budgetary coordination France and the SGP: a moving target



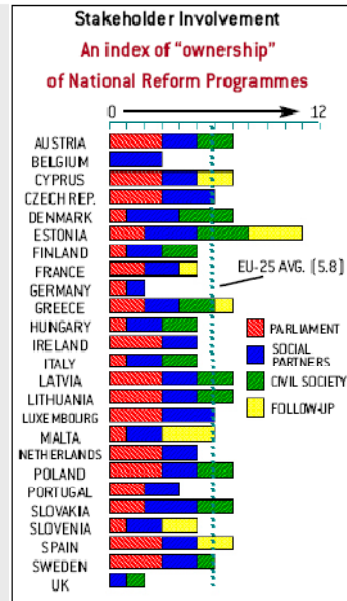
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The Lisbon strategy

- Lisbon's aim is to coordinate national reform programmes to make them consistent with EU growth and employment goals
- However incentives are absent
 - No role for EU budget
 - No 'name and shame'
- Result is low ownership and low effectiveness



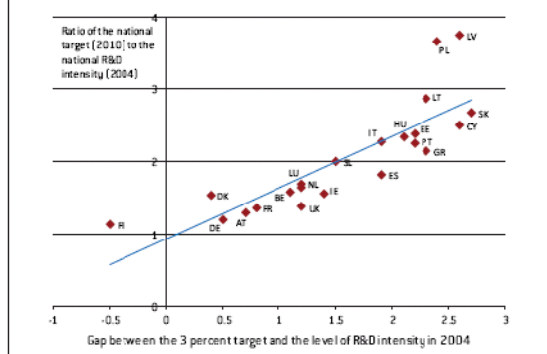
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The Lisbon strategy (cont'd)

- National R&D targets are set to match EU-wide goal, irrespective of specialisation

Figure 3: R&D intensity targets for 2010 compared 'the Lisbon gap' in 2004



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