DOI: 10.1007/s10272-010-0347-2

Eckehard Rosenbaum*

Lisbon, Europe 2020, and the Case for Soft Coordination in EU Policymaking

Positive spillovers from structural and other reforms figure among the key reasons for the Lisbon and the Europe 2020 Strategies. This paper investigates the theoretical and empirical evidence for such spillovers and shows that the need for coordination in some policy areas is less evident than commonly assumed, whereas in others a lack of coordination is at the root of persistent economic imbalances.

In 2000 the Lisbon European Council pledged to "make Europe, by 2010, the most competitive and the most dynamic knowledge-based economy in the world". A key rationale of the strategy was that reform interdependencies exist between Member States and that coordinated action is more effective and efficient than acting alone.[1] Since then, the same idea has resurfaced repeatedly, not least in the European Economic Recovery Programme (EERP). The new Europe 2020 Strategy,[2] the follow-up to Lisbon, even sets out to further strengthen coordination. And while Europe 2020 makes the case for coordination in rather broad terms, there is one exception. Macroeconomic imbalances and divergences in competitiveness amongst Member States are highlighted as the main reasons for better coordination.

Thus interdependencies play a focal role in the economic policy narrative of the Commission. But where do such interdependencies occur and how significant are they? The aim of the present paper, then, is to investigate reform interdependencies and their implications for policymaking. The key question is: how strong is the case for improving coordination, in particular in areas where voluntary cooperation is the main governance tool?

Is There a Case for Coordination?

What Does Interdependence Mean?

The view that coordination is beneficial suggests that it makes a difference to the overall impact of reform x in country a whether this reform is undertaken together with reform y in country b.

However, reform interdependencies may exist not only between countries but also within countries. Having said this, the Lisbon Integrated Guidelines (IGs) did not identify cross-country interdependencies systematically: while interdependencies amongst policy areas were mentioned in at least 22 cases (out of 276), there is no reference to interdependencies across countries. The same picture emerges for the Europe 2020 Strategy. As before, reform interdependencies across Member States are not acknowledged explicitly.

Reasons for Coordination

Broadly speaking, at least four different reasons for coordination can be distinguished. The first argument holds that coordination facilitates policy learning about best practices. However, as Begg[3] points out, such knowledge can be obtained without extensive governance structures. Moreover, the notion of coordination suggests that all parties involved adapt their behaviour. But that is more than what mutual learning implies.

According to the second argument, coordination acts as a lever to counter opposition. Thus coordination may help Member States to go further or faster than normally the case, for instance by pointing to peer pressure from Brussels. However, the argument is a difficult one, sug-

* European Commission, Directorate General Enterprise and Industry, Brussels, Belgium. The views expressed are purely those of the author and may not in any circumstances be regarded as stating an official position of the European Commission.

1 European Commission: European Competitiveness Report 2007, COM (2007) 666 final, Brussels 2007.

2 European Commission: A strategy for smart, sustainable and inclusive growth, COM (2010) 2020, Brussels 2010.

3 Iain Begg: Is there a convincing rationale for the Lisbon Strategy?, in: Journal of Common Market Studies, Vol. 46, No. 2, 2008, pp. 427-435; European Commission: Spillovers and complementarities in the context of the Lisbon Growth and Jobs Strategy including economic effects of the Community Lisbon Programme, SEC (2007) 1689, Brussels 2007.

gesting as it does that it is legitimate to interfere with democratic decision-making processes.

According to the third argument, coordination may enhance the quality of economic reforms by providing a template of reform that seeks to benefit from the experience of others. The point appears to be that mistakes can be avoided by doing what others have already successfully done themselves. Hence, at issue is now *how* a successful reform has been implemented in practice, not so much *whether* a reform has to be undertaken at all.

Spillover Effects

The most important – and least controversial – argument for coordination refers to spillovers.[4] Thus coordination is either a means of avoiding *negative* spillovers, or of benefiting from enhanced *positive* spillovers. However, the notion of spillovers is somewhat ambiguous. I therefore distinguish between two types of interdependencies:

- spillover effects proper, i.e. one-directional positive or negative effects of reforms
- complementarities, i.e. bi-directional effects between reforms.

The first case can be conceptualised using notions such as externalities or public goods, while the second case rests more on functional properties or politico-economic and institutional considerations.

The textbook case of a positive externality is of course the introduction of a tax which curbs pollution by making emissions more costly. Here benefits are not restricted to those who undertake the investment, nor do they stop at national borders. But neither are such effects at the heart of the Lisbon or Europe 2020 debate. For this debate, it is more significant that spillover effects can also be conceived as the provision of a public good.[5] For instance, the knowledge generated through R&D – provided marginal user costs are negligible – may also be useful for other actors in industry or science.

How big are the effects? Following Armstrong[6], effects are difficult to detect. Indeed, there seems to be little evidence except for a number of simulations undertaken by DG ECFIN on the benefits of coordination in the EU. In these, the biggest effects can be observed for R&D, ranging from 20% to 50% of the overall effect. By comparison, the effect for skills is estimated to be just 5%.[7]

In view of both the characterisation as an externality or as a public good and the size of the spillover effect, the case for coordination is straightforward. Not surprisingly, R&D expenditures receive much political attention at the European level.

Spillover effects which are not public goods or externalities occur whenever a reform generates changes in relative prices or demand which are felt in other sectors of the economy and thus generate additional income in these sectors. Cases in point are demand-stimulating policies such as tax reductions. In an open economy, such measures will not only boost domestic demand but also import demand.[8] They will be discussed below.

Complementarities of Reforms

Following the above terminology, some complementarities can best be conceived as bi-directional spillover effects. R&D expenditures and policies to enhance the skills of workers, for instance, are complementary in that R&D which leads to new products or services needs skilled workers to produce these.[9] But while valid, the issue is most likely of greater relevance within a country than between countries. Thus although R&D and education policies should be coordinated, EU-level coordination of R&D does not enjoy precedence over national coordination. In fact, the opposite is equally plausible in view of the above simulation results for skills.

In some instances, however, complementarities are better understood without recourse to externalities or public goods. This is the case when a policy measure contributes directly and intentionally to the effectiveness of another policy measure and vice versa. Complementarities so conceived exist for example between measures which facilitate entrepreneurship and R&D expenditures. The commercial exploitation of innovations often takes place in newly founded enterprises, while (public) R&D expenditures are particularly important for SMEs which cannot afford large-scale research and thus depend on research undertaken by public research insti-

4 European Commission, ibid.

5 European Commission, ibid.; Xavier Debrun, Jean Pisany-Ferry: Economic Reforms in the Euro Area: Is there a Common Agenda?, Bruegel Policy Contributions, Brussels 2006.

6 Kenneth Armstrong: Governance and Constitutionalism after Lisbon, in: Journal of Common Market Studies, Vol. 46, No. 2, 2008, pp. 415-426.

7 European Commission: Spillovers and complementarities in the context of the Lisbon Growth and Jobs Strategy including economic effects of the Community Lisbon Programme SEC (2007) 1689, Brussels 2007, op. cit.

8 Ibid.

9 Ibid.

tutions. Another argument maintains that Community action complements policy actions at the national level.[10] Thus financial market integration is complementary to efforts to reduce administrative entry barriers. Note, however, that here the need for coordination at the *European* level does not primarily result from mutual spillovers but from the fact that some competences rest with the Union while others remain with Member States. Thus coordination between Member States tends to be a by-product.

Before turning to macroeconomic spillovers, I shall briefly discuss complementarities between product and labour market reforms, since these have attracted considerable attention.[11] The argument here is that product market liberalisation aims at inducing more competition in product markets, which leads to lower prices and increased demand, thereby boosting demand for resources. Increased factor demand induces upward pressure on wages and puts a brake on the expansion of output. Hence, labour market reforms which augment the elasticity of labour supply help to dampen price increases and enhance the effects of liberalising the product market.

A similar relationship holds for the impact of labour market deregulation at different levels of product market regulation. Accordingly, lower product market regulation increases the elasticity of demand. This boosts the impact of real wages on output and factor demand and makes wage moderation more effective. Alternatively, reforming labour markets may aim at boosting labour supply.[12] In this case, product market reforms facilitate labour market reforms if increased competition in product markets dampens prices and thus in part compensates the pressure on nominal and real wages.

To summarise, several complementarities between product and labour market reforms exist. But there is little to suggest that coordination at the Community level is required beyond the exchange of information on best practice. All potential effects call first and foremost for more coordination among national policies. That picture changes once we look at macro-interdependencies.

Macroeconomic Interdependencies

Microeconomic Reforms and the Macroeconomic Environment

In the macroeconomic domain, there are a number of important spillovers which may or may not call for coordination. Obviously, there are interdependencies between microeconomic reforms and the macroeconomic environment. Thus a favourable macroeconomic environment, in particular strong growth, should facilitate R&D and thus innovation in that growth may alleviate liquidity constraints due to malfunctioning capital markets. Such liquidity constraints can be relevant for investment in intangibles such as R&D. Conversely, R&D and innovations resulting from R&D are a major source of productivity and GDP growth. Aghion et al. underline the significance of these interdependencies from an empirical point of view.[13]

Complementarities also exist between product and labour market reforms on the one hand and stabilising fiscal or monetary policies on the other.[14] Thus structural reforms may in the short run induce reallocation processes which lead to a temporary underutilisation of input factors and hence to a temporary slowdown of economic activity.[15] Moreover, some labour market reforms, in particular those reducing the level of employment protection legislation, may themselves induce lay-offs and increase short-term unemployment. These considerations have led some economists to argue that some labour market reforms will only be successful if undertaken in a growing economy.[16]

From a European perspective, these considerations imply that reforms of the Stability and Growth Pact aimed at better integration of the budgetary consequences of structural reforms into the overall assessment, for instance by focussing on structural rather than actual deficits, went in the right direction. The same is true of the Europe 2020 Strategy when it aims to better align reporting on structural reforms and fiscal policies.

10 Ibid.

11 See Andrea Bassanini, Ekkehard Ernst: Labour Market Institutions, Product Market Regulation, and Innovation, OECD Economics Department Working Papers, No. 316, Paris 2002, OECD Publishing; Helge Berger, Stephan Danninger: Labor and Product Market Deregulation: Partial, Sequential, or Simultaneous Reform?, IMF Working Paper 05/227, International Monetary Fund, Washington DC 2005.

12 Anthony Annett: Lessons from Successful Labor Market Reformers in Europe, IMF Policy Discussion Paper 07/1, International Monetary Fund, Washington DC 2007.

13 Philippe Aghion, Robert Barro, Ioana Marinescu: Cyclical Budgetary Policies: Their Determinants and Effects on Growth, 2006, mimeo.

14 Prognos: Makroökonomische Flankierung struktureller Reformen im Rahmen der Lissabon-Strategie, Studie im Auftrag des Bundesministeriums für Wirtschaft und Technologie, Basel 2007.

15 Some evidence of this is provided by Karsten Staehr: Reforms and Economic Growth in Transition Economies: Complementarity, Sequencing and Speed, in: The European Journal of Comparative Economics, Vol. 2, No. 2, 2005, pp. 177-202.

16 Adam S. Posen: Taking the German Recovery Less Seriously, in: The International Economy, 7 July 2007.

The Fallout of the Financial Crisis

The foregoing interdependencies are dwarfed by the financial and economic crisis which has brought to the fore the issue of (negative) spillovers in EMU. When the crisis broke out, policymakers faced two big questions. Number one: Should governments embark on a Keynesian fiscal stimulus? Number two: Should the response, if any, be coordinated? On the first question, initial skirmishes between fiscal doves in Paris and fiscal hawks in Berlin soon gave way to Germany's announcing fiscal stimulus measures accounting for almost 50% of the total euro area stimulus.[17] On the second question, the Commission argued that "[t]he Stability and Growth Pact provides a common and credible framework for policy coordination"[18], thereby suggesting that a coordinated fiscal response would indeed be more effective.

However, the case for coordination rests upon certain conditions. While demand-stimulating measures produce spillover effects since a proportion of the stimulus is spent on imports and thus can have first-order welfare effects if output and employment are demand-constrained, coordination is only warranted if there are domestic costs to, or constraints on, fiscal expansion.[19] Moreover, any costs depend on the final size of the spillover, i.e. after taking into account second-round effects.

Fundamentally, second-round effects depend on the response of interest and exchange rates and the repercussions on aggregate demand. Two cases can be distinguished. With high capital mobility and given interest rates, the fiscal stimulus reduces the trade surplus or increases the deficit. Consequently, the home currency depreciates and this reduces the spillover again by supporting exports. Hence, there is no interest rate crowding out but some exchange rate crowding in. If, by contrast, the interest rate is allowed to increase, then the induced crowding out is reinforced by a (transitional) appreciation of the exchange rate[20], which lowers exports and increases imports. Hence the spillover will be greater. All other things being equal, the need for coordination is therefore greater in the second case.

In EMU, exchange-rate effects can only occur *vis-à-vis* the rest of the world while short-term interest rates are uniform across countries. This implies that, theoretically, spillover effects should be greater among EMU countries. It is still possible though that a unilateral fiscal stimulus drives up interest rates for the euro zone as a whole and thereby leads to a (temporary) appreciation of the euro. Indeed, simulations find that for demand-stimulating measures, spillovers between euro area countries are negligible or even negative since the euro appreciation counterbalances demand effects.[21] Empirically, by contrast, the recent up-and-down of the euro against the dollar makes it difficult to draw firm conclusions. Hence, coordination appears justified in principle, but the case remains somewhat inconclusive.

In a monetary union, though, the most important spillover relates to unsustainable fiscal policies. Accordingly, a member of a monetary union in fiscal turmoil can either default on its debts, demand transfers from other members or bully the central bank into relaxing monetary policies. No matter which option is chosen, other members of the monetary union have to foot a large part of the bill, because either public bonds become worthless, taxes increase or inflation rates rise. That is why the Stability and Growth Pact came into being.

However, seeing budgetary discipline as the "mother of all policies"[22], the SGP is ill-suited to deal with the crisis. First of all, the increase of budget deficits is primarily a consequence of the economic downturn and its impact on revenues, expenditures and – indirectly – the need to transfer risks from the banking sector to the governments. The latter induced an increase in sovereign spreads, which affected in particular Greece and Ireland and thus led to a further deterioration of their budgetary situation.[23]

Second, the SGP cannot avert imbalances which are only loosely related, if at all, to budgetary deficits.[24] Despite the convergence of business cycles across euro area countries, there has been a tendency for growth, inflation and current account positions to diverge. For the most part, the imbalances result from three fac-

17 Tobias Cwik, Volker Wieland: Keynesian Government Spending Multipliers and Spillovers in the Euro Area, CFS Working Paper No. 2009/25, Frankfurt am Main 2009.

18 European Commission: FAQs on the European Economic Recovery Plan, MEMO/08/735, Brussels, 26 November 2008.

19 Willem H. Buiter: The Limits to Fiscal Stimulus, CEPR Discussion Paper No. 7607, London 2009.

20 Rüdiger Dornbusch: Expectations and Exchange Rate Dynamics, in: Journal of Political Economy, Vol. 84, No. 6, 1976, pp. 1161-1176.

21 Tobias Cwik et al., op. cit.

22 Benedicta Marzinotto, Jean Pisany-Ferry, André Sapir: Two crises, two responses, bruegelpolicybrief 2010/01, Brussels 2010.

23 Jacob W. Ejsing, Wolfgang Lemke: The Janus-Headed Salvation – Sovereign and Bank Credit Risk Premia during 2008-09, Working Paper Series No. 1127 / December 2009, European Central Bank, Frankfurt am Main 2009.

24 Benedicta Marzinotto et al., op. cit.

tors: decreasing price competitiveness relative to Germany and other Member States, sluggish import demand, and high domestic demand fuelled by the housing boom and low interest rates.[25] The key point now is that a current account deficit implies net capital imports, i.e. the external net-debt increases, and so will payments for interest and for servicing the debt. Eventually, lenders begin to demand a risk premium. In addition, interest payments and debt service place an increasing burden on domestic demand and hence growth. With the tax base at risk, however, government bonds sell at increasingly unfavourable terms and so the budgetary situation deteriorates further. The interest spreads between countries with current account imbalances and Germany provide some evidence of this effect. For instance, Portugal's net external debt is roughly 122% of GDP, whereas that of Greece is 103% of GDP, yet the spread has been higher for Greece. By contrast, total net external debt as a percentage of exports is 512 for Greece and 441 for Portugal.[26] This suggests a causal link from imbalances to deficits rather than vice versa.

But why did the SGP not provide for the means of avoiding imbalances? One part of the answer has already been given. Resting as it does on the belief that budgetary discipline is key, there was, conceptually, no appropriate place for such means in the SGP. Of course, the SGP was not meant to address the emergence of imbalances either. In fact, Art. 121 provides the legal basis for the coordination of economic policies. Alas, the provisions in Art. 121 are neither as rigid as those in the SGP, nor have they really been used to address "risk(s) jeopardising the proper functioning of economic and monetary union".[27]

The second part of the answer is that policymakers assumed that a stabilising mechanism would be at work which would prevent persistent imbalances.[28] This mechanism, dubbed the competitiveness channel, rests on the responsiveness of inflation to economic activity and of the level of output to changes in competitiveness. Accordingly, if buoyant economic activity drives up wages and prices, growth is dampened since, without flexible exchange rates, the external price competitiveness deteriorates. Since this process ends as soon as competitiveness has deteriorated sufficiently, it helps to align growth and inflation rates across EMU. Conversely, sluggish economic activity restrains wages and prices, and this improves competitiveness. Exports and growth are bolstered until growth and inflation rates are aligned with those of the other EMU members.

Alas, there is another mechanism. The so-called interest channel slows down convergence since the perceived real interest rate falls if a country is going through an upward adjustment of its price level stemming from buoyant domestic growth. As a result, domestic demand is boosted further and the external imbalance overshoots. This is what happened in Spain and Greece.[29] For convergence, it is of crucial importance therefore that the competitiveness channel works and that it is stronger than the interest channel. On the face of it, neither assumption is valid.

The situation is even more worrying if wage moderation and thus the depreciation of the real effective exchange rate are pursued deliberately by a country on the assumption that low growth and unemployment are the result of a misalignment of the relative factor prices of labour and capital.[30] Such a strategy is all the more problematic if the trading partners suffer from deteriorating cost competitiveness. They then have to restore competitiveness *vis-à-vis* the rest of the world *and* overcompensate the competitiveness loss *vis-à-vis* the depreciating country in EMU.[31]

The Policy Response

As pointed out above, the Commission has highlighted the emergence of macroeconomic imbalances as the main reason for better economic coordination. The

25 European Commission: Surveillance of Intra-Euro-Area Competitiveness and Imbalances, European Economy 1/2010, Brussels 2010.

26 All data for 2009, q3, source: Cinzia Alcidi, Daniel Gros: Is Greece different? Adjustment difficulties in southern Europe, http://www.vox-eu.org/index.php?q=node/4914.

27 Jean Pisany-Ferry: Euro-Area Governance: What Went Wrong? How to Repair it?, Bruegel Policy Contribution 2010/05, Brussels 2010.

28 European Commission: EMU@10: successes and challenges after 10 years of Economic and Monetary Union, COM (2008) 238, Brussels 2008.

29 It has been argued that Spain and Greece differ in that Spain has a competitiveness problem whereas Greece suffers mainly from fiscal difficulties (Benedicta Marzinotto et al., op. cit.). However, this view does not stand up to closer scrutiny. Whereas Greek manufacturing has not suffered from a loss of price competitiveness in recent years, the services sector clearly has, as evidenced by the development of unit labour costs of services.

30 Hans-Werner Sinn: Can Germany Be Saved? The Malaise of the World's First Welfare State, Cambridge Mass. 2007, MIT Press.

31 For Germany, it has been argued that the country had entered the EMU at an overvalued exchange rate. However, Germany's current account was balanced at the time and its trade performance was normal. Thus the fact that the improvement of price competitiveness immediately turned market shares, the trade balance and the current account to Germany's advantage makes a prior overvaluation hardly plausible (Heiner Flassbeck, Friederike Spiecker: Cracks in Euroland and no way out, in: Intereconomics, Vol. 44, No. 1, 2009, pp. 2-3).

same is true of the Eurogroup.[32] Nevertheless, what exactly is to be coordinated, how this is to be achieved and whether it will suffice to reduce imbalances is still being discussed.

There are some indications, however, that the focus is (again) on strengthening budgetary surveillance, *inter alia* by introducing an *ex ante* assessment of national budgetary plans by the Commission and by introducing better incentives and sanctions.[33] By contrast, no concrete actions have as yet been proposed to address diverging competitiveness. For this, current proposals envisage only better and more comprehensive surveillance.

The Eurogroup is somewhat more outspoken but appears to place the burden of adjustment on deficit countries by calling for wage and price adjustments. Surplus countries are only asked to undertake structural reforms to strengthen demand. Conspicuously missing is a call to better align wages with productivity in surplus countries, too.

Thus while the need to control wage inflation has been acknowledged, the same is not true for wage *deflation.* Yet adherence to the inflation objective of the ECB necessitates that real wage growth neither exceeds *nor* falls behind productivity growth. For if real wage growth falls behind in a country, then imbalances emerge, even if wages increase in line with productivity plus the ECB inflation target elsewhere. What is more, increased price competitiveness persists and is only reversed if wages grow for some time at rates above productivity growth.

Importantly, recent IMF work suggests that trade surpluses can be reduced without having a negative impact on growth and employment and that surplus reversals were often associated with exchange-rate appreciations.[34] Translated into the context of EMU, this indicates that putting an end to Germany's focus on wage restraint will not hamper growth but contribute to Germany's reaching an average growth rate which no longer consistently underperforms.

32 Eurogroup: Surveillance of Intra-Euro-Area Competitiveness and Macroeconomic Imbalances, Conclusions of the Eurogroup, Brussels 15 March 2010.

33 European Commission: Reinforcing economic policy coordination, COM (2010) 250, Brussels 2010; European Commission: Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance, COM (2010) 367/2, Brussels 2010.

34 International Monetary Fund: World Economic Outlook – Rebalancing Growth, April 2010, Washington DC 2010.

Here, then, is a clear case for better coordination of wage policies. If this does not occur, then negative spillovers for other Member States will threaten the stability of EMU. Of course, it is often objected that governments cannot influence wages, but this argument is not convincing. Governments have various instruments at their disposal. For instance, German governments have repeatedly reduced social security contributions, occasionally coupled with an increased VAT, with a view to lower wage costs. Hence, either they were wrong in the past or they are now.

Conclusion: Is There a Need for Coordination?

Both the Lisbon and the Europe 2020 Strategies rest on the argument that coordinated action is more beneficial than acting alone.

In the above discussion, various examples of spillovers have been identified. Often these take the form of externalities or public goods. Complementarities, by contrast, occur when a reform is more effective if undertaken together with another reform. In both instances, there is a clear case for coordination.

Arguably, however, interdependencies at the national level are often stronger than those among Member States. After all, the magnitude of interdependencies is contingent upon the strength of economic relations between sectors or industries. Although production chains are increasingly international, proximity still matters.

These considerations, then, hint at the possibility of a conflict between coordinated action at the European level and coherent reform strategies at the Member State level. European coordination might come at the cost of diminished coordination at the national level. While at present this remains a mere possibility, the likelihood of conflicts is bound to increase should coordination at the European level gain more prominence.

Macroeconomic interdependencies, by contrast, make a much stronger case for coordination. Failure to do so has led to the emergence of imbalances in the euro zone and threatens its stability. The need for better coordination has been acknowledged, yet what exactly is to be coordinated still remains somewhat opaque. While budgetary consolidation has an important role to play, the above discussion suggests that coordination has to be extended to other areas, most notably wage policies, in order to avoid the emergence of imbalances which may ultimately put the future of EMU at risk.