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Paying for climate change: can we afford not to?

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Editorial

Finding fair and sustainable solutions to long-term economic challenges

Dear Reader,

During the economic and financial crisis the primary focus of economic policy makers and economic agents has necessarily been on crisis management and mitigation – in other words, on the short term. But the big economic challenges of the next decade have not gone away simply because there are pressing immediate concerns.

Some of those long-term challenges are now back under the spotlight and we examine several of them in this issue. First and foremost is the issue of fighting climate change, including the key question of climate finance and how the developed and developing world should share the financial burden of mitigation and adaptation.

December's Copenhagen Climate Change Conference fell short of expectations. The Copenhagen Accord is not the comprehensive, ambitious, global agreement that the EU had set as its objective. Although it acknowledges the need to hold the increase in global temperature below 2°C, the action to which developed and developing countries have so far committed themselves will not put the world on a path to achieving this goal. There was, however, progress in mobilising climate finance, and this may pave the way for more ambitious action in future. The EU showed its willingness to take the lead at its December summit, putting up €7.2 billion in 'fast-start' funding over 2010-12 to help the world's poorest countries combat climate change.

This comes on top of an earlier commitment by the EU to shoulder its fair share of the **overall** financing costs of climate change in developing countries which is estimated to amount to about €100 billion per year by 2020. Key to achieving this will be the creation of a well designed global carbon market which can generate the bulk of the required financial flows to developing countries – here too the EU has been a trailblazer by creating the world's largest carbon market (European Trading System). Designing efficient climate change mitigation and financing policies has been and will continue to be a key element of economic policy making in the years to come.

This is particularly true at the current juncture, where such policies could actually contribute positively to a successful exit from the crisis. By getting the policy framework for the accelerated development of highly energy efficient and low-carbon technologies right, the EU would be well placed to reap 'first-mover' benefits of growth and jobs that will accrue from the development of these markets. This will be particularly important in the post-crisis world with traditional sources of growth having taken a battering and unemployment back at high levels not seen for many years.

Now is therefore the time to mobilise all sources of future growth and employment. As the single market approaches its twenty-year milestone it is time to move it up a gear. Barriers to a truly single, internal market in the Union still exist. This means that many benefits have yet to be realised and that the potential of the single market to contribute to a more dynamic, innovative and competitive EU is not being fully exploited. We believe it is time to move towards a more economics-based and results-oriented approach using the targeted monitoring of selected markets and sectors. In this issue we report on a major new review by DG ECFIN on the functioning of product markets – an important contribution to this approach.

The crisis has put government budgets under enormous strain, and the Commission's 2009 *Sustainability Report*, which we report on in this issue, concludes that fiscal policy in most Member States is not sustainable. Fiscal stimulus and other measures intended to re-start the European economy were necessary and successful, but have brought with them a large increase in government deficits and debt. Moreover, this will be exacerbated by the projected impact of ageing populations, which is expected to dwarf the effects of the crisis many times over. The gross debt-to-GDP ratio for the EU as a whole is projected to rise to 100% as early as 2014. This will need to be corrected once the withdrawal of fiscal stimulus measures begins in earnest in 2011 – subject to the recovery proving self-sustaining – together with structural reforms to boost growth potential and help ensure the sustainability of public finances.

Many countries, and not just the EU, are facing similar problems in the wake of the crisis. However one that has weathered the recession rather well is EU candidate Croatia, whose economy we profile in this issue. Croatia is making steady progress in re-structuring its economy and is expected to complete negotiations for EU accession in 2010.

Finally, the beginning of a new year is traditionally a time to review progress, set new goals and take a fresh look at one's direction. This is very much the case for us with a new Commission expected to be confirmed this month for a fresh five-year mandate. We look forward to working with our new Commissioner Olli Rehn on what looks like being a very challenging economic and financial agenda over the next few years.

Marco Buti
Director-General
Economic and Financial Affairs DG

Climate change:
Who is going to pay?

Although the outcome of the UN climate change conference that ended on 19 December was disappointing, the Copenhagen Accord nevertheless represents the first step in determining how to finance mitigation and adaptation measures. It puts in place fast-start funding of 30 billion US dollars for the period 2010-2012 and sets a goal of mobilising 100 billion dollars a year by 2020 to address the needs of developing countries.

According to the Intergovernmental Panel on Climate Change (IPCC), the cost of cutting global greenhouse gas emissions by 50% by 2050 could be in the range of 1-3 percent of GDP worldwide[1]. Moreover, developing countries are likely to bear the brunt of the cost. The Commission estimates that by 2020, developing countries will face annual costs of €104-118 billion (in 2005 prices) – or about 1% of GDP – to mitigate their greenhouse gas emissions and adapt to the impacts of climate change.

Much of the finance needed can come from domestic sources and an expanded international carbon market in which developed countries offset their emissions by investing in low-carbon technologies in developing countries. Nonetheless, the Commission estimates that developing countries could need €9-13 billion of additional financing from international sources of public finance in 2012, rising to €22-50 billion per year by 2020.

The cost of inaction

Given the staggering costs to mitigate and adapt to the effects of climate change, there may be a temptation not to act or to take only half-hearted measures. But delay will only increase the cost of action. Climate scientists have calculated that we can emit in total no more than 250,000 megatonnes of greenhouse gases in order to have a 75% chance of limiting global warming to 2°C – the threshold beyond which many changes will be irreversible and others will pose a serious threat to millions of people. But at current rates we will have used up this ration in 20 years. If the world uses up a large portion of its remaining emissions "budget" in earlier years, then countries will have to take more drastic – and costly – measures to stay within budget in later years.

"The earth's atmosphere is like a box which we can fill with a given amount of emissions," says Mark Hayden, Deputy Head of Unit for Environmental Policies with DG ECFIN. "In the end we will run out of space."

Unfortunately, it is easier to quantify the economic costs of dealing with climate change than the economic costs of not adequately addressing the issue. "We can't do a proper cost-benefit analysis because we have more information about the costs than about the benefits, namely the avoided damages," says Hayden. According to Hayden, projections for GDP growth are based on the implicit assumption that climate change won't affect agriculture, infrastructure and other parts of the broader economy. But in reality there would be costs such as repairing bridges, building sea defences, and relocating people.

José Manuel Barroso, President of the European Commission, addresses the United Nations Climate Change Conference on 18 December.

Who is going to pay?

The real question, however, is not whether action is necessary but who should pay for it. In its Communication of 10 September, "Stepping up international climate finance: A European blueprint for the Copenhagen deal", the Commission proposed that industrialised nations and economically more advanced developing countries provide the requisite public financing in line with their responsibility for emissions and ability to pay. The EU formula is consistent with both the spirit and letter of the UN Framework Convention on Climate Change (UNFCCC) which speaks of "common but differentiated responsibilities" and "respective capabilities".

Responsibility for climate change could be determined based on annual emissions while ability to pay could be determined based on

[1] "World Development Report 2010", World Bank, 22 October 2009.

GDP. On this basis, the EU share in financing would lie somewhere between 10-30% as the EU contributes 10% of world emissions and represents 30% of world GDP.

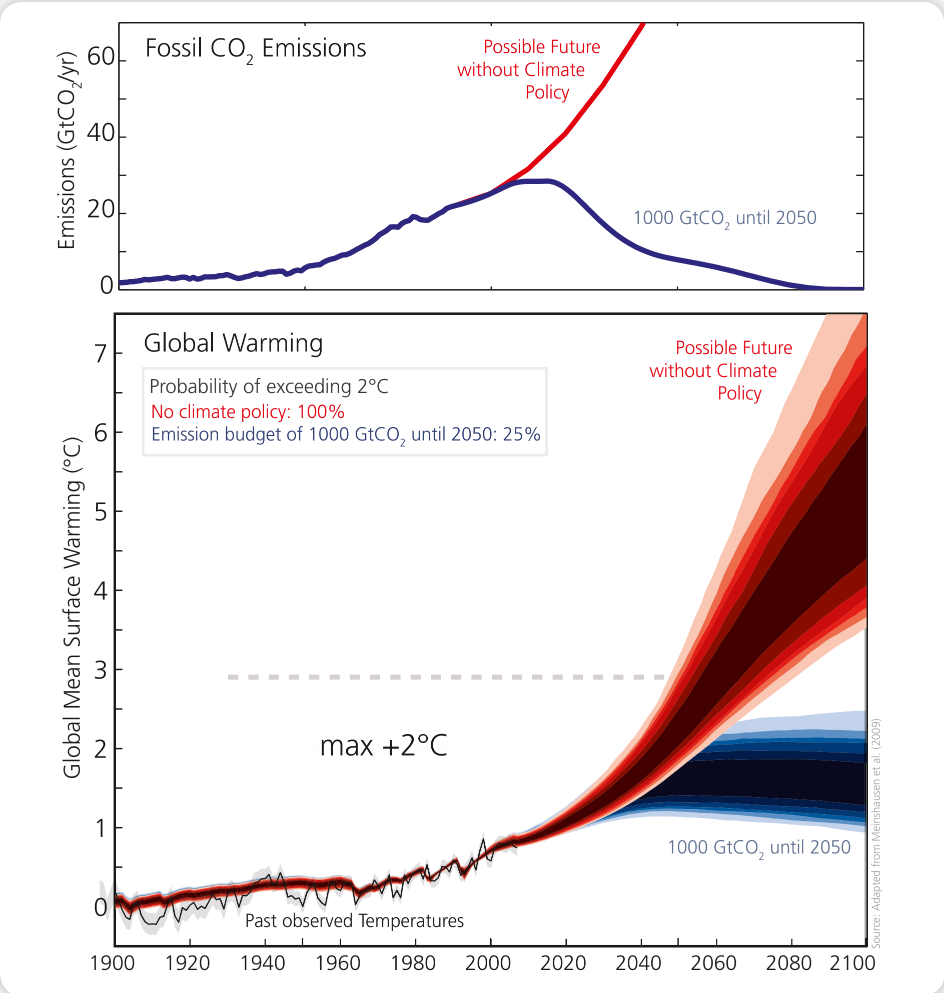
How to pay?

Who is going to pay is not the only issue, however. How to finance mitigation and adaptation measures is of equal importance. According to the Commission, establishing a global carbon market combined with a 30% reduction target for developed countries would cut global mitigation costs by about a quarter by 2020, and generate annual financial flows to developing countries of around €38 billion. This assumes that a sectoral crediting mechanism is introduced for advanced developing countries in place of the project-based Clean Development Mechanism. A global carbon market could cover 40% of the cost of mitigation and adaptation measures in the developing countries, with the remainder coming from domestic public and private finance (20-40%) and international sources. Introducing a global emissions trading system for international aviation and shipping or a levy on their emissions could also generate international funding. A significant portion of the contribution from the EU and Member States could be covered by revenues from the auctioning of EU Emissions Trading System (EU ETS) allowances.

Aid effectiveness

Given the large transfer of funds from North to South, aid effectiveness is sure to be an issue. For mitigation, the EU proposes using country-driven Low-Carbon Growth Plans as a key tool. All nationally appropriate mitigation actions and their financial support would be recorded in a central registry, and backed up by annual emission inventories and regular peer reviews. "This will provide greater transparency since all initiatives will be on the radar screen," states Hayden.

The EU also proposes a "matching mechanism" in which developing countries approach developed countries with their proposals for funding. The UN could ensure that funds are allocated where they are needed most, and not just based on existing or historical relationships between donor and recipient countries.

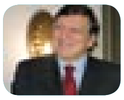


Two possible futures:one in which no climate policies are implemented (red), and one with strong action to mitigate emissions (blue). Shown are fossil CO_2 emissions (top panel) and corresponding global warming (bottom panel). The shown mitigation pathway limits fossil and land-use related CO_2 emissions to 1000 billion tonnes CO_2 over the first half of the 21st century with near-zero net emissions thereafter. Greenhouse gas emissions of this pathway in year 2050 are ~70% below 1990 levels. Without climate policies, global warming will cross 2°C by the middle of the century. Strong mitigation actions according to the blue route would limit the risk of exceeding 2°C to 25%.

For more details, see Figure 2 in Meinshausen, M., N. Meinshausen, W. Hare, S. C. B. Raper, K. Frieler, R. Knutti, D. J. Frame and M. R. Allen (2009): "Greenhouse-gas emission targets for limiting global warming to 2°C" in Nature 458(7242), 30 April 2009.

Support would be bottom-up and de-centralised rather than top-down. It would depend on specific programmes being proposed and developed by developing countries. Moreover, as there are bigger scale effects by dealing at sector rather than project level, there would be a natural progression: countries would move from a project focus under the Clean Development Mechanism to a sector focus and then beyond to sectoral carbon caps, economy-wide caps and ultimately to participation in an international carbon trading system.

In all cases, the EU will ensure that money is well spent. "It's not a blank cheque," says Hayden. "We're not going to pay without knowing what we get for our money."



"Our level of ambition has not been matched."

José Manuel Barroso, President of the European Commission

Environmental activists from the World Wide Fund for Nature (WWF) demonstrate on 7 December 2009 outside the Climate Change Conference.

The long-term economic impact

Despite concerns about the cost, financing climate mitigation and adaptation measures could be budget-neutral. The cost will depend on the policy mix used, and governments are free to determine for themselves whether to employ revenue-generating instruments such as carbon taxes and the auctioning of EU Emissions Trading System (EU ETS) allowances or non-revenue-generating instruments such as subsidies and regulations.

Financing could also have a neutral or even positive impact on economic growth. Far from requiring additional investment, shifting to a low-carbon economy requires re-orienting investment from carbon technologies to clean technologies. Moreover, the costs of technology may be far lower than foreseen thanks to innovation. A breakthrough in battery technology, for example, could dramatically alter the market for electric vehicles.

A clear commitment to reducing emissions would reduce uncertainty and make investing in clean technologies more attractive to industry. And the region that invests decisively in these technologies may benefit from a first-mover advantage as the markets for low-carbon technologies emerge. Without action on a global scale, however, these nascent markets will never develop. Europe cannot do it alone.

The Copenhagen Accord and the state of play

Global action was the subject of two weeks of intensive negotiations and much political grandstanding at the COP 15 UN Climate Change Conference which ended on 19 December. The outcome of the conference was disappointing. According to José Manuel Barroso, the European Commission president, the outcome fell "far short of our expectations." Barroso added: "Our level of ambition has not been matched."

Several developing countries refused to even endorse the final agreement, the Copenhagen Accord, meaning that it could not be formally adopted as a decision of the UN meeting. The conference agreed instead to a much weaker "decision to note" the accord's existence.

Despite disappointment with the final deal, the Copenhagen Accord nonetheless represents tangible progress. It recognises the scientific case for keeping the rise in global temperatures to 2°C and establishes a February deadline for nations to specify their commitments to curb emissions.

Agreement was also achieved on new and additional funding from developed countries amounting to 30 billion dollars for the period 2010-12. This so-called fast-start funding is roughly in line with the Commission proposal. It will be provided to poor countries to help them adapt to climate change, reduce their emissions and embark on a low-carbon development path. Developed countries also made a broad commitment to financing climate change mitigation and adaptation measures. They agreed "to set a goal of mobilising jointly 100 billion dollars a year by 2020 to address the needs of developing countries."

While the Copenhagen Accord falls short of EU objectives, Hayden prefers to look for the silver lining. "It's not a bad sign if countries agree to keep on talking," he says, "and set a deadline or ambition for reaching a firm deal in 2010."

A global agreement is essential, however. "The EU accounts for approximately 10% of world emissions," states Hayden, "so even if we reduced our emissions to zero or near zero, 90% of the problem would remain unsolved."

Further information

• The Copenhagen Accord:
http://unfccc.int/2860.php

"Down but not out":

The sustainability of public finances in a turbulent economy

The Sustainability Report 2009 concludes that fiscal policy in most Member States is not sustainable. Fiscal stimulus and other measures intended to re-start the European economy were necessary and successful, but have brought with them a large increase in government deficits and debts. Moreover, the projected impact of ageing populations is expected to dwarf the effects of the crisis many times over. Nonetheless, the success of several countries in getting their finances under control shows that it can be done. Fiscal strategies to reduce deficits and debt should be coupled with structural reforms of labour markets and social protection systems – particularly public pension and healthcare regimes.

Policy makers have taken bold measures – including fiscal stimulus – in order to pull the EU economy out of recession. As a result, however, public finances throughout the EU are being battered. From an average deficit of 0.8% of GDP in 2007 – the best result for thirty years – government deficits in the EU are now forecast to have risen to almost 7% of GDP in 2009 and to rise again to 7½% in 2010, while gross debt is likely to increase by nearly 20 percentage points over the same period.

While policy makers have rightly focused on pulling the EU economy out of recession in the short term, long-term issues such as the economic implications of demographic ageing can neither be forgotten nor ignored. Put simply, the current levels of deficit and debt will not be sustainable in the long run. Moreover, the projected impact of ageing populations on Member States' public finances is expected to dwarf the effects of the crisis many times over. "The financial crisis is not a piece of cake for public finances," says João Nogueira Martins, Head of Unit for Fiscal Sustainability, "but the impact of ageing will be much greater."

The Sustainability Report 2009

The Sustainability Report 2009 provides a detailed analysis of the long-term sustainability of public finances. The report, an update of the 2006 report, is based on long-term projections (to 2060) of demographic developments, government expenditure, revenue and deficits that take into account the current situation and medium-term forecasts. New age-related expenditure projections from the 2009 Ageing Report[1] are incorporated. The projections show that the EU faces a significant budgetary challenge as the result of its ageing population, which is magnified by a projected deceleration in economic activity – which is itself a consequence of demography – and the crisis-related accumulation of debt. The analysis zooms in on pensions, healthcare, long-term care, education and unemployment-related expenditure – i.e. the variables that are more directly influenced by demographic developments. To quantify the sustainability risks, the authors of the study use "sustainability gaps". Devised by the Commission services, sustainability gaps measure by how much taxes or spending would need to be adjusted, now and going forward, to ensure that debt ratios remain within manageable limits over the projection horizon.

Assessment of sustainability by country

There are large variations across Member States in terms of the degree of risk to which they are exposed and the source of that risk.

Bulgaria, Denmark, Estonia, Finland and Sweden have relatively stronger budgetary positions and have undertaken comprehensive budgetary reforms in recent years. Though the crisis is leading to a deterioration in government balances and an increase in debts, their structural fiscal positions remain sounder than in most other EU countries and, therefore, present a low long-term risk.

For **Belgium, Germany, France, Italy, Hungary, Luxembourg, Austria, Poland and Portugal**, the long-term sustainability risk is medium. Austria and Germany have large costs of ageing, but initial budgetary positions which are relatively sound, provided that the crisis-driven deterioration in government finances does not become structural. For Belgium and Italy, the high debt ratios constitute a burden and specific risk. For France, Hungary, Poland and Portugal, the long-term costs of ageing are not projected to be particularly high but their initial fiscal positions are unsustainable even without any increase in age-related expenditure. The projected increase in age-related expenditure in Luxembourg is the highest in the EU, though the risk is cushioned by a low debt and large amount of government-owned assets.

In the **Czech Republic, Cyprus, Latvia, Lithuania, Malta, the Netherlands, Romania and Slovakia**, the sustainability gaps are all above 6% of GDP, and over double that level in **Ireland, Greece, Spain, Slovenia and the United Kingdom**. Hence all these countries are exposed to higher long-term risk. Closing the sustainability gaps, therefore, will require both reducing deficits and debt, and far-reaching reforms of social protection systems.

These categories do not refer to the risk of default. Risk of default refers to solvency – i.e. the ability to honour payment commitments and refinance debt – which is a concept related to but different from sustainability. Sustainability refers to a government's ability to pursue its current revenue and spending policies without an excessive accumulation of debt. Thus, the three risk clusters show Member States' degree of exposure to long-term sustainability risks and indicate that different Member States will have to adopt measures of different sizes in order to return to a sustainable path.

[1] 2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060), joint report of the European Commission and the Economic Policy Committee, European Economy 2/2009.

> *Ageing will have a much greater impact than the crisis on public finances.*
>
> *João Nogueira Martins, Head of Unit for Fiscal Sustainability, DG ECFIN*

Sustainability: difficult but do-able

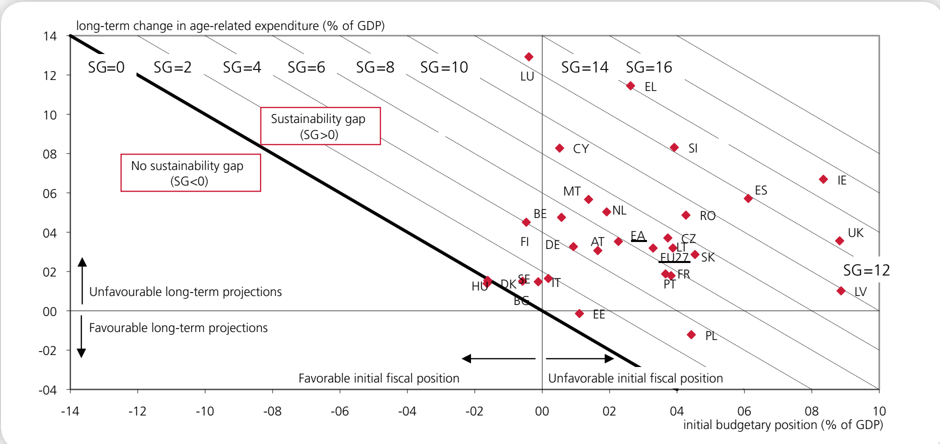
The Sustainability Report 2009 concludes that fiscal policy in most Member States is unsustainable. Given their current budgetary situation, projected changes in the population structure and long-term scenarios for productivity growth, government debt ratios in many countries are set to balloon. Without effective fiscal consolidation, the gross debt-to-GDP ratio for the EU as a whole could reach 100% as early as 2014 and 130% by 2020.

The increase in debt ratios, however, can be avoided. Fiscal strategies aimed at ambitious and realistic medium-term objectives (MTOs) should be mapped as soon as possible and implemented in a decisive manner as soon as the recovery is firmer, taking into account the specific situations of individual countries. Structural reforms, particularly of labour markets, have increased employment rates among older workers and women, and further reforms should be pursued. Reforms to social protection systems – particularly increases in retirement ages – should be considered by all countries. The success of several countries in instituting reforms, however, shows that it can be done, if the appropriate social and political consensus exists. Many of these countries have established a link between increases in life expectancy and retirement age and pensions, discouraged early retirement or adjusted pension award formulas to better reflect contributions paid during working lives. "Bold measures are required, not simply adjustments," says Martins. "Profound reforms to social welfare systems are inevitable."

Crisis response and sustainability: two sides of the same coin

Successful fiscal expansion to counter recession and longer-term fiscal sustainability are not incompatible. Fiscal measures to increase confidence and support demand are only successful if they are perceived by the markets and public opinion as temporary and consistent with long-term sustainability. According to Martins, since economic actors are forward-looking any fiscal stimulus will be undermined if the markets perceive it as endangering public finances in the long-term.

Experience shows that, by illustrating the need and urgency for structural reforms, crises constitute a window of opportunity that governments can use to make decisive breakthroughs in structural reforms.



Sustainability gaps in the EU Member States

The chart shows the required adjustments in fiscal policy given the initial budgetary position and required adjustment given the long-term changes in ageing-related expenditure. The further along the horizontal axis countries are, the larger the required adjustment to stabilise the debt ratios given the initial budgetary position, and before considering the long-term costs of ageing. The higher up the vertical axis a country is, the greater the required adjustment due to ageing-related costs. The sustainability gap (SG) is the sum of the vertical and horizontal distances from each dot to the diagonal line.

Further information

- Sustainability report 2009: *http://ec.europa.eu/economy_finance/thematic_articles/article15994_en.htm*

Product Market Review 2009:
Microeconomic consequences of the crisis and implications for recovery

Examining the microeconomic consequences of the crisis can help us better understand the drivers of recovery. The 2009 Product Market Review explores the impact of the crisis on the structure of the EU economy and on innovation. It concludes that the bulk of adjustments will be within rather than across sectors and that product market support measures need to be smoothly withdrawn in order to avoid distorting competition in the Internal Market. The Review notes that the framework conditions for R&D and innovation must be improved as public spending neither can nor should make up for gaps in private sector R&D.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The fall in EU GDP since autumn 2008 is unprecedented in the history of the Union and is partly the aggregate outcome of microeconomic decisions taken by firms and households. An in-depth examination of the microeconomic consequences of the crisis, therefore, is necessary in order to better understand how decisions by consumers and producers may shape the drivers of the recovery. "The way and extent to which markets and whole sectors have been affected by the crisis will in the end have a major impact on aggregate, macroeconomic outcomes. But more importantly, the nature and characteristics of these microeconomic reactions contribute to shaping the recovery. This is why understanding them is crucial in designing appropriate and effective policies to return Europe to robust growth," said Gert Jan Koopman, ECFIN Director responsible for the economic service and structural reforms.

Is this recession different?

A key question is whether in the longer term the crisis will lead to significant shifts in the sectoral composition of the EU economy. Since productivity varies widely across sectors, any change in the structure of the economy would have a profound impact on economy-wide productivity. Moreover, the allocation of capital and labour across sectors would have to change, posing a formidable adjustment challenge. Experience from past downturns suggests that once growth resumes, Europe's sectoral structure does not durably deviate from its adjustment path, which tends to be determined by long-run trends. Despite the fact that this crisis is broader and much more severe than past downturns, preliminary evidence points at possibly modest changes in the relative importance of broadly defined sectors. However, given very low capacity utilisation rates and pre-existing weaknesses in a number of sectors, there is likely to be a significant degree of restructuring and consolidation within sectors. These processes pose their own significant challenges but might be easier to complete than major cross-sectoral changes which in Europe are hampered by significant product and labour market rigidities. If the initial indications that the EU economy will follow this pattern when exiting from the present crisis prove right, the impact on potential growth may be relatively muted.

In fact, most adjustments are likely to be *within* rather than across sectors and, in some sectors, are likely to concern not just sub-sectors but also markets and even companies. Some sectors have developed production overcapacity as a result of the crisis and have problems in market functioning that pre-date the crisis. These sectors may need to restructure.

Using the recently re-formulated market monitoring tool, the Commission's departments have evaluated possible evidence of market malfunctioning. Sectors experiencing market malfunctioning appear to share a weak performance in innovation and often exhibit poor levels of market integration. Reforms that improve the EU's performance in innovation, rapid implementation of the Services Directive to reduce service market fragmentation and a generally well-functioning internal market could help Europe recover faster from the crisis. "We need "deep dives" into the causes of Europe's relatively low productivity growth. Without looking in depth into sectors and innovation systems, it is not going to be possible to formulate truly adequate policy responses. This is why we need high quality evidence-based instruments such as market monitoring", stresses Koopman.

Unwinding support measures

Member States have introduced support measures on a scale not seen in Europe since the 1980s, one third of which have targeted specific sectors, especially motor vehicles, tourism and construction. Every effort has been made to ensure that they do not unduly distort competition and that they support long-standing EU objectives such as enhancing R&D and innovation. An assessment by the Commission's departments of the crisis measures implemented by Member States suggests that these objectives have broadly been achieved[1]. Nevertheless, such measures may affect the conditions of competition in the Internal Market, especially if they are maintained over time, given that they differ across actors in production chains and Member States. With fiscal space in the Member States diminishing, consideration should increasingly turn to how

[1] "The EU's response to support the real economy during the economic crisis: an overview of Member States' recovery measures", European Economy Occasional Paper 51/2009

"The pre-crisis agenda is still relevant today - indeed it has become even more urgent than before."

Gert Jan Koopman, Director, Economic Service and Structural Reforms, DG ECFIN

Case: the car manufacturing sector

The significant support given to the car manufacturing sector illustrates the challenges facing policy makers. The sector generates up to 3.5% of GDP in Germany and the Czech Republic and directly or indirectly accounts for a significant share of all manufacturing jobs in the EU as a whole. It has been hit very hard by the crisis and is now struggling with overcapacity. It also shows evidence of pre-existing poor market performance and depends on innovation and strategic R&D capacity for a competitive edge (car producers and their suppliers spend more on R&D than any other sector in the EU). For these reasons, a very large share of all the sectoral measures introduced across the EU support the European car industry. On the demand side, for example, temporary car scrapping schemes costing €8 billion over 2009-10 were introduced in 12 Member States to encourage the purchase of new cars. On the supply side, some Member States provided loans and guarantees worth approximately €10 billion to the automotive sector, and a €5 billion partnership was established by the Community, the European Investment Bank, industry and Member States to fund research into a broad range of technologies and smart energy infrastructures.

The scrapping schemes may have encouraged car sales in 2009 and car production has rebounded in some Member States. However, the current rise in demand may reflect consumers taking advantage of incentives today at the expense of future car purchases. If so, the measures may only be postponing restructuring. Increased car sales may also have replaced purchases of other durable goods, which would partially offset the macroeconomic impact of the schemes.

The automotive sector supply chain is also an area of concern. Currently, many of the leading technologies needed to produce cleaner cars are owned and developed by upstream suppliers. But these suppliers have received much less public sectoral help than manufacturers. There is, therefore, a risk that manufacturers may exploit this relative financial strength to lever control of new technology development away from the suppliers, which could affect innovation incentives. Since policy must ensure a sufficient degree of competition at every level of the supply chain, improving upstream suppliers' access to finance should be a priority.

they could be smoothly withdrawn. Otherwise, the efficient functioning of the Internal Market could be impaired and necessary adjustments hindered, with negative consequences for EU growth.

Innovation

A key risk is that the crisis could lead to a deterioration of current levels of accumulated knowledge capital or create a drag on their growth. This would have a lasting effect on Europe's future economic growth. Commission departments estimate that, after strong growth in 2008, business R&D spending may contract by over 6% in 2009 and 2010.

However, since the crisis broke, two thirds of Member States have stepped up public R&D spending, especially through direct funding but also through tax incentives to encourage private R&D spending. Member States' public R&D investments are estimated to offset about half the contraction in private R&D spending. Whilst this is welcome, constraints on public finances mean that policies must ultimately focus on improving the framework conditions for private sector R&D. This entails improving the general business environment to facilitate the emergence and growth of innovative, new companies and removing regulatory barriers to R&D and innovation. R&D regulatory reform should address both horizontal and sectoral issues. One important horizontal issue is the impossibility

in Europe of obtaining a valid patent enforceable throughout the EU27; this puts European businesses at a severe disadvantage compared to their international competitors. The importance of broad framework conditions is illustrated by the fact that about half of the gap in private R&D expenditure between the USA and the EU is due to the relatively unfavourable sectoral structure of the EU economy.

Taking microeconomic reform forward

The crisis may lead to a less radical change in the European economy's sectoral structure than expected. The pre-crisis microeconomic policy reform agenda, therefore, remains very relevant, especially since public finances will be extremely constrained. And developing systematic evidence-based instruments such as market monitoring is essential. These instruments can be used to analyse structural microeconomic problems with macroeconomic impacts, and help to more precisely identify reform needs.

Further information

- 2009 Product Market Review: *http://ec.europa.eu/economy_finance/publications/publication_summary16501_en.htm*

Crisis encourages a re-examination of economics

DG ECFIN 6th Annual Research Conference: Crisis and Reform

The financial crisis and recession have presented a major challenge for policy makers – and for the economics profession. While there has been little disagreement regarding the immediate crisis response, there has been less agreement on the medium- to long-term approach. How will the crisis affect countries' willingness to implement reforms, such as reforms to improve the design of the financial system? And how will the crisis affect the very paradigms underlying our economic thinking? DG ECFIN's 6th Annual Research Conference, held on 15-16 October in Brussels, examined these interrelated questions.

The illusion of stability

Axel Leijonhufvud of UCLA opened the conference with a keynote lecture *("Macroeconomics and the crisis: a personal appraisal")* in which he concluded that a modern economy is not globally stable. Leijonhufvud asserted that the instabilities that general equilibrium theories ignore are precisely the problems that macroeconomists should address.

The political economy of reform

How then to deal with these instabilities was the topic of the first conference session: *"The political economy of reform". In his keynote address ("Financial market crisis, financial market reform: Why hasn't reform followed crisis?"),* Allan Drazen of the University of Maryland examined arguments supporting the hypothesis that crises induce reform: (1) crises make people more aware of needed changes; (2) crises make groups willing to forgo private gain while weakening groups that block reform; (3) a deterioration of the status quo makes groups more willing to accept uncertainties associated with large structural changes; and (4) crises weaken powerful interest groups that block reform. Drazen concluded that the empirical evidence of the link between crisis and reform is mixed and that reforms are easier to implement during times of crisis.

Paul van den Noord of DG ECFIN and his co-authors found that the chances of re-election for an incumbent government are not significantly affected by its record of "pro-market reforms" (*"Reforms and re-elections in OECD countries"* co-authored by M. Buti, A. Turrini and P. Biroli). But the authors also found that reformist governments tend to be voted out of office in countries with rigid product and labour markets.

Financial sector reform

Reform in practice was the subject of the second conference session: "The design of financial systems". Charles Goodhart of the London School of Economics started his keynote address (*"Banks and the public sector authorities"*) with an examination of the limitations of the Anglo-Saxon model. He noted two possible responses: (1) a return to the status quo ante, in which the State would no longer be a general guarantor; and (2) limiting the range of institutions or functions to which the safety net applies (e.g. "Narrow Banking"), but also noted the limitations of each. Fears that narrow banking would create shadow banking were expressed.

Economics under the microscope

The final session of the conference revisited elements of the economic paradigm. In his keynote address on *"Top-down versus bottom-up macroeconomics"* Paul De Grauwe of the Catholic University of Leuven distinguished between a system in which one or more agents fully understand the system (top-down) and one where no individual understands the whole picture (bottom-up).

The conference ended with a lively panel discussion. Panellists said that the ideal economic model should help policy makers see reality better, that it was time to rethink the role of the financial system in the macro economy and redesign financial institutions, and that taxpayer bailouts and other violations of budget constraints provide fertile ground for extremist political movements. Several panellists also stated that central banks should be responsible for monitoring asset prices and not just for stabilising the consumer price level.

Further information

• Annual Research Conference 2009:
http://ec.europa.eu/economy_finance/events/event13393_en.htm

Croatian accession:

"Nearing the finish line…?"

Croatia has weathered the recession relatively well thanks to the inherent strengths of its economy. Nevertheless, the country's large foreign debt is a key vulnerability. The country also needs to complete the re-structuring of its inefficient public sector, reform labour markets and finalise the privatisation of loss-making state industries. Despite the challenges ahead, Croatia is expected to complete negotiations for EU accession in 2010.

Amidst talk of "enlargement fatigue", Croatia is an outstanding success story. The country was already on track for accession in the near term, and its prospects have not been dimmed by the economic crisis. In fact, the country has weathered the crisis well. "If there is one country that does not seem to be affected by enlargement fatigue, it's Croatia", affirms Uwe Stamm, ECFIN Croatia expert.

Inherent strengths of the Croatian economy

Croatia has not been immune to the global slowdown, however. GDP growth dropped by nearly half to 2.4% in 2008 and is projected to turn sharply negative to -5.8% in 2009[1]. Nonetheless, the country has shown resilience thanks to several inherent strengths. Croatia has benefited from an effective macroeconomic policy mix, and perhaps the cornerstone of this has been the country's prudent monetary policy. The Croatian National Bank has maintained a tightly managed floating exchange rate regime. This de facto fixed exchange rate has anchored inflation expectations. Maintaining a stable exchange rate is important as the economy's financial system is highly "euro-ised" and the EU is Croatia's largest trading partner. The EU's share in Croatian exports and imports is 61% and 64% respectively[2]. Moreover, tourism represented nearly 20% of GDP in 2008 and together with remittances from abroad accounts for a substantial share of Croatia's foreign exchange earnings[2].

© iStockphoto.com - Dubravko Grakalic

Another strength of the Croatian economy is its relatively solid banking sector[2]. At 90% of net assets, high foreign ownership has had a stabilising effect on the sector. Furthermore, thanks to prudential and supervisory measures taken before the onset of the crisis, Croatian banks have remained well capitalised. Given that the majority of loans are based on variable interest rates and denominated in or indexed to foreign currencies, however, risks related to unhedged balances remain.

A relatively sound fiscal policy has also helped Croatia weather the recession. The fiscal authorities initially underestimated the impact of the economic slowdown: the budget needed to be revised three times in order to respond to the crisis. Eventually, a number of important fiscal measures were taken with a view to containing the deficit.

Apart from these policy strengths, Croatia has also reaped benefits based on its geographic position and the structure of its economy. The tourist trade has provided stability and helped the country build its substantial foreign currency reserves. The pre-crisis consumption boom was also more limited in Croatia compared with its peer countries, and growth was driven more by investment than consumption. As a result, the economic slowdown has been less pronounced compared with other small open economies such as the Baltic nations. At the same time, however, it will not be easy for Croatia to quickly return to pre-crisis growth rates.

Croatia (Hrvatska)

Currency: Kuna (HRK)

Population: 443,5056 [Eurostat 2009]

Real GDP growth rate: 2.4% (2008); -5.8% (2009)

Unemployment rate: 8.4% (2008); 10.0% (2009)

GDP deflator: 6.4% (2008); 2.8% (2009)

General government balance (as % of GDP): -1.4% (2008); -3.7% (2009)

General government gross debt (as % of GDP): 33.5% (2008); 37.8% (2009)

Current account balance: -9.3% (2008); -6.3% (2009)

Source: DG ECFIN

2008: actual figures, 2009: forecast autumn 2009

Room for improvement

Croatia still faces several major economic challenges. Perhaps the most imminent danger to the economy is the large debt. Gross foreign debt is nearly 100% of GDP, and government debt is about one-third of GDP. Moreover, much of this debt has to be rolled over in the short-term. Nearly a quarter of the debt will mature by the end of 2010. Still, Croatia is no basket case. Thanks to sizeable foreign currency reserves, the net debt is only about 40% of GDP. A recent $1.5 billion government bond issue was 100% oversubscribed, and the government did not consider IMF assistance necessary.

Longer-term, Croatia must deal with more intractable structural issues. The first important steps have been agreed with the European Commission to restructure the shipbuilding sector and these now need to be implemented vigorously. State aid to loss-making industries such as steel, agriculture and railways is still an issue, and efforts at privatisation are largely unfinished. The share of private-sector activity in total production is estimated at only around 60-70%.

[1] European Economic Forecast - autumn 2009. European Economy 10/2009.

[2] "Progress towards meeting the economic criteria for accession: the assessments of the 2009 Progress Reports".

> *From an economic point of view, Croatia is relatively close to accession.*
> *Carole Garnier, Head of Unit for the economies of the candidate and potential candidate countries, DG ECFIN*

© Amro – Fotolia.com

Furthermore, network industries such as energy and telecommunications are still dominated by incumbents. Indeed, while Croatia is deemed to have a functioning market economy for purposes of accession, there is a lack of strong competition across all industries.

The labour market is another problem area. Due to rigidities in hiring and firing, Croatia is plagued by an extremely low participation rate and high unemployment levels, especially amongst the young. One legacy of the Balkan conflict is that a large portion of the population are living on replacement incomes. War veterans enjoy state benefits that can act as a disincentive to work and an incentive to take early retirement. The pensioners' party is even a key part of the governing coalition.

The wartime legacy also skews social compensation schemes. Most benefits are doled out based on criteria – often war-related – other than actual need.

"Social assistance is not well-targeted at the moment," says Carole Garnier, Head of Unit for the economies of the candidate and potential candidate countries. "It should be targeted to the poor."

Social spending is, in general, inefficient, and apart from limited healthcare financing reforms, little progress has been achieved.

On a more positive note, the business environment has improved. Efforts have been made to reduce company registration costs. However, entrepreneurs are still hampered by a patchwork of ad hoc administrative interventions such as different licensing requirements across municipalities and para-fiscal taxes. While small and medium enterprises have continued to benefit from large-scale government support, their share in the overall economy has not increased.

How close is "close"?

Croatian accession was held up by a border dispute with Slovenia over access to the international waters of the Adriatic Sea, but in November, Croatian Prime Minister Jadranka Kosor and her Slovene counterpart Borut Pahor signed a border arbitration agreement that is expected to settle the dispute.

Although there is still work to be done and a few outstanding non-economic issues, Olli Rehn, the outgoing EU enlargement commissioner, and other observers now expect Croatia to complete membership negotiations by 2010. As of the most recent intergovernmental conference, Croatia had opened 28 chapters and closed 12, but had yet to reach the halfway point. In the economic sphere, the country is close but still needs to implement reforms to cope with competitive pressure and market forces within the Union. The 2009 Progress Reports and their assessments factually analyse the state of Croatia's compliance with the Copenhagen economic criteria[3].

"From an economic point of view, Croatia is relatively close to accession," says Garnier. Nonetheless, Garnier would like to see Croatia accelerate the pace of restructuring, particularly of its shipbuilding, steel, agriculture and railway sectors.

With a per capita income of 65% of the EU average, Croatia is more affluent than many of the newer EU members. But the nation is not tapping its full potential.

"Staying static entails the risk of going backwards," says Garnier. "By advancing reforms, Croatia can catch up with and converge with the EU countries. They should not miss this opportunity to increase the living standards of the population."

Further information

- DG Enlargement website: *http://ec.europa.eu/enlargement/candidate-countries/croatia/*
- More on Croatia in European Economy Occasional Papers: *http://ec.europa.eu/economy_finance/publications/publ_list24909.htm*

[3] In 1993, the Copenhagen European Council identified the economic and political requirements candidate countries will need to fulfil to join the EU. It also concluded that accession could take place as soon as they were capable of fulfilling them.

In brief

Commissioner-designate Olli Rehn in EP confirmation hearing

President José Manuel Barroso announced the portfolio responsibilities for the next Commission on 27 November. Olli Rehn, a Finnish national, was nominated as Commissioner-designate for Economic and Financial Affairs, while outgoing Commissioner Joaquín Almunia will take over the competition portfolio and become a Vice-President of the Commission. Mr Rehn previously served as Commissioner for Enlargement and has a long political career behind him, including as a Member of the European Parliament, Economic Policy Adviser to the Prime Minister of Finland, and Head of Cabinet of former Finnish Commissioner Erkki Liikanen. All appointments have to be approved by the European Parliament following hearings of all the new Commissioners. The final vote on the full Commission is planned for 26 January.

Council launches excessive deficit procedures against 9 EU countries

EU finance ministers meeting in the ECOFIN Council on 2 December opened excessive deficit procedures for Austria, Belgium, the Czech Republic, Germany, Italy, Slovakia, Slovenia, the Netherlands and Portugal, on the basis of a Commission recommendation. They set the deadline for correction of the excessive deficits at 2013, except for Belgium and Italy, where the existence of high debt ratios called for an earlier deadline of 2012. They also extended by one year the existing deadlines for Spain, France, Ireland and the UK. All 13 countries, along with Greece, whose response was deemed insufficient, have deficits above the 3%-of-GDP threshold specified in the Stability and Growth Pact. In all, 18 EU Member States had excessive deficit procedures opened against them in 2009, bringing the total to 20.

EU Finance Ministers reach "groundbreaking"agreement on new financial supervisory framework

At the same meeting, the ECOFIN Council agreed on the creation of three European authorities for the supervision of banking, insurances and pensions, which together with the new European Systemic Risk Board, complete the new supervisory framework to be put in place over the course of 2010. Finance Ministers also agreed on a common approach to exit strategies from financial market support measures, which should encourage banks to return to a competitive market through the gradual withdrawal of government guarantees.
www.consilium.europa.eu

Trichet calls for 'timely and gradual' phasing-out of crisis measures

In his quarterly monetary dialogue with the European Parliament, held on 7 December, ECB President Jean-Claude Trichet said that he expected the euro-area economy to grow "at a moderate pace" in 2010 but warned that any growth would be "surrounded by a high level of uncertainty". Mr Trichet added that exit strategies need to be "timely and gradual", and closely coordinated among national governments. Mr Trichet also took a somewhat positive view on the 2 December Council deal on the financial supervisory package. While it might not be "the best option" he felt that "the Swedish presidency had done a good job" given the complexity of the issue. The main Parliament groupings had condemned the deal.
www.europarl.europa.eu

Post-crisis structural changes in the spotlight

The latest Quarterly Report on the Euro Area, published on 22 December, reviews the most recent economic and financial developments in the euro area and analyses the impact of the crisis on labour markets and exchange-rate movements. This new issue takes a closer look at structural reforms and how the public perception on the need for such reforms has changed with the crisis. Also, a new model is used to better assess the effects of knowledge-related reforms on growth performance. The report also includes two focus sections on the impact of the crisis on the banking sector and the sustainability of public finances in the euro area. The next QREA is expected in March 2010.

Labour market review analyses crisis impact on employment and labour market functioning

Released in October 2009, the Labour Market Review analyses labour market and wage developments in the EU before and during the worst economic and financial crisis since World War II. The report focuses on how the crisis is affecting employment trends and the functioning of the labour market, analysing the interaction with key macroeconomic variables such as productivity, wages and GDP. It also examines the situation in individual countries and specific measures taken to minimise the impact of the crisis.

Brussels readies plans for 'EU 2020' strategy

On 24 November, the Commission issued a consultation document on EU 2020, a new strategy to give the EU economy a brighter future. EU 2020 aims to deliver greener and socially inclusive growth, and to solidify recovery from the crisis while preventing a similar one from occurring again. The new strategy, endorsed by EU leaders at the European Council in December, will build on the achievements of the Lisbon Strategy, which expires next year. Following the consultation, the new Commission will make a detailed proposal to the Spring European Council to be held in March.
http://ec.europa.eu/eu2020/

New financial instrument ELENA launched by Commission and EIB

The European Local Energy Assistance (ELENA) facility, launched on 15 December, will help local authorities invest in energy efficiency, renewables and sustainable urban transport. A budget of €15 million will be made available over the first year from the Intelligent Energy Europe II programme to leverage a minimum investment by municipalities of at least EUR 375 million. Technical assistance in assessing the projects will be provided by European Investment Bank (EIB) specialists. The new instrument was jointly launched by the Commission and the EIB yesterday, and will contribute to the EU's objectives in terms of emissions reduction.

Further information

- The latest news and press releases from DG ECFIN are available at: *http://ec.europa.eu/economy_finance/index_en.htm*

Looking ahead

For your diary

February 2010

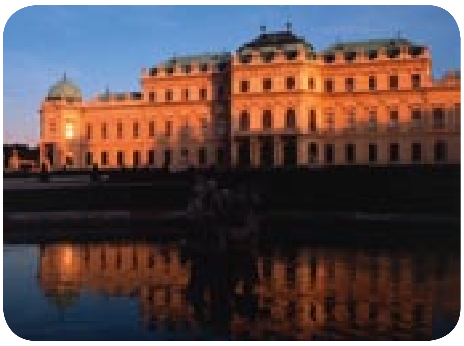
Interim forecast, 20 February

DG ECFIN's twice-yearly interim economic forecast updates the fully fledged forecast published in spring and autumn. The interim forecasts are more limited in scope and cover a shorter time horizon (one year rather than two). They update the data for the biggest EU members and key indicators for the EU and euro area as a whole.

The Commission's autumn forecast, published in November predicted a relatively strong near-term recovery, becoming more gradual in 2010-2011 with EU and euro-area GDP growing by ¾% in 2010 and by 1½% in 2011.

March 2010

ECFIN seminar "Six years after EU enlargement: Austria and its Eastern Neighbours" Brussels, 12 March



Owing to its historical ties and geographic vicinity, Austria has been a major beneficiary of the transformation in Eastern Europe and EU enlargement. But the current economic crisis has revealed vulnerabilities. This country seminar will focus on the impact of enlargement on Austria's competitiveness; migration and labour markets; and on the exposure of Austrian capital markets to Central and Eastern European countries.

Quarterly report on the euro area

The first 2010 issue of the Quarterly Report on the Euro Area will be released in March, and will focus on competitiveness and external imbalances within the euro area.

First quarter

Assessment of Stability and Convergence Programmes

The first quarter sees the annual round of SCP assessment by the Commission. Under the provisions of the preventive arm of the Stability and Growth Pact (SGP), euro-area Member States prepare annual stability programmes and other EU Member States prepare convergence programmes and submit them to the Commission and the Council, normally by 1 December of each year. The aim is to ensure more rigorous budgetary discipline through surveillance and coordination of budgetary policies within the euro area and EU.

ECFIN photo competition for young people

DG ECFIN is organising a photo competition on the theme of **"The euro: What does it mean to us?"** The contest is for 14-18-year-olds resident in the EU who can work together in teams of 2 or 3. There will be national prizes as well as an overall winning team, which will be invited to Brussels to receive their award.

April 2010

2010 Spring Meetings of the International Monetary Fund and the World Bank Group Washington, DC, 24-25 April

The EU Commissioner for Economic and Monetary Affairs will attend these meetings of the Boards of Governors of the World Bank Group and International Monetary Fund (IMF), where a range of issues related to poverty reduction, international economic development and finance will be discussed.

G20 Ministerial Meeting Washington, DC, April

G20 Finance Ministers and Central Bank Governors will meet to prepare for the G20 Summit meeting to be held in Huntsville, Canada, 25-27 June.

May 2010

Convergence Report

2010 will see the publication of a new convergence report that examines whether the Member States not yet in the euro area satisfy the conditions necessary to adopt the single currency. The EC Treaty requires the Commission and the European Central Bank to issue these reports at least once every two years or at the request of an EU Member State which would like to join the euro area. The last report was issued in 2008.

Second quarter

Brussels Economic Forum 2010 "Strategies for a post-crisis world: enhancing European growth"

DG ECFIN's major annual event, the Brussels Economic Forum, will look into the crisis exit strategies as an opportunity to create new sources of growth and enhance EU competitiveness, with a special focus on the key role climate change should play in the post-crisis growth model.

Further information

• A list of the events organised by ECFIN is available at: *http://ec.europa.eu/economy_finance/events/index_en.htm*

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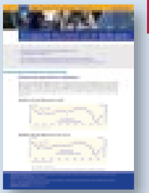
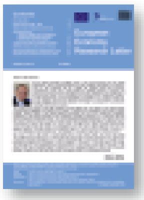
Recent research and analysis by DG ECFIN



NEW: European Business Cycle Indicators

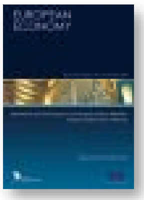
This new monthly online publication provides short-term analysis based on the joint harmonised EU programme of business and consumer surveys. The surveys gauge sentiment in various business sectors and measure confidence among consumers.

The first issue includes a focus on the manufacturing sector investment survey conducted in autumn 2009, which reveals the largest contraction in investment expectations since the series began in 1985. If you wish to be alerted when a new issue is published, please subscribe to the email alert service on DG ECFIN's home page.



European Economy Research Letter

The December issue of the European Economy Research Letter reports extensively on DG ECFIN's Annual Research Conference and features an interview with keynote speaker Axel Leijonhufvud of UCLA on economic paradigms and the crisis. It also reports on a new intiative by DG ECFIN that brought together around 30 economic research directors from a wide range of organisations to establish research priorities in the post-crisis period. Other articles look at DG ECFIN's special report on the crisis, and government bond spreads during the crisis.



Economic Papers

The European Economy Economic Papers provide economic research with an analytical focus that is relevant to the European Union. The research is conducted by staff of the DG, sometimes in cooperation with external researchers.

Recent titles include:

- Did the introduction of the euro impact on inflation uncertainty? – An empirical assessment
- A comparison of structural reform scenarios across the EU member states - Simulation-based analysis using the QUEST model with endogenous growth
- The euro: It can't happen, It's a bad idea, It won't last. US economists on the EMU, 1989-2002
- Institutions and performance in European labour markets: taking a fresh look at evidence
- Study on the efficiency and effectiveness of public spending on tertiary education
- Macroeconomic effects of cost savings in public procurement
- Determinants of intra-euro area government bond spreads during the financial crisis
- A model-based analysis of the impact of Cohesion Policy expenditure 2000-06: simulations with the QUEST III endogenous R&D model

Occasional Papers

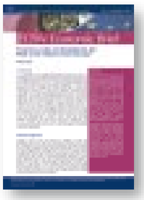
The European Economy Occasional Papers provide economic research with a policy focus that is relevant to the European Union. The research is conducted by staff of the DG, sometimes in cooperation with external researchers.

- Progress towards meeting the economic criteria for accession: the assessments of the 2009 Progress Reports
- Pension schemes and pension projections in the EU-27 Member States, 2008-2060
- 2009 Pre-accession Economic Programmes of candidate countries: EU Commission assessments
- An analysis of the efficiency of public spending and national policies in the area of R&D
- Economic performance and competition in services in the euro area: policy lessons in times of crisis

Country Focus series

The Country Focus series covers topical economic issues affecting one or more Member States. This series is published online only.

- Public investment, transport infrastructure and growth in Poland
- The global financial crisis and its effects on the Netherlands
- US household saving: how far will it rise?



Economic Briefs

Economic Briefs showcase new policy-related analysis and research by DG ECFIN staff on a variety of topics. This occasional series is published online only.

- Economic cycles and development aid: What is the evidence from the past?

All research publications can be downloaded free of charge from the DG ECFIN website: **http://ec.europa.eu/economy_finance/publications/**

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