TO THE COMMISSIONER RESPONSIBLE FOR ECONOMIC AFFAIRS

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* The good news is that the economic situation has considerably improved compared to the first half of this decade. New jobs are being created in every member state. But there are signs the upswing is slowing and the growth potential is weak. In this context, the need for structural reforms remains pressing. Major questions also remain over the euro-area architecture.

You should reinforce the European Semester, including by focusing more on climate policies, and push countries to reduce their debts. As part of this, you should establish a European Fiscal Council. More broadly, the low interest rate environment creates the opportunity for a richer discussion on fiscal policy.

Meanwhile, progress is needed on deepening the euro area. You should aim to influence the discussion, in particular on completing the banking union and the development of sovereign contingent debt and a euro-area safe asset.

* STRUCTURAL REFORMS
* PLANNING FOR SLOWDOWN
* EUROPEAN FISCAL COUNCIL

Your portfolio is important for fostering competitive, employment-rich economies by promoting structural reforms, sound public finances, investment and a deeper and fairer euro area[1]. You will have a major influence over the implementation of the European Union's fiscal rules, which is a strong macroeconomic instrument. You'll be able to influence the country-specific recommendations (CSRs) made via the European Semester, which is a much lighter instrument. The advice you will give to other commissioners and to national politicians on economic policies will have a significant impact on policymaking in the EU.

*COORDINATION

To achieve your goals, you will have to coordinate with other commissioners responsible for financial stability, innovation, digital and climate issues – to name just a few – which are areas with major implications for economic development. Similarly important will be the coordination with the commissioner responsible for social issues to improve the perceived fairness and acceptability of economic policy measures. You should also coordinate with the commissioner responsible for the Joint Research Centre, since about a fifth of its more than 2,700 staff work on issues closely related to your area.

Your predecessor had to combine medium- and long-term issues with firefighting duties in the aftermath of the euro crisis, including the completion of the Cyprus financial adjustment programme and the design and the completion of the third Greek programme. Now that all EU countries have exited their adjustment programmes and job creation has returned, you will be able to execute your work programme for the next five years in a calmer environment. Nevertheless, there will be multiple challenges.

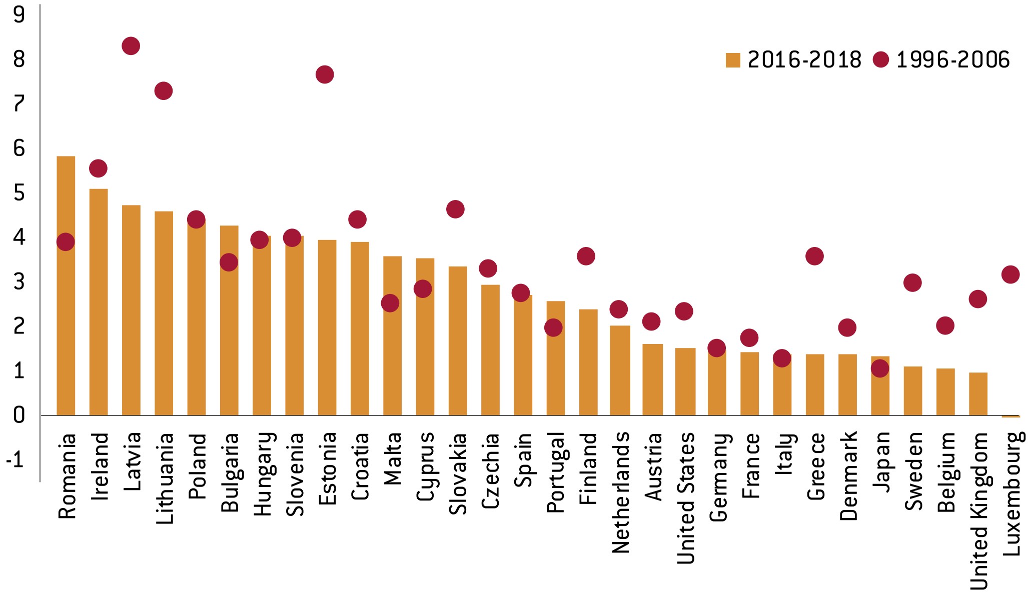
1 STATE OF AFFAIRS

We draw your attention to five pertinent issues.

*SIGNS OF SLOWDOWN

First, the economic situation has improved considerably compared to the first half of this decade, and new jobs are being created in every member state. This is good news. However, the recent cyclical upswing is slowing. Productivity growth is weak, while actual *per-capita* growth rates have fallen in most EU countries (Figure 1). There are major labour shortages in some countries

Figure 1: Growth rate of GDP per capita, average of 1996-2006 and 2016-2018



Note: The growth rate is calculated on the basis of the indicator: 'Gross domestic product at 2010 reference levels per head of population.' Source: Bruegel based on European Commission's AMECO dataset, May 2019.

while in others there is persistent high unemployment, especially high youth unemployment.

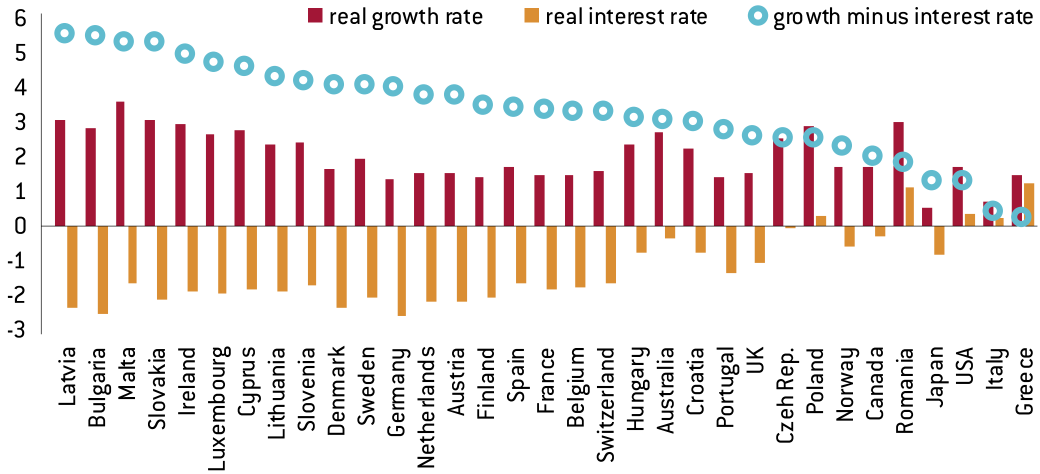
*STRUCTURAL REFORMS

Second, while there has been some progress with structural reforms, there remains a pressing need for more. The European Semester, the EU's main economic policy coordination tool, has had mixed impacts. Efstathiou and Wolff (2019) concluded that implementation rates of Semester recommendations are modest, and have worsened since the economic environment has improved and market pressure on sovereigns has subsided. They also concluded that stronger surveillance does not drive implementation rates.

*LOW INTEREST RATES

Third, safe interest rates are low and are expected to remain so for the foreseeable future (Blanchard, 2019). Real interest rates on new borrowing are negative most EU countries. The expected growth-interest rate differential is positive and generally quite large (Figure 2). Such a positive gap greatly helps the gradual reduction of the debt/GDP ratio – which is set to decline even when there is a certain level of primary deficit. At the same time, the negative impact of public debt on private capital accumulation is likely very small given the low interest rates and the abundance of savings.

Figure 2: The 5-year ahead expected real interest rate on new borrowing and the real economic growth rate, 2019-2024



Source: Bruegel. Note: Real growth rate: average annual growth rate from 2019-2024 according to the April 2019 IMF World Economic Outlook (WEO). Real interest rate: the 5-year government bond yield (January-April 2019 average) deflated by the average annual GDP deflator change from 2019-2024 as projected by the April 2019 IMF WEO. Estonia is excluded because of the lack of government bond yield data.

*EURO AREA

Fourth, partly because of favourable interest rate developments and fiscal consolidation efforts, progress has been made towards meeting the EU fiscal targets. At the time of writing, a recommendation had been made for the last country under the Excessive Deficit Procedure (EDP), Spain, to be taken out of EDP. However, in some countries the debt ratio has increased in recent years (Italy, France) and Italy might face a new EDP. Some fiscal-rule decisions are seen as political and in our assessment EU fiscal rules have rather low credibility, not least because they have become overly complex[2].

Finally, significant progress has been made to complete the architecture of the euro area, primarily related to the banking union. But important questions remain, of which the most prominent is to mitigate the doom-loop between banks and sovereigns. Capital market development remains a major issue and will be even more prominent after Brexit (Sapir *et al*, 2018). The proposals for a euro budget, including the Budgetary Instrument for Convergence and Competitiveness, are weak (Claeys and Darvas,

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2018). It is also notable that discussions on the international role of the euro and the need for a safe asset have been revived.

2 CHALLENGES

Several factors will make your job challenging during your mandate.

*POPULISM

First, there are uncertainties in Europe, including uncertainties related to a large share of non-mainstream parties in national parliaments and governments and the European Parliament, Italian economic policies (which might fuel a new crisis) and Brexit. The reasons for the EU cyclical economic slowdown in 2018 are also not well understood. Global uncertainties could have repercussions for the EU economy, such as the China slowdown, US trade policy and the erosion of support for multilateral arrangements. Reinvigorating actual growth and boosting potential growth in such an uncertain environment will be a challenge.

*INFLATION

Second, inflation has been low for several years with core inflation stuck at 1 percent, while headline inflation fluctuates with energy-price movements. European Central Bank (ECB) and European Commission inflation forecasts have turned out to be systematically upward biased, so we cannot rely on current forecasts being be more accurate (Darvas, 2018). Inflationary expectations have become de-anchored from the 2 percent medium-term objective, causing uncertainty for business. Inflation in highly-indebted euro-area countries might be even lower than the euro-area average, which would make deleveraging difficult.

Third, European economic policy and governance reform will be difficult in a politically more diverse EU, when the threat of a crisis is distant and mainstream political parties are weakened in many member states. Overcoming the divides within the EU will be a major challenge.

*BREXIT

Fourth, from an institutional perspective, Brexit will imply a profound changing of the equilibrium between the euro ins and outs, because the relative economic weight of the outs will decline significantly. This could lead to a potentially destabilising institutional disequilibrium in several areas, including the division of work between the Eurogroup and the Economic and Financial Affairs Council.

Fifth, the risks of a dollar-centred payment system become more evident. Dollar liquidity shortages after the collapse of Lehman Brothers in 2008 caused financial difficulties, requiring global cooperation among central banks. More recently, the US administration is using the dollar, and the dollar-based payment system, to foster foreign policy goals, such as punishing companies that trade with Iran. The dollar-based payment system exposes the EU to US foreign policies, even if EU foreign policy has different priorities.

3 RECOMMENDATIONS

The issues we have outlined require you to push for changes to economic policies both at the national and the European levels in order to return Europe to a path of sustainable and inclusive growth, employment and productivity, and to make the EU a strong and credible global player. European instruments and policies mostly have a guiding, coordinating and incentivising nature. It is only in conjunction with the right set of national policies that they can produce the desired outcomes.

3.1 Structural challenges, imbalances and the European Semester

*CONVERGENCE

The EU as a whole needs to focus more than in the past on its growth and productivity dynamics in a way that fosters convergence within and between countries (Demertzis *et al*, 2019). Economic divergence might lead to dissatisfaction, fuelling votes for non-mainstream political parties, which sometimes challenge core EU principles. Coherent macroeconomic, fiscal, financial

*EUROPEAN SEMESTER

and structural policies have to be implemented by member states. The European Semester is the main European policy instrument to help this process. We appreciate the efforts to give the recommendations a higher degree of visibility, at the political level and among civil society and in the media. This process should be vigorously continued.

However, the low implementation rates of CSRs suggest lack of ownership. While low implementation rates might reflect the inherent difficulties in economic policy coordination between sovereign countries, you should aim for greater implementation and ownership, otherwise the rationale for making recommendations is questionable. A higher level of engagement with national stakeholders, including ministries, national parliaments, competitiveness councils and other national institutions, might reinforce ownership. Stronger analytical underpinnings would boost the credibility of the CSRs and thus we call for higher-level involvement of the EU's Joint Research Centre to support the scientific basis of recommendations, in order to foster theory- and evidence-based policymaking. It is vital that good economics should not become politicised.

*MACROECONOMIC IMBALANCE PROCEDURE

While several countries violate key criteria of the Macroeconomic Imbalance Procedure (MIP), your predecessors always found an excuse not to launch an Excessive Imbalance Procedure. Such a lenient attitude undermines the credibility of the MIP and encourages the neglect of other EU rules, such as the fiscal rules. You must be the unbiased guardian of EU economic rules and leave political considerations to the Council.

Publishing the CSRs for all member states on the same day has traditionally made a big splash in Brussels, but the respective national echo has been more muted. We suggest reforming the instrument in a way that focuses more attention on the individual member states, and their associated recommendations.

Institutional quality and governance arrangements do not meet European standards in some member states, which can have economic repercussions. Devising instruments to incentivise good governance is a perennial challenge, but well worth investing in. We advocate raising this issue in the CSRs.

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Climate policies have major economic and budgetary implications. There is a need for leadership by you and national finance ministers. Without such a concerted strategy, finance ministers might block major initiatives. We advise you to push climate issues even more in CSRs.

3.2 Fiscal rules and institutions

*FISCAL FRAMEWORK

Fiscal policies need to operate within the triangle of cyclical stabilisation, fiscal sustainability and their impact on long-term growth and productivity in the context of a rules-based system, the broad outline of which is enshrined in the EU Treaty. But the EU fiscal framework has become a highly complex, non-transparent and error-prone system, exposing the Commission to criticism. The rules are used as a scapegoat by anti-European populists because they are seen as a manifestation of centralised micro-management that infringes on national sovereignty. This is counterproductive.

After a number of reforms (the Six Pack in 2011, Fiscal Compact in 2012 and Two Pack in 2013), there might be little appetite for a major overhaul, even if that is desirable (Darvas *et al*, 2018). Therefore, you should first try to restore trust in the fiscal framework by applying the current rules in an objective, non-political and transparent way, while initiating changes that are possible without changing the legal texts. Second, you should work on a major reform to be presented in the second part of your term.

An immediate priority is to reinstate the principle of "*identifying gross errors*" (Article 126 of the TFEU), instead of focusing on every detail. The central aim of bringing high debt levels down to sustainable levels must remain. Much less emphasis should be placed on the imprecise estimates of structural balances. The rules need to become clearer and implementable in practice.

You should establish a European Fiscal Council, with a mandate to safeguard the proper implementation of the fiscal framework

A system based merely on automaticity does not do justice to the complexities of economic developments. A certain amount of discretion needs to be retained, but it cannot be a central feature. Whenever discretion is exercised, the Commission should provide more detailed explanations, including to a committee of the European Parliament, to enhance democratic accountability and transparency.

A helpful element of trust building would be the delegation of some of the analytical work, including the medium-term GDP growth and inflation projections, to national independent fiscal councils, provided that their minimum standards are raised – they currently range from fairly efficient to barely noticeable, in our view. They should be independent, competent and effective (OECD, 2016). They could be entrusted with making recommendations to their governments on how to correct fiscal policies that violate the rules. Such moves would spare the Commission from being criticised and might increase the sense of national ownership of recommendations. Member states might approve such a change in exchange for less Commission intrusion.

*EUROPEAN FISCAL COUNCIL

In the medium term, we recommend the establishment of a European Fiscal Council (EUFC), with a structure similar to the ECB's Governing Council: about six executive board members (with the same appointment and accountability procedures that ECB executive members face), plus the heads of national fiscal councils. The EUFC's mandate should be to safeguard the proper implementation of the fiscal framework with a focus on gross errors and cross-border spillovers. EUFC decisions would not be binding, but decisions would be made public in a timely manner, providing a major input into the Commission's recommendations to the Council. The European Fiscal Board, which was set up in

2016, has a different mandate, and different appointment and accountability procedures, to what we recommend for the EUFC.

A deeper reform of the rules necessitates addressing the issues of:

- Increasing the credibility of the system and making decisions more enforceable;
- The trade-off between realism and complexity;
- Making the application of the rules more predictable;
- Looking at the use of incentives, possibly to partially substitute for sanctions;
- A better way of treating investment in fiscal rules;
- The role of institutions versus market mechanisms, which necessitate reflecting on the role of debt restructuring;
- The degree of discretion the Commission should have in the application of rules.

There are various different proposals along these lines, which involve various trade-offs.

Finally, you should keep up the analytically sound work on the quality of public finances, which should focus both on the process of budgeting (planning, execution, control and audit) and the composition of taxes and expenditures to support long-term growth and productivity. A higher degree of public awareness of cross-country comparisons of input costs, efficiency and outcomes would foster the adoption of best practices.

3.3 Fiscal policies

The low interest rate environment (Figure 2) creates the opportunity for a richer discussion on fiscal policy. You should lead the discussions on how to channel the excess of euro-area savings, as reflected in the sizeable current-account surplus, to investments including public investments, such as the transition to a carbon-neutral economy, rail and road, research and development, and digital infrastructure.

*PUBLIC INVESTMENT

However, the situations in member states vary widely and the boost to public investment needs to be done within the framework of EU fiscal rules.

*DEBT REDUCTION

Progress on debt reduction has been varied across member states. Consequently, countries have differing scope to make use of the present low interest rate environment. Nevertheless, for most EU countries the growth/interest rate differential is so large, and public debt levels not that elevated, meaning there is some room for manoeuvre. But the highly-indebted countries should not repeat past mistakes of pretending that they can spend their way out of the debt sustainability trap.

*PRODUCTIVITY AND SUSTAINABILITY

A crucial issue is that the money needs to be spent on investment (both physical and human capital) in future productivity and sustainability, while recognising the risks of a possible medium-term reversal of interest-rate developments. You should make such recommendations to EU member states. But you need to be aware that it is national parliaments that decide the distribution of resources – your role is strictly advisory.

An important question is how to manage the next economic slow-down or crisis. If that happens in the near term, before monetary policy is normalised, the ECB and most central banks in non-euro area EU countries will have limited scope for additional monetary easing[3]. Therefore, fiscal policy will have to play a greater role in cyclical stabilisation. In the absence of an EU or euro-area counter-cyclical fiscal stabilisation instrument, you will have limited tools, including fiscal policy coordination and speeding-up payments from the EU budget. The Barroso Commission in 2009 provided a good example of coordinated fiscal stimulus of about 1.5 percent of GDP, which was differentiated between member states depending on their fiscal space.

*RISK OF DOWNTURN

The fiscal challenge will obviously depend on the severity of the next economic downturn. A mild slowdown or recession without a financial crisis would be easier to manage given the improved fiscal situation of member states and the low interest rates. But a severe recession, similar to the wake of the 2008 crisis, especially if it is combined with a financial crisis, would be tough. In such a case you should coordinate a discretionary stimulus, while allowing countries to run their automatic stabilisers to their full extent. You should explain to member states that they should not fear an excessive deficit procedure and in your analysis and recommendations to the Council you will consider the favourable interest rate environment.

However, an eventual deep recession would find EU members

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*ITALY

in different fiscal situations. For example, Germany would have ample fiscal space, while Italy would hardly have any. The shakiness of Italian fiscal sustainability might give rise to a deep financial crisis and could have major social and political consequences[4]. Brokering a European Stability Mechanism programme for a large country like Italy could be difficult, given that such a programme would come with unpopular conditions (including fiscal adjustment). The politics of such a programme could be hugely destabilising, not only in Italy, but also in the rest of the euro area. Capital flight would increase the liability to the Eurosystem of the banking system of the country under stress, which could require the ECB to grant a large amount of emergency liquidity assistance, especially if sovereign credit rating downgrades make the government bonds of the country under stress into unacceptable collateral for standard monetary policy operations. In any case, in the event of a deep fiscal crisis, early decisive collective action by member states should be advocated in order to avoid prolonged adjustment problems, as seen in Greece.

3.4 Deepening the euro area

After setting up banking union, the process of deepening the euro area has been excruciatingly complex and slow as fragmentation risks have receded. Significant national differences in approaches persist, making it increasingly difficult to engage in genuine policy cooperation that takes into account the interests of the euro area as a whole.

One of your tasks will be to engage in a broad political debate on these issues in search of more common ground. You might have to accept a certain degree of intergovernmental cooperation in order to move forward at least a few steps. While not optimal, this approach can give democratic legitimacy at the national level in certain policy areas for which the EU is not yet equipped.

*EURO-AREA REFORM

Important elements of the reform are beyond your direct responsibilities, such as completing the banking union, fostering capital market integration and supporting the soundness of financial institutions to ensure financial stability. But the economic analysis your team produces can influence the discussion, and your cooperation with other commissioners can ensure that the interface between macroeconomic policies and financial-sector policies within the Commission is seamless and mutually supportive.

*EURO-AREA SAFE ASSET

A particular aspect relates to the introduction of new financial instruments in the form of sovereign contingent debt (debt with payment obligations that are contingent on the economic conditions of the sovereign) or a euro-area safe asset. We suggest you actively advance the ongoing discussions. Especially in the context of introducing single-limb collective action clauses by 2022, contingent debt can play multiple roles and serve as buffers. Contingent debt provides countercyclical buffers, opportunities for long-term investors to invest in the *"wealth of the nation"* (an argument made by Kamstra and Shiller, 2009), and automatic extensions for countries entering an adjustment programme (as suggested for the European Stability Mechanism by Andritzky *et al* 2016). It could also contribute to breaking the bank-sovereign doom loop from the sovereigns' side, complementing current efforts to break the loop from the banks' side[5]. In this regard, a euro-area safe asset could decouple banks' balance sheets from individual sovereign risk and might foster a greater international role for the euro.

The current weak euro-area budget proposals, put on the table by the Juncker Commission in May 2018 and by the Eurogroup in June 2019, are perhaps the most realistic in the current context. You will have no choice but to keep working on these proposals. You should ensure that financed projects offer genuine value added from an overall euro-area perspective, and are not mere co-financing of projects in the national interest. You should also call on the Eurogroup to not replicate the EU budget's existing cohesion and competitiveness instruments. We also would encourage you to support further the work on a euro-area unemployment insurance scheme.

*EURO-AREA ENLARGEMENT

Enlargement of the euro area will figure prominently on your agenda. The criteria in the Treaty are quite clear, even if subject to dispute (Darvas, 2010). But the euro area has changed since the Maastricht Treaty, necessitating reflection. In particular, we consider that joining banking union at an early stage is an important aspect in signalling how prepared a country is to join ERM II and ultimately adopt the euro. This also shows preparedness in relation to important aspects of the economic governance structure of the member state concerned.

The issue of the international role of the euro was the subject of a December 2018 European Commission communication (COM(2018) 796/4). We trust that this issue can move forward under the next Commission, recognising that such developments are largely demand-led. Practical measures can be taken to facilitate a greater global role for the euro, requiring the cooperation of a variety of economic players, within the EU and outside.

We consider that installing a full-time Eurogroup Chair could contribute to finding good solutions for some of the issues facing the euro area. It would also contribute to better anchoring euro aspects in national economic policies. However, you as the commissioner should not take over this role, as this would involve conflicts of interest (Wolff, 2017).

NOTES

1 See https://ec.europa.eu/info/departments/economic-and-financial-affairs/mission-statement-economic-and-financial-affairs_en.

2 See Wieser (2018) and Darvas *et al* (2018). ECA (2018) highlighted a number of worrying European Commission decisions and called for a change in the implementation of the rules and the Commission's practice.

3 However, the tools used during the recession, such as asset purchases and targeted long-term lending, could be adopted again while interest rates can be cut to deeper in negative territory, as the example of the Swiss National Bank shows. Central banks might also invent new instruments.

4 An important underlying problem for Italian public finances is the halting of productivity growth since the 1990s (Pellegrino and Zingales, 2017).

5 Demertzis and Zenios (2019) suggested that these instruments could provide insurance for euro-area countries in future crises.

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