TO THE COMMISSIONER FOR ECONOMIC AND MONETARY AFFAIRS

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You will need to press member states to move ahead with structural reforms, implement the fiscal rules with vigour, promote demand management measures to stimulate growth and remain vigilant in case of a re-emergence of the crisis

STATE OF AFFAIRS

Many of your policymaker colleagues have declared the EU's economic and financial crisis to be over, but we would like to warn you not to be complacent: the European economy, in particular the euro-area economy, has underlying weaknesses. Nevertheless, there are several monetary and economic developments you can be positive about:

- A break-up of the euro area, which was a major source of uncertainty and a deterrent to investment throughout Europe, is no longer an immediate risk;
- The second dip of the Great European Recession seems to have bottomed out and Europe has been growing since the second quarter of 2013, though at subdued speed;
- Structural reforms are being implemented, which is also visible in indicators such as the World Bank's *Ease of Doing Business* indicator;
- Financial fragmentation has eased in the euro area and interest rate differentials across the euro area have narrowed considerably during the past two years;
- Pre-crisis current account deficits in the euro-area periphery and central and eastern Europe are turning to surpluses, supported by strong export performances in many of the countries;

- The overriding aim of fiscal consolidation – the stabilisation and reduction of public debt to GDP trajectories – is within reach in most EU countries, though significant uncertainties remain in a number of countries;
- Hungary, Latvia, Ireland and Portugal have exited their financial assistance programmes in a clean way, ie without any kind of follow-up assistance.

But there are a number of key factors that suggest you should not declare the crisis to be over.

Post-crisis vigilance

First, the recession was deeper than expected, partly because of policy mistakes, and production is still well below potential and just slightly above the previous peak level in the EU. Activity, especially in some countries of southern Europe and in Denmark, France, the Netherlands and Finland is still subdued and there is little hope of a strong recovery. Labour markets remain weak in aggregate with very high unemployment in a number of countries and low unemployment in others. Contrary to previous hopes, the euro has not resulted in significant economic convergence.

Second, neither fiscal adjustments nor the implementation of structural reforms have been completed. Major adjustments still lie ahead, which will prove difficult under weak economic conditions, likely increasing the popularity of anti-austerity political parties and the reform fatigue felt by mainstream parties.

Third, while progress was made on budget and current account deficits, high public, private and external debts pose very serious threats in a number of EU countries. History suggests that the deleveraging process will be protracted and will constrain the growth of highly indebted sectors and countries.

Fourth, while bank balance sheet weaknesses are being slowly addressed, it is far from certain that bank lending will be restored in weaker countries, in which there are currently credit supply problems that compound weak demand conditions. The development of non-bank financing is advancing, but this is happening mostly in those EU countries in which such markets were already well developed. In core EU countries where there are no credit supply constraints, credit

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demand is lacking. Without credit, it is unlikely that robust growth will restart.

Fifth, inflation throughout the EU, and in particular in the euro area, is on a downward trend. There is a significant risk that inflation will remain stuck well below the European Central Bank's two percent threshold for a long period. As a consequence, inflation in the countries with debt overhangs and previous losses of competitiveness, will likely stay very low or could even move into negative territory. These countries therefore face the risk of debt deflation that will ultimately make debt sustainability unachievable.

And sixth, while current accounts deficits adjusted, surpluses remained, which has led to a sizeable EU external surplus. This situation has arisen largely because of the euro area, where a small surplus of 0.07 percent of world GDP in 2007 has increased to more than half a percent of world GDP. In addition, the combined deficit of non-euro area EU countries, amounting to 0.18 percent world GDP in 2007, has shrunk and is on the way to a small surplus, according to International Monetary Fund projections. The EU has been deservedly criticised by the rest of the world for not creating sufficient domestic demand.

Economic governance

On the institutional side, you will have to manage a major new and revamped toolkit to pursue the EU's economic objectives. EU and euro-area economic governance was significantly reformed during the past four years. The Six-pack, Two-pack, Euro Plus Pact and Fiscal Compact have reformed fiscal governance, including national fiscal frameworks, equipped the EU with a new Macroeconomic Imbalances Procedure to tackle private-sector vulnerabilities and introduced a regular annual cycle of economic policy coordination under the socalled European Semester. You will be responsible for managing the resulting complicated system, which may not be well understood by all stakeholders.

European Stability Mechanism

A major additional institutional change was the creation of a European Stability Mechanism (ESM), which is primarily under the responsibility of the euro-area finance ministers. However, you have to prepare the ESM decisions, including the assessment of debt sustainability prior to a new programme, and your services work on behalf of the Eurogroup as part of the Troika in the programme countries to impose conditionality that is seen as necessary to reform the crisis countries.

Banking union

The emerging European banking union, the most significant European policy initiative since the creation of the euro, will not be primarily under your authority. But we wish to highlight that it will have major implications for your work, because of the fundamental importance of the banking system for the European economy.

You will therefore face an economic situation that has clearly improved, but about which markets might be overly optimistic. You will also have a bigger toolbox at your disposal to tackle the challenges, but this toolbox has become very complicated. In the context of financial assistance, you have to act on behalf of the Eurogroup rather than the whole European Union.

CHALLENGES

Reinvigorating growth and creating jobs will be your primary objectives: they are essential for addressing Europe's social problems. In this respect, you will face four major challenges.

Fostering growth

The first is to foster growth when both the public and private sectors are deleveraging and the financial sector is still weak, inflation is too low and even the economically stronger countries generate only subdued demand.

The second key challenge is related to the available instruments to foster growth. Many elements of the European growth strategy will not belong to your portfolio, such as the completion of the single market, labour and product market reforms, research and education, the digital and green agendas or the development of capital markets. In the Annual Growth Survey, which kick-starts the European Semester each year, you will have a chance to propose improvements in these areas, but you will have little direct impact on them.

Application of fiscal rules

While you can influence the aggregate fiscal stance of the euro area in the way you apply the new fiscal rules and in the advice you provide to countries to change their stances, you have no direct control over deficits and both European- and national-level fiscal rules almost exclusively consider fiscal targets at the national level, disregarding the euro-area wide fiscal stance. The scope to use national fiscal policies in a number of euro-area countries is also severely hampered by the already high debt levels and the potential negative market reactions. In some countries national fiscal rules are tighter than European rules, limiting your scope to change the fiscal stance. At the same time, there is no fiscal instrument available at euro-area level except for the ESM. You are therefore faced with a framework in which your primary instrument to influence the fiscal stance is the making of fiscal policy recommendations to national policymakers.

The third key challenge is related to domestic politics and member-state attitudes to reform. The major differences in economic and social conditions mean that policy priorities are different in different countries, which will make it hard to build consensus in various areas. Member states with brighter outlooks wish to stay the course of fiscal consolidation and structural reform, while some of the member states with weaker outlooks wish to dilute the fiscal framework.

The key question for you will therefore be how strictly you want to apply the fiscal rules in the face of serious political opposition, such as that from France and Italy recently, and from Germany and France previously. You might face a formidable challenge if some member states do not meet the fiscal targets as you define them. In such a situation you will face the tough choice between:

A. Being tough and taking the route of so far never-used sanctions, protecting the spirit of the European fiscal framework but risking a major clash between member states and a political backlash against Europe in the sanctioned countries, with potentially far-reaching consequences;

Financial assistance programmes and post-programme monitoring will last for decades

B. Opening the Pandora's box of renegotiation of the European fiscal framework, undermining trust in it when it faces its first test and further disillusioning large segments of the societies in those countries that support tough fiscal rules;

C. Using the complexity and vagueness of the fiscal framework to navigate through without imposing sanctions, thereby undermining its spirit and making it toothless.

Furthermore, some member states wish to design new pan-European initiatives, such as a euro-area instrument for stabilising economic cycles, while others turn a deaf ear to this issue. You will have to take a position on it that does not only refer to long-term treaty changes but is meaningful in the current context.

Financial assistance

And fourthly, you will also face the challenge of managing financial assistance programmes and post-programme monitoring that will last for several decades. If things go well and debtor countries repay their euro-area partners easily, the creditor-debtor relationship should not pose major problems. But if growth remains subdued and debtors find it difficult to repay, you will need to broker a reasonable deal between creditors, who will accuse debtors of not implementing properly fiscal adjustments and structural reforms, and debtors, who will accuse you and creditor countries of forcing them to implement economic policies which have undermined them. Among the current programme countries, such tensions are most likely to arise over Greece. You should be ready to prepare a deal alleviating the burden on Greece even further if necessary.

RECOMMENDATIONS

We make five key recommendations.

Structural reform

First, following on from your predecessor, you should press member states to move ahead relentlessly with structural reforms. When regulations inhibit the formation or growth of firms, when it takes them an excessively long time to address administrative requirements, when competition is undermined because of protectionist regulations, when labour market regulations do not encourage workers towards higher performance and make it difficult to reallocate the labour force efficiently, and when public institutions work inefficiently and various kinds of public spending are used wastefully and need to be financed by distorting taxes, it is no surprise that investment and growth is low. Structural reform needs are different in every country. Your role is to push countries to implement reforms, while the details of the reforms will have to be decided on by the countries themselves, and you assess them from the outside.

Fiscal rules

Second, you should implement the fiscal rules with vigour. Fiscal space is limited in several countries and trust in you and your institution would be undermined if you were to play with the vagueness of the rules. This would be harmful for any further plans to create a true fiscal union and is also risky because member states might stop listening at all to you and might run uncoordinated fiscal policies. For countries with limited fiscal space the only ‘flexibility’ we suggest you exercise is to grant more time for consolidation if this can protect growth-enhancing public investment and structural reform. A contract between the Commission and the member state could be signed in which a commitment to reform is given and consolidation delays are allowed in exchange. For countries that have fiscal space, you should not be shy of calling for fiscal measures that better correspond to the optimal aggregate fiscal stance of the euro area, as we discuss below.

However, in the medium term, as we have recommended to your president and the presidents of the European Council and European Parliament, further institutional reform is necessary, also for the creation of a euro-area fiscal capacity that could potentially be integrated into the EU budget. While this work should be initiated in the European Council, you will have to play a leading role in the reflection

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process. You should not shy away from pointing out that a monetary union without a common budget is incomplete.

Demand managment

Third, you have to realise that relying predominantly on supply-side oriented structural reform and a tough adherence to current fiscal rules is not enough to stimulate growth. Demand management is similarly important. Without growth, it will also become economically and politically impossible to respect the spirit of the fiscal rules, and you might be faced with a situation in which a large number of member states will reject your recommendations. For example, both France and Italy will find it very difficult to meet the deficit targets in the next few years. Moreover, Italy will not meet the debt reduction rule during 2016-19, according to the April 2014 IMF forecast, which foresees 2.5 percent annual nominal GDP growth. The IMF-projected annual reduction in the debt ratio, 2.9 percent of GDP per year, falls short of what the 1/20th debt rule would require, which would be 3.5 percent per year. Should Italian growth disappoint relative to the 2.5 percent IMF projection (and we see a significant likelihood of this), Italy will miss the debt rule even more significantly. You will therefore have to clearly warn the Eurogroup that it will be impossible to keep debt sustainable and follow the deficit rules if growth and inflation do not pick up. In particular, you should call for the following measures:

— You will have to ensure that euro-area wide recommendations from the European Semester and its Annual Growth Survey are first of all optimal for the euro area, which was not always the case in the past few years. You should explain clearly how you derive the optimal fiscal stance of the euro area. Equally importantly, you should ensure that euro-area recommendations are translated into concrete country-specific policy recommendations that ensure appropriate euro-area wide demand management.

Investment programme

— Together with your president, you should broker a deal for a new European investment programme. Given the weaknesses of the European economy, the new programme should amount to at least 1 percent of EU GDP in addition to investments currently planned. Part of this investment should be designed and implemented through national fiscal policies, by increasing public investment and creating new incentives for private investment. In particular, you should ensure that countries with fiscal space invest more and stop outperforming against the fiscal targets, while countries with limited fiscal space should not start a new deficit-financed investment programme. The perhaps greater part of the investment programme should be conducted at EU level and be financed by the European Investment Bank, project bonds and an increase and improvement in the EU budget. Countries with weaker economic situations and higher unemployment should benefit disproportionally, similarly to the EIB's practice of the past few years.

— Which projects would be worthwhile undertaking and how could they be financed? The European energy network comes first to mind. In fact, with Ukraine's gas-supply crisis, the question of an adequate EU response to a potential gas shortage has become urgent. Building a better European energy network that could address energy shortfalls caused by such external shocks is critical. Yet, much of the energy network as it stands currently is in private hands. A public intervention should avoid the crowding-out of private investment or rendering private investments unprofitable, and it therefore must focus on those parts of the network that the private sector does not deliver.

A further important area for investment of public resources is energy savings. Subsidising and supporting investment in this area would not only make sense to meet Europe's climate goals. It also can represent meaningful amounts of resources in order to have a macroeconomic impact on demand.

Similarly, in telecommunications, building a better European network makes sense, but the public hand should not crowd out private spending. Therefore, support for broadband roll-out and other networks must be focussed on areas where the private sector would not typically invest, such as rural areas. In addition, more resources for a European mobility scheme for young workers would be useful.

Inflation

— It will also be imperative that inflation returns quickly to the 2 percent threshold both in the euro area and in other EU countries. You should state this necessity clearly and support an expansionary policy stance on the part of central banks in the EU (without of course infringing on their independence), even if some stakeholders challenge expansionary monetary policies. But you should also highlight to finance ministers that monetary policy alone would be too slow in pushing inflation back to 2 percent, and therefore national fiscal and income policies should also play a major role in this process.

— It is essential that demand increases in particular in countries with large current account surpluses. For Germany, the Netherlands and some of the Nordic countries, you need to seriously press for structural reforms that allow for market-driven domestic adjustment. Public and private investment and wages will have to rise. Your main tool is to use the macroeconomic imbalances procedure to give the right policy recommendations.

Post-crisis vigilance

Fourth, you should prepare for a re-emergence of the crisis. In particular, if you see that inflation and growth remains subdued and debt dynamics remain unfavourable, it will be only a matter of time until the next financial attack against member states. While you may sound like a Cassandra to the member states, they are best served by the truth, however uncomfortable it might be. The ECB can and should

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intervene in case of liquidity crisis with the Outright Monetary Transactions (OMT) programme, but it should not finance insolvent countries. You should ensure that any new financial assistance programme (which is also a precondition for OMT) avoids the Greek debacle – the pretence that a non-sustainable fiscal position is sustainable. This also means that you might have to advocate debt re-profiling or even restructuring if debt is unsustainable. As this would have substantial implications for financial stability, significant work to reduce the impact on the financial sector is needed, for example by gradually introducing single exposure rules to sovereign debt. You need to remind policymakers that the best way to prevent further financial assistance programmes and the hard choices involved with them is to change the current macroeconomic policy stance towards more demand, and to press ahead with bold structural reforms and determined bank restructuring.

Financial assistance

Fifth, you need to work on a redefinition of the Troika set-up and financial assistance. While you might hope that no new Troika programme will be needed, you cannot exclude it. We see three key elements:

— First, the dual role of the European Commission needs to be revisited, because in the context of the Troika, the Commission acts only as an agent of the Eurogroup, and not as an EU institution. A more elegant solution would be to strengthen the role of the ESM and turn it into a true European Monetary Fund, which would not only grant financial assistance but would also have staff seconded from the Commission to exercise the necessary conditionality.

— Second, the role of the ECB should be reduced to that of a silent participant, because there are potential conflicts with the ECB's prime objective of price stability, with the ECB's function of lender of last resort to banks and with the ECB's bond-purchase programmes. One cannot completely exclude the ECB from the Troika because many parts of the programme conditionality are intimately linked to monetary policy and supervisory policy, but the ECB should not define conditionality.

— Third, a strengthening of *ex-post* democratic control should be envisaged. While parliaments cannot be included in the *ex-ante* definition of conditionality as this is not only a time-sensitive but also a very technical matter, they should play an increased role in the monitoring of the Troika *ex-post*. We see a special role for the European Parliament, and also for the national parliaments that provide the actual financial resources. The national parliament of the country with an assistance programme is involved in any case throughout the process.