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upgrading to a smarter, greener, more inclusive economy

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Editorial

Europe at the crossroads

Dear Reader,

Europe has reached a fork in the road. Recent events in Greece and the broader EU along with a still fragile recovery have exposed significant weaknesses in the European economy. Moreover, the unprecedented economic crisis has wiped out most of the steady gains in economic growth and job creation achieved over the past decade and made the task of securing future economic growth much more difficult. Far from being a reason for despair, however, recent developments should be taken as opportunities and give a sense of renewed purpose.

Recent developments provide the impetus for change. We now have the opportunity to focus on Europe's long-term future by taking action today. The **Europe 2020** strategy has the ambition of securing Europe's future economic growth and ensuring our place in the new global order. Its aim is not only to help us exit the current crisis but also to move beyond it to an era of smart, sustainable and inclusive growth.

One of the things we need to do in order to get there, however, is to improve economic governance. Europe 2020 improves upon the Lisbon Strategy by putting the European Council in the driver's seat. Full ownership of Europe 2020 by European leaders will increase the likelihood of its success.

Key in addressing Europe's policy challenges is improving economic surveillance and coordination. This is particularly true for the euro area. Fortunately, for the first time, a broad consensus is emerging among Member States on the need to do so at the European level. The Greek crisis is symptomatic of broader – albeit less critical – problems throughout the euro area and EU. In an article in this issue we look at the **divergences in the competitive positions and current-account balances** of euro-area Member States that have been building up over the past decade. The divergences threaten both the economic stability of individual countries and the cohesiveness of the euro area. The message is clear: we need to pay closer attention to divergences in real effective exchange rates, and keep on the path of convergence. Within the euro area, the Eurogroup should play a key role in the coordination process by identifying adjustment needs and fostering a common diagnosis. Eventually, its work could inform efforts to tighten economic governance of the EU economy as a whole.

Recovering from the recession and returning to an upward path of prosperity via Europe 2020 will require investment. The crisis has also demonstrated the significant costs of financial instability for the real economy and the taxpayer. Moreover, financing climate mitigation and adaptation measures in developing countries could require as much as EUR 100 billion per year by 2020 while meeting official development aid commitments could cost EUR 100 billion in 2015. With a view to these future funding requirements, the Commission is exploring **innovative financing instruments**. The assessment shows that some of these instruments could offer a 'double dividend'. A stability levy on banks' balance sheets, for example, could not only raise finance but might also reduce systemic risk within the financial system. Some form of carbon tax could raise funds as well as curb carbon emissions where it costs the least to do so.

To navigate the stormy seas it now faces, Europe clearly needs good information. The **business and consumer surveys** produced by ECFIN provide timely and useful information which helps policymakers to take the right decisions.

Commissioner Olli Rehn took over the economic portfolio at a critical moment. While proactively dealing with the Greek crisis, he has also put in place or proposed changes that will improve economic governance within the EU and euro area. The Commissioner is ready to tackle the day-to-day issues while taking steps to realise his long-term vision for Europe's economy. The EU's current difficulties are, in fact, an opportunity in disguise. This is truly Europe's 'moment of truth'.

Marco Buti
Director-General
Economic and Financial Affairs DG

Interview with Commissioner Olli Rehn

Olli Rehn, the new Economic and Monetary Affairs Commissioner, took office on 10 February 2010 following endorsement of the whole Commission line-up by the European Parliament. The Finn was previously Commissioner for Enlargement and has a long political career at European level as a Member of the European Parliament, Economic Policy Adviser to the Prime Minister of Finland, and Head of Cabinet of former Finnish Commissioner Liikanen. Here Commissioner Rehn tells European Economy News about his vision for his five-year term of office.

What is your vision for Europe's economic future and how does it mesh with the Europe 2020 strategy?

My vision is clear and simple: jobs and growth for the benefit of all our citizens, within a context of overall macroeconomic stability.

Therefore, my vision fortunately converges with our Europe 2020 strategy of smart, sustainable and inclusive economic growth. *Smart*: meaning investing in research, innovation and education to make sure Europe retains its competitive edge. *Sustainable*: both environmentally and socially. *Inclusive*: empowering people and getting as many as possible of them into the workforce.

While continuing the work which begun with the Lisbon strategy, Europe 2020 is a streamlined and focused policy programme and backed by stronger governance. This time, we will also have the European Council to drive the strategy. This should ensure the political support for Europe 2020 and its implementation throughout Europe. It will of course be a challenge to mobilise the resources needed to reach the Europe 2020 objectives, given that we have to consolidate public finances at the same time.

What measures will the Commission take to deal with the larger issue of competitive divergences and macroeconomic imbalances within the euro area?

The crisis has proven that economic policy coordination cannot be limited to fiscal matters, no matter how central they are. Other macroeconomic imbalances can also have serious consequences for individual countries and for the euro area as a whole.

In particular, weak competitiveness and current account deficits compound the detrimental effects of fiscal deficits. Without doubt, the most pressing and urgent need to take corrective measures is in the deficit countries that have lost their competitiveness.

But large and persistent current account surpluses may also be problematic. In the next few years, the necessary adjustment of the deficit countries is likely to act as a drag on growth. For that not to lead to an overall weakness of demand, the surplus countries should stimulate private demand. That cannot happen through fiscal stimulus, as also the countries with strong current accounts have fiscal deficits. Therefore, one should work to realise such structural reforms that can help increase private demand.

It is self-evident that this cannot and will not mean weakening the export performance of any surplus country. Instead, the aim is to improve both export competitiveness where needed and domestic demand where needed and possible.

Hence, I am not suggesting that Bayern München should play below its standard against Olympique Lyon, just to ensure an equal game. Rather, both should play better and improve their standard by making both offence and defence stronger, and ideally play as a European team: competitive at world level and strong domestically. This way Europe can grow stronger.

What can be done to reinforce economic policy coordination? In your perception, how serious is the threat to confidence in the euro and euro-area cohesiveness?

The Greek crisis has demonstrated the need for enhanced economic policy coordination in the euro area. This was already recognised in the Lisbon Treaty. We are preparing proposals for the implementation of its Article 136. My intention is that the Commission will present a Communication on reinforced economic governance in the euro area in the course of this spring.

First and foremost, we need it to prevent unsustainable public deficits, and thus we need to be better able to monitor the mid-term budgetary policies of the euro-area member states. We need to be able to issue broader and more stringent recommendations to the member states to take credible corrective measures.

But we can also make a better use of existing instruments. The Council can address recommendations to a member state whose economic policies risk jeopardising the proper functioning of EMU. This has been used probably too rarely in the past.

Under Article 121 of the Lisbon Treaty, the Commission can issue similar early warnings directly to a member state. This is something we must do once needed to help member states to address emerging economic problems at a much earlier stage.

The latest economic developments, not least in Greece, and divergences in competitiveness, are a serious wake-up call for further actions by the EU in economic governance. A new broad consensus on collective actions to improve economic coordination and surveillance is emerging. We must seize this moment.

Based on your experience as Commissioner for Enlargement and in view of the divergent competitive positions of many new Member States, do you think that EU enlargement and expansion of the euro area can continue under a 'business as usual' scenario?

Despite the recent economic crisis and deteriorating employment situations, the EU membership is still attractive. The EU is still able to provide stability and prosperity in the continent as well as an access to a single market of over 500 million consumers. The euro has also maintained its attractiveness.

We can and should continue to pursue deepening and widening in parallel. I do not see any contradiction between the two, if they are both done in a way that respects the rules and reinforces Europe.

Unemployment is still over 9% in Europe and the most recent economic data show a lacklustre recovery. When do you think Europe will fully enter economic recovery and how fast do you think the economy will recover? Is it really the right time to put in place exit strategies?

There are clear, albeit still fragile, signs of recovery. We are coming back from the deepest recession in the post-war period. Historically recessions triggered by financial crises tend to be more protracted.

But growth is taking root and we can expect also the employment situation to stabilise towards the end of the year. Assuming that this overall perspective does not change, it is appropriate to start withdrawing the stimulus measures at the latest in 2011 and in a number of countries already this year.

However, economic growth alone is not enough if the growth will not be able to create jobs and increase employment. That's why we need the Europe 2020 strategy and investment in human capital and job creation.

Member States' public finances have been battered by the recession and cost of bailouts and social welfare measures, and Europe's ageing population will soon become an additional burden. How can we improve public finances in EU Member States and, realistically, how long will it take until they recover to their pre-crisis levels?

Before the economic crisis hit, public finances were going in the right direction. Deficits and debt levels were falling, and long-term sustainability was improving through the reform of pension systems in several countries. The crisis set us back by 20 years. We urgently need to return to fiscal prudence.

To achieve the required consolidation, restraining expenditure is necessary. In some cases increasing taxes is also feasible and necessary. In addition, we need structural policies that lift productivity growth and lead to significantly higher employment rates. Europe 2020 is about that.

The stability and convergence programmes and the excess deficit procedures will set exact time paths for deficit reductions for the coming years. Determined implementation is the key. Reducing debt levels will be much harder, as potential growth is not likely to be at the same level as in the past decades.

How will you work with other Directorates-General and EU and international institutions? Do you see them as having competing or complementary functions? What will be the impact of the Treaty of Lisbon on your work and on cooperation with other institutions?

In addition to the European Commission, I have experience from the European Parliament as an MEP, and from working in a national administration. This gives a good basis for, and proper appreciation of, the work of all three institutions. They all have a key role to play for the benefit of Europe and its citizens.

In economic and monetary policy we have also other key interlocutors. The European Central Bank and our relation with it are crucial for the EU's economic and financial development. We have also close cooperation with, and a role in, the European and international financial institutions such as the EBRD and the IMF. We need to build stronger global economic governance together.

In order to make successful economic policies in Europe, we need to start from home and develop close working relations between all DGs. We should join our forces to pursue our common goals.

What changes have you made to the ECFIN organisation and what changes are still in store? How will the changes impact economic policymaking in Europe?

The crisis already led to changes at DG ECFIN before my arrival: a new Directorate for Macrofinancial Stability was created, given the new prominence of financial sector issues. This reflects the situation in other European and international organisations too, and the ongoing development of a new EU-wide financial supervision architecture – most notably the proposed European Systemic Risk Board.

More recently, the DG has again responded to the latest developments by putting in place a special task force to monitor the situation in Greece. It works closely with the ECB and IMF.

We need this type of rapid, flexible response in order to be able to react properly to crises and other changing circumstances.

What would you like your legacy as Commissioner for Economic and Monetary Affairs to be?

I know from my own experience as a keen football player that any team needs a meaningful division of labour, based on insightful leadership, individual excellence and smooth, seamless teamwork. To score, we need one or two strikers, but also an astute playmaker and a smooth winger – not to speak of a competent defence. I would like to be remembered as the team player who helped Europe enter a new era of better competitiveness, higher productivity and growing prosperity for current and future generations.

Europe's 'moment of truth':
how the Europe 2020 strategy must transform the Union

The crisis has made the task of securing Europe's future economic growth more difficult and exposed some structural economic weaknesses. A lack of concerted action could consign Europe to relative decline. The Europe 2020 Strategy is a fresh approach designed to help Europe exit and move beyond the current crisis by emphasising smart, sustainable and inclusive growth and improving the governance structure needed to make it happen.

Europe now faces its 'moment of truth'. The unprecedented economic crisis has wiped out the steady gains in economic growth and job creation achieved over the past decade. European GDP fell by 4% in 2009, industrial production dropped by 20% to 1990s levels, and 23 million people, or 10% of the active population, are now unemployed.

The crisis has also made the task of securing future economic growth much more difficult. The still fragile financial system is holding back recovery as firms and households have difficulty borrowing, spending and investing. Moreover, public finances throughout the EU have taken a beating. Deficits now stand at 7% of GDP, on average, and debt levels at over 80% of GDP. Two years of crisis have erased twenty years of fiscal consolidation. As a result of the crisis, Europe's growth potential has halved.[1]

Europe's structural weaknesses exposed, as global challenges intensify

Even a return to the pre-crisis situation will not solve Europe's long-term challenges. Europe's average growth rate has been structurally lower than that of its main economic partners, largely due to a productivity gap that has widened over the last decade. Europe has also lagged behind in R&D, spending just 2% of GDP compared to 2.6% in the US and 3.4% in Japan.

Demographic ageing is also accelerating. From 2013, the working age population will start to shrink. The number of people over age 60 is now increasing twice as fast as it did before 2007, by about 2 million every year. The combination of a smaller working population and a higher share of retired people will place additional strains on welfare systems and public finances.

In the financial sector, distress following the bursting of the real estate bubble after summer 2007 has led to significant distress. Much has been done, but more action is still needed if credit flows, and hence spending and investment, are to return to something approaching normality. Meanwhile, global competition is intensifying. Europe has lost export market share to emerging economies such as China and India. Last but not least, Europe faces climate and resource challenges that require drastic action.

Europe must act to avoid decline

Europe now faces clear choices. The Union can collectively meet the immediate challenge of economic recovery as well as the long-term challenges of globalisation, pressure on resources and ageing, or continue with the status quo. A proactive, collective approach would enable the EU to regain competitiveness, boost productivity and ultimately return to an upward path of prosperity. A largely passive approach risks putting Europe on a permanently lower growth trajectory and would entail a permanent loss of wealth. In a 'lost decade' scenario Europe would experience high levels of unemployment and social distress, and a relative decline on the world scene.

Lessons learned from the crisis

While Europe's current position is challenging, the crisis has underscored the fact that all 27 EU economies are highly interdependent and proved that coordination within the EU works. Indeed, EU-level measures such as full implementation of the Services Directive could add close to EUR 300 billion to EU GDP through 2020.

'The beauty of the Single Market Programme is that Europe can get an economic kick without it costing any money,' says Declan Costello, head of unit for coordination of structural reforms and of the economic service.

Assessing the Lisbon Strategy

Even the much maligned Lisbon Strategy was more successful than many realise. Eighteen million new jobs were created before the crisis hit, and the EU employment rate reached 66% in 2008, just 3 percentage points shy of the 70% target rate. Moreover, public finances improved in many countries for most of the past decade.

'It was working,' states Costello, referring to the Lisbon Strategy. 'We were focusing on the right topics; it was more a delivery problem.'

The Europe 2020 strategy

The Europe 2020 strategy is a fresh approach designed to help Europe exit the current crisis and move beyond. Three priorities lie at the heart of the new strategy:

EU targets, adopted by the European Council on 25-26 March

Increase the employment rate: the employment rate of the population aged 20-64 should increase from the current 69% to at least 75%, including through the greater involvement of women, older workers and the better integration of migrants in the work force.

Improve R&D and innovation intensity: the current EU target of investing 3% of GDP in R&D should be kept, but the focus should be on impact rather than input. The Commission proposes developing an indicator which would reflect R&D and innovation intensity.

Achieve the 20-20-20 environmental goals: reduce greenhouse gas emissions by at least 20% compared to 1990 levels or by 30%, if the conditions are right; increase the share of renewable energy sources in our final energy consumption to 20%; and a 20% increase in energy efficiency.

Raise educational levels, in particular by reducing school drop-out rates and increasing the share of the population having completed tertiary or equivalent education. Targets will be set in June 2010.

Promote social inclusion, in particular through the reduction of poverty. Further work is needed on the indicator for this target. Heads of State and Government will return to this issue in June 2010.

[1] "EUROPE 2020 A strategy for smart, sustainable and inclusive growth", Brussels, 3.3.2010, COM(2010) 2020.

- **Smart growth**: developing an economy based on knowledge and innovation.
- **Sustainable growth**: promoting a more resource-efficient, greener a nd more competitive economy.
- **Inclusive growth**: fostering a high-employment economy that delivers economic, social and territorial cohesion.

In contrast to the Lisbon Strategy, Europe 2020 focuses on a limited number of headline targets for 2020. Moreover, the Commission will ask Member States to commit to national targets. This should both increase the likelihood of successful implementation and ensure that each Member State tailors the Europe 2020 Strategy to its particular situation. To meet the targets, the Commission has proposed a Europe 2020 agenda consisting of a series of flagship initiatives.

A stronger emphasis on economic coordination and surveillance will also be essential. 'Up until now, we monitored fiscal policy and structural reforms,' notes Costello, 'but we missed everything related to imbalances. We need to pay more attention to divergences in real effective exchange rates.' The new approach will also be more integrated. Rather than looking at individual economic policy elements in isolation, all elements will be examined together at a single moment in time.

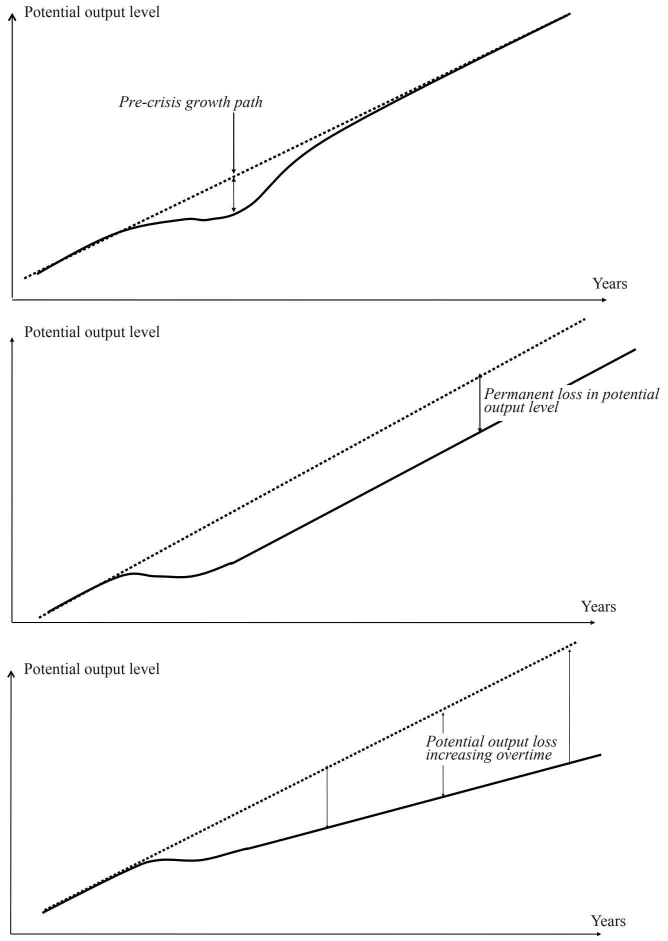
Governance: the key role of the European Council

Full ownership of the Europe 2020 strategy by European leaders is essential to its success. In the present governance structure, an issue often either gets bogged down in debates among technical experts and interest groups, or comes to deadlock because it is simply too big to solve at the working level. Contrary to the present situation, therefore, the Europe 2020 strategy should be steered by the European Council so that EU leaders take personal responsibility for the strategy's success, while council formations retain responsibility for implementing the programme.

Ultimately, however, it will really be up to national, regional and local authorities to implement the strategy. 'Good governance at the national level, and a willingness to implement reforms, will always determine a country's economic future,' says Costello.

Successful exit is a priority

Different scenarios for GDP in Europe



Scenario 1: Strong recovery

Europe is able to make a full return to its earlier growth path

Scenario 2: Sluggish recovery

Europe suffers a permanent loss in growth rates

Scenario 3: Lost decade

Europe suffers a permanent loss in future growth potential

Source: European Commission

Looking to the future

The European Council kicked off the Europe 2020 Strategy at its spring 2010 meeting on 25-26 March by agreeing on the thematic priorities for the strategy, setting a number of headline targets and eliciting proposals for flagship initiatives from the Commission. European leaders also agreed that 'the European Council must improve the economic governance of the European Union' and 'increase its role in economic coordination and the definition of the European Union growth strategy.' They called upon Herman Van Rompuy, the European Council president, to head a working group tasked with proposing, by the end of this year, ways to strengthen the legal framework for the surveillance of economic and budgetary risks, as well as the instruments for their prevention.

The economic crisis has made the task of securing Europe's economic future more difficult, but it has also been a catalyst for change. Now it is time to set an ambitious agenda and move the Union forward.

Further information

- EUROPE 2020 A strategy for smart, sustainable and inclusive growth: *http://ec.europa.eu/eu2020/*

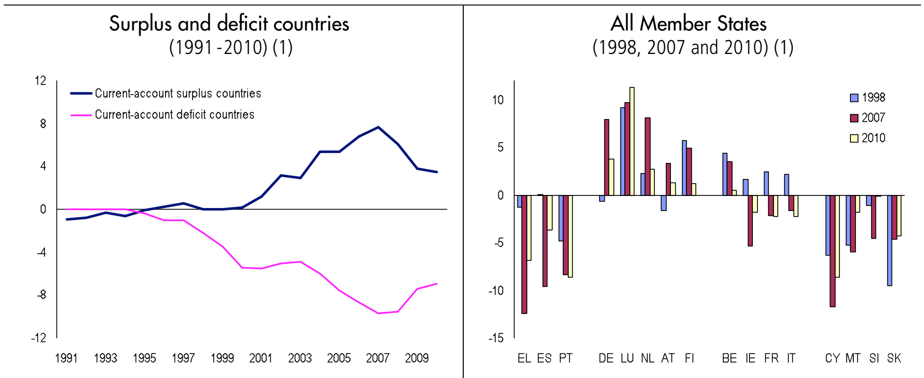
Divergences within the euro area: threat and opportunity

Divergences in the competitive positions and current-account balances of euro area Member States have been building up over the past decade. The divergences may threaten both the economic stability of individual countries and the cohesiveness of the euro area. Addressing the divergences will require significant price and cost adjustments in current-account deficit countries and removing the structural factors that hinder domestic demand in surplus countries. Nonetheless, the euro area and the EU as a whole now have the chance to improve economic surveillance and policy coordination.

The recent financial and economic turmoil in Greece has exposed weaknesses in the euro area. The problems in Greece, however, are only the most visible manifestation of a situation that has been brewing for years, as the Commission has been pointing out for some time.[1] Over the past decade, the euro area has experienced a steady divergence in the competitive positions and current account balances of Member States. Countries such as Germany, Finland and Austria gained in price/cost competitiveness while others such as Ireland, Greece, Spain, the Netherlands and Portugal lost competitiveness. These divergences are reflected in the important divergence in real effective exchange rates among Member States.[2]

Divergences in competitiveness have been associated with the steady widening of differences in current account positions. Germany, Luxembourg, the Netherlands, Austria and Finland have accumulated significant surpluses while Greece, Spain, Portugal and Cyprus have accumulated very large deficits. While the crisis has prompted a convergence in current account positions across Member States, the improvement is partly temporary and not backed by the necessary changes in relative prices except in Ireland. Key drivers of the convergence, such as the collapse in global demand for the exports of surplus countries or the substitution of imports in some deficit countries, are purely cyclical factors. The pre-crisis divergence trend is likely to continue once the recovery takes hold.

Current-account positions, euro-area Member States (in % of GDP)

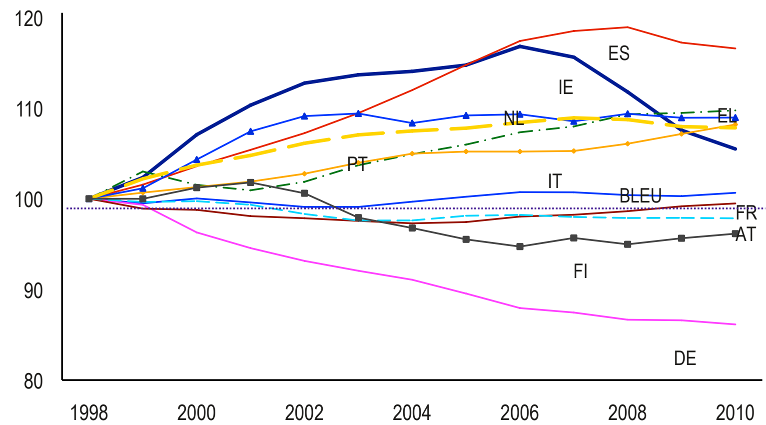


(1) Surplus countries include DE, LU, NL, AT, FI.
Deficit countries include EL, ES, PT, CY, IE, MT, SI and SK.

(1) Net lending (+) or net borrowing (-), total economy; for LU balance on current transactions.

Source: European Commission

Intra-area real effective exchange rate developments, based on GDP deflator, euro-area Member States (1998-2010, 1998=100)



Source: European Commission

Is divergence a problem?

Divergence is not necessarily bad in a monetary union. Catching-up countries, for instance, need inflows of foreign capital for investment purposes. It may be normal for them to run current account deficits for a period of time.

'There are "good" divergences and "bad" divergences,' according to Reinhard Felke, head of the unit dealing with the economy of the euro area and EMU. 'Unfortunately, capital inflows in many of the deficit countries fuelled asset price bubbles rather than productive investment.'

[1] See for example the 2006 EU Economy Review, European Economy 6/2006, and EMU@10: successes and challenges after 10 years of economic and monetary union, European Economy 2/2008.
[2] Quarterly Report on the Euro Area, Volume 8 N° 1 (2009), Special report: Competitiveness developments within the euro area.


© AFP/Belga

Protests like this one in Athens could spread across Europe unless we act now to reduce competitive imbalances.

The divergence trend has been driven primarily by domestic economic imbalances, including the poor adjustment of wages to a slowdown in productivity, excessive credit growth and housing bubbles. Surplus countries have experienced an entrenched weakness in domestic demand, while in current account deficit countries, the large capital inflows led to an unsustainable accumulation of household and corporate debt. Moreover, in some deficit countries the situation has been exacerbated by inappropriate fiscal policies.

Threat to the euro area?

Persistent divergences in competitiveness and macroeconomic imbalances are a cause for serious concern. They increase the economic and financial vulnerability of individual countries, may jeopardise confidence in the euro and weigh on the cohesiveness of the euro area. The situation, if not addressed, will eventually lead to a correction that may be abrupt and potentially disruptive, both for the countries concerned and for the euro area as a whole.

Unfortunately, most euro-area countries suffer from a relatively low adjustment capacity. Due to rigidities in labour and product markets, regaining competitiveness and unwinding macroeconomic imbalances is likely to be a painful and protracted process.

Structural recession and a persistent rise in unemployment are the likely outcomes of poorly managed adjustment processes. Moreover, the longer adjustment is postponed, the higher its ultimate social cost is likely to be.

The impact of the economic crisis

The economic crisis has added further pressure to an already volatile situation. The global financial crisis has demonstrated the vulnerability of euro-area countries to cross-border financial spillovers both via bank linkages and in terms of the widening of risk premiums on sovereign debt. Furthermore, Member States with large competitiveness problems face reduced growth potential. And due to pre-crisis profligacy, the costs of bank bailouts and economic stimulus, many countries' public finances are also constrained.

The policy response

The smooth adjustment of intra-euro-area competitiveness and macroeconomic rebalancing are key for economic recovery and for the successful and sustainable functioning of EMU in the long-term. Tackling divergences in competitiveness and current account imbalances will require action across Member States, both deficit and surplus countries. While policies must be tailored to the specific competitive situation of each country, coordinated efforts would reduce the amount of adjustment to be done in any given Member State.

Policies should address four key areas: macroeconomic policies, credit markets, labour markets, and product and service markets. Large price and cost adjustments will be needed in deficit countries to enhance their export competitiveness, but non-price competitiveness factors, such as technology-intensity, quality of services and the dynamics of export destinations, also have a role to play. The need for action is less pressing in surplus countries, but they need to address structural weaknesses in private domestic demand. This would make them better off and also facilitate adjustment in deficit countries by raising their exports.

Longer-term, mechanisms need to be put in place to improve the surveillance of external imbalances, and prevent them or tackle them if they emerge. It could be beneficial to put in place structural changes that reduce the occurrence of credit and asset price bubbles, for example.

The Eurogroup should play a key role in the coordination process by identifying adjustment needs and fostering a common diagnosis. Its work could eventually inform other efforts to strengthen the EU economy such as the Stability and Convergence Programmes and the emerging Europe 2020 strategy.

The opportunity

Ironically, the economic crisis may turn out to be an opportunity for the euro area and the EU as a whole. It has shown the strengths of the euro and has also revealed that there is unfinished business that needs to be addressed.

Without the euro, countries would have gone through exchange rate crises and the adjustment shocks would have been bigger. On the other hand, membership of the euro area has allowed some countries to delay taking action.

Nonetheless, there are reasons to be optimistic. The Commission has been looking into these divergences for quite some time now, but a policy consensus is finally emerging among Member States on the diagnosis of the problem and how to tackle it.

Exploring new avenues: innovative financing at a global level

At its meeting in October 2009, the European Council agreed on the need for a coordinated exit from fiscal stimulus policies and for fiscal consolidation. But at the same time Europe, and the world, is likely to face enormous financing needs in the coming decades, to meet the costs of financial stability, climate change and development. The Council therefore invited the Commission to examine the potential contribution of innovative financing mechanisms in response to which Commission, including ECFIN, staff have recently published a working document on 'Innovative Financing at a Global Level'.

The global financial and economic crisis has strained public finances worldwide. As a result of the massive fiscal intervention measures taken, EU-wide government deficits are expected to reach 7.5% of GDP in 2010, while the EU average debt to GDP ratio – assuming constant policies – is projected to increase to 120% by 2020.[1] The total cost of restoring public finances could exceed EUR 800 billion over the next few years. On top of the short-term financing needs related to the crisis, age-related public expenditure in the EU is expected to increase by about 4¾ percentage points of GDP by 2060.

Global challenges with budgetary implications

Public finances will come under further pressure due to the global challenges of development and climate change. To achieve the Millennium Development Goals (MDGs) by 2015, the EU pledged to increase its official development aid (ODA) to 0.7% of Gross National Income (GNI) by 2015, which could imply a doubling of the EU's ODA from EUR 50 billion in 2008 to EUR 100 billion in 2015. Financing climate mitigation and adaptation measures in developing countries will be another drain on government coffers. Developed countries have agreed to provide funding of USD 30 billion from 2010 to 2012, and the goal of mobilising jointly up to USD 100 billion a year by 2020 from various sources.

Innovative financing

While these challenges for public finances need to be addressed mainly by reductions in expenditure and increases in tax collection, innovative sources could also have an important role to play. 'We have to look at a broad range of instruments in order to meet these challenges,' says Peter Grasmann, head of unit for Financial Integration and Governance within ECFIN. Innovative financing is public finance that is raised in new, non-traditional ways. This can entail new instruments for raising revenues or new approaches to already existing fiscal instruments. It does not include mechanisms which are exclusively private.

A potential advantage of innovative financing is that it may enjoy greater political acceptance, particularly when the fiscal burden is imposed on groups or sectors that are perceived as not currently shouldering their fair share. Acceptance may also be higher when revenues are earmarked to support global public goods such as climate change mitigation actions. Earmarking, however, can lead to budgetary inflexibility and the suboptimal use of resources.

'We need to assess the relative merits of the various options objectively before decisions are taken to implement some of them,' says Martin Hallet, head of sector in ECFIN's unit for globalisation and development policy. 'The working document doesn't focus on how the funds might be actually used.'

Ideally, innovative financing should be implemented at the global level since most of the challenges facing the world will require burden-sharing and since the tax base of an innovative source is often highly mobile. In the latter case, global cooperation is necessary because companies or individuals may simply relocate their economic activities to avoid or evade tax.

Innovative financing related to the financial sector

One of the prime candidates for innovative financing is the financial sector. Member States' support to the financial sector amounted to around 13% of EU GDP in 2009 or more than EUR 1.5 trillion. Such massive public sector support has created the widespread view that financial institutions should help bear the costs of the bailing out the sector and reducing systemic risk.

A financial transaction tax (FTT) is conceptually similar to a Tobin tax but could be levied on broad classes of transactions, not just on foreign exchange transactions. According to figures by an Austrian research institute, a general FTT rate of 0.1% could raise between 0.8 and 2.0% of global GDP or between EUR 327 and 845 billion in absolute terms. The premise that taxing transactions reduces systemic financial risk may be flawed, however. 'It was excessive risk-taking, and not excessive transactions, that caused the crisis,' states Grasmann.

Rather than taxing transactions, another approach is to tax leverage. The 'stability fee', which Sweden introduced in 2009 and which the Swedish Minister of Finance Anders Borg proposed to adopt at the EU level, is levied on certain balance sheet positions on a consolidated basis in order to reduce leverage and bank size. The US proposal for a 'Financial Crisis Responsibility Fee' is similar to the Swedish fee but is constructed in such a way that it falls only on the largest financial companies with the largest leverage, which are presumably those that pose the greatest systemic risk.

A levy on liabilities could generate revenues of between EUR 11 and 50 billion, depending upon the tax rate and other assumptions. Moreover, since the levy targets balance sheets rather than more mobile financial market transactions, relocation and avoidance of tax could be less of a problem. Aside from its revenue-raising potential, a levy could limit the excessive risk-taking which usually goes along with high leverage and is partly to blame for the recent crisis. The downside of such a tax, however, is that bankers might shift the tax burden to companies and consumers in the form of higher borrowing costs which would in turn dampen economic activity.

[1] European Commission Forecast – autumn 2009, European Economy 10/2009, and Sustainability Report 2009.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Innovative financing related to climate change

Putting a price on emissions of CO_2 and other greenhouse gas emissions is another promising source of innovative financing. Moreover, imposing a price on greenhouse gas emissions can offer a 'double dividend': it has the advantage of dealing with climate change externalities while providing revenues at the same time.

A single carbon price globally would be the ideal, but would require a degree of international cooperation that may not be immediately achievable. In any case, the EU currently has a cap-and-trade scheme, the EU Emissions Trading Scheme (ETS), which is the biggest carbon market in the world. Some Member States have already taken advantage of their right to auction a percentage of their allowances, and by 2013 auctioning allowances will become obligatory. By 2020 total annual revenues from auctioning allowances could amount to EUR 25.8 billion. The only major drawback of a price on carbon is the risk of carbon leakage: carbon-intensive industries may relocate to countries which have only a low or no price on carbon emissions.

Cap-and-trade schemes may be difficult to apply to small or diffuse emissions sources such as transportation. In such cases, carbon taxes may be an option for complementary action. The Nordic countries have introduced taxes on CO_2 emissions, and Ireland and France are planning to follow suit. The UK, the Netherlands and Germany have introduced taxes on carbon-based energy products. While these initiatives should be applauded, introducing different ways of taxing carbon emissions across EU Member States could hamper efficiency and competitiveness within the Single Market. A Community framework for taxation of carbon emissions could help to address these concerns.

Innovative financing for development

Innovative sources of financing have a long tradition in the development field, and are important to ensure the Millennium Development Goals are reached by 2015 on which progress will be reviewed in a UN High-Level Plenary Meeting in September this year. The main mechanisms for innovative financing in development policy are frontloading public finance and leveraging private finance. The problem with frontloading is that it spends money today by postponing budgetary pain until tomorrow. On the other hand, frontloading can be economically efficient if investing today – in climate adaptation measures, for example – helps a country avoid much higher costs in the future.

Given the current disarray of public finances and the enormous future financing requirements, 2010 should be the year for advancing and implementing the innovative financing agenda within both the EU and G20, and indeed both the informal ECOFIN on 16 and 17 April and G20 Finance Ministers meeting on 23 April are set to discuss how the financial sector can contribute its fair share to the fiscal costs of financial crises.

Further information

• Commission Staff Working Document, 'Innovative financing at a global level'
http://ec.europa.eu/economy_finance/articles/international/2010-03-31-global_innovative_financing_en.htm

Business and Consumer Surveys:
accurate and timely indicators complement official statistics

Business and consumer surveys are a proven, and increasingly sophisticated, tool for economic analysis. The results of such surveys reflect economic agents' judgements about past, current and future economic developments. They provide policymakers, economists and business managers with useful information to assess the current state of the economy and forecast short-term developments. The business and consumer surveys produced by ECFIN are used, among others, by the ECB to monitor inflation expectations and other economic variables.

The Joint Harmonised EU Programme of Business and Consumer Surveys (BCS) was set up in 1961, with the first survey, the harmonised business survey in industry, conducted in 1962. Since then the scope of the programme has expanded considerably in terms of both countries and sectors covered.

Currently six harmonised surveys are conducted on a monthly basis: industry, construction, consumers, retail trade, services and financial services. In addition, an investment survey is conducted twice a year and additional questions are posed on a quarterly basis covering industry, consumers, services, construction and financial services. The surveys are unique in that they cover all 27 EU Member States as well as Croatia, the Former Yugoslav Republic of Macedonia and Turkey. More than 125,000 firms and over 40,000 consumers are surveyed every month across the EU.

'Hard data' vs. 'soft data'

The surveys use 'soft data' to reflect the sentiment – optimistic, pessimistic or neutral – of managers and consumers. This soft data is surprisingly robust: many of the sentiment indicators closely track the 'hard data' (official statistics). The Industrial Confidence Indicator, for example, has closely tracked actual industrial production, as measured by the Industrial Production Index, for nearly 30 years. Similarly, the euro area Economic Sentiment Indicator (ESI) is highly correlated (0.94) with real GDP growth.

The high correlation between sentiment (soft data) and actual results (hard data) is important because it means that the various sentiment indicators can be used for economic surveillance and short-term forecasting. ECFIN's Markov-switching model, for example, has been used to accurately predict economic turning points, including the recent recession.

'In the case of the recent crisis, our soft data predicted turning points with a high degree of accuracy,' states Kristine Vlagsma, Head of ECFIN's unit for economic studies and business cycle surveys.

Advantages: accuracy, timeliness and frequency

The main advantage of soft data is timeliness. Unlike the official statistics, soft data are typically available within weeks, while hard data are typically available with a minimum delay of 45 days. 'There's also an "inertia" in hard data,' observes Vlagsma. 'Sentiment may be going up or down while hard data stays the same.' Expectations adjust much faster, for example, than inventories or order books do.

> *"We're able to capture the mood, the 'animal spirits', of consumers and managers."*
> *Kristine Vlagsma, head of ECFIN's unit for economic studies and business cycle surveys.*

Another advantage of soft data is that it can be collected with a high frequency – on a monthly basis, and that soft time series – which reflect opinions as expressed at a certain point in time – are

NEW: Flash Consumer Confidence Indicator

In January 2010, ECFIN launched the Flash Consumer Confidence Indicator. This new indicator provides the earliest estimates of consumer confidence in the EU and euro area. Data are received from most European countries, which collect them within the first 15 days of the month. Values for missing countries are imputed using statistically proven econometric methods. The Flash estimate is then published a few days later, during the third week of each month.


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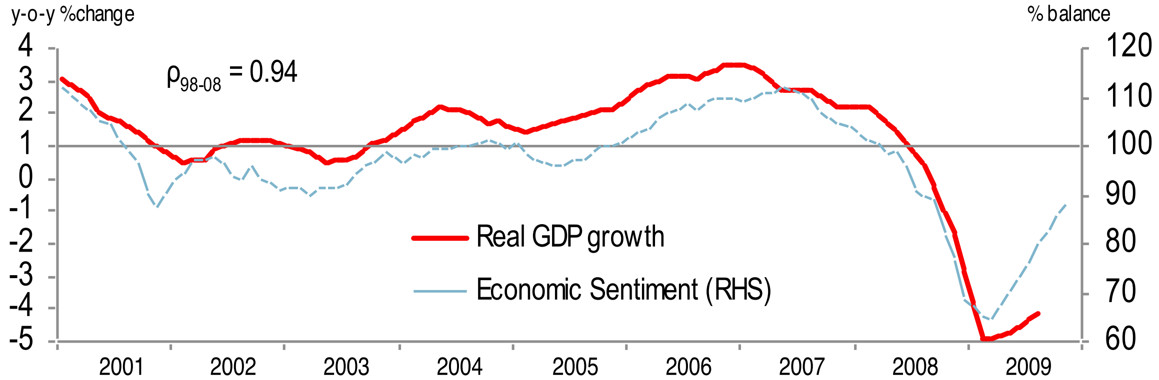
Economic sentiment closely tracks real GDP



Note 1: in rhs 100 = average 98 to date

Note 2: both series are plotted at monthly frequency. GDP monthly data are obtained through a linear inerpolation of quarterly data.

Source: European Commission, European Business Cycle Indicators, March 2010

not subject to revisions, contrary to what happens with hard data.

Despite these advantages, sentiment indicators do have their limitations: they are less good at forecasting the magnitude of changes. And it is up to economic analysts to determine whether a diverging signal is significant or just a blip.

A solid methodology

Most of the indicators are computed using questions based on a three-option ordinal scale. Participants in surveys answer 'positive' ('increase', 'improve', etc.), 'neutral' ('remain unchanged', 'sufficient', etc.) or 'negative' ('decrease', 'not sufficient', etc.) to questions. The answers are usually then aggregated in the form of a balance statement which is the difference between the percentages of respondents giving positive and negative replies. Institutes at the country level conduct the actual surveys and apply inner weights to reflect the structure of each economy. Weights are calculated based on a sector's value-added relative to GDP. ECFIN then applies weights at the European level to reflect the size of each country in the EU economy.

The role of national institutes

Administering the surveys and collecting the data is not a trivial exercise. The annual programme budget is EUR 6 million and ECFIN works with 50 institutes throughout Europe, one or more in each Member State. Some of the institutes are government institutions while others are commercial organisations. The institutes work under a three-year framework contract in which ECFIN covers 10-50% of the cost of administering surveys via a system of grants.

ECFIN also takes great pains to ensure that the data gathered are accurate. Questions are carefully screened to ensure that they are robust for all cultures and languages. And ECFIN holds an annual workshop with the institutes to discuss both methodological and practical implementation issues, such as changes in questions or sector coverage.

Both institutes and the programme as a whole are carefully audited. Institutes have to provide reports about questions they have asked and other information. Moreover, ECFIN checks the procedures and accounts of a random sampling of institutes. An external audit of the programme is also conducted by the EU Court of Auditors.

Additional uses and future developments

The sentiment indicators have proven their usefulness, not only in predicting economic turning points and measuring the economic climate, but also for understanding the behaviour of economic actors. The data have been used, for example, to analyse how consumers' inflation perceptions have evolved since the cash changeover to the euro: in that case, the discovery of divergences between perceived and actual inflation pointed to the necessity of a better communication policy.

One of the greatest assets of the BCS programme is the availability of historical data. The availability of long time series is particularly useful for researchers who analyse long-term trends. With this in mind, Vlagsma and her team plan to target new applications for the data, as well as in-depth academic studies. In this vein, they regularly participate in academic conferences such as that of the Centre for International Research on Economic Tendency Survey (CIRET).

Containing a wealth of information stretching back as far as four decades, the business and consumer surveys have become a major asset. Yet ECFIN produces these surveys with a small team of just 7 people.

'We're using the taxpayer's money very well – offering a good product at a competitive price,' says Vlagsma.

Further information

• Business and Consumer Surveys home page

http://ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm

In brief

Euro-area leaders reach agreement on Greek aid

Euro-area leaders agreed at the European Council meeting held on 25 March on coordinated financial support to help Greece finance its debt. Euro area Member States are expected to contribute about two thirds of the overall funding, leaving the remaining third to the IMF. The mechanism will only be activated as a last resort, if market financing is insufficient, and the interest rate offered to Greece will not be too favourable, in order to encourage Athens to return to market financing as soon as possible. Moreover, the mechanism can only be triggered by unanimous agreement of all 16 members of the euro area. The contribution of each euro area member to the mechanism will be based on their respective European Central Bank capital key, suggesting that wealthier nations will contribute most. In order to address future problems, Herman Van Rompuy, the European Council president, is to head a working group tasked with proposing, by the end of this year, changes to the euro area's legal framework for economic governance.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Commission finds risks to budgetary consolidation in Member States' stability and convergence programmes

The European Commission has examined the updated stability and convergence programmes of 24 Member States, announcing its conclusions on 17 and 24 March. The crisis has had a major impact on public finances, with 20 Member States currently subject to the EU's excessive deficit procedure following the operation of automatic stabilisers and the significant fiscal stimulus measures put in place since the start of the crisis. The Commission, calling for budgetary consolidation to begin in all states by 2011 at the latest, found in several cases that growth assumptions underlying budgetary projections were optimistic and that budgetary consolidation strategies were not sufficiently concrete from 2011 onwards. The Commission's recommendations for Council opinions on these programmes will be discussed at the ECOFIN meeting of 16-17 April.

Commission adopts recommendation on the euro as legal tender

Although euro-area Member States share a single currency, interpretations of what its legal tender status means still differ confusingly from one country to another. Can a retailer refuse payments in cash at all times? Can shops refuse payments with high denomination banknotes? The Commission recommendation on the scope and effects of legal tender of euro banknotes and coins defines good practice and gives guidelines on issues with direct implications for daily life such as the acceptance of cash payments or high denomination banknotes in shops, the validity of surcharges for cash payments, the legal tender status of 1- and 2-cent euro coins and rounding rules.

Competitiveness divergences persist in euro area

The global economic crisis has only temporarily reduced current-account divergences within the euro area, according to DG ECFIN's first Quarterly Report on the Euro Area for 2010. The report, released on 30 March, also finds that the competitiveness divergences which had been building up since the introduction of the euro have not been corrected significantly, and that the need for adjustment remains. Urgent policy action is particularly needed in those euro-area countries showing persistently large current-account deficits and large competitiveness losses.

ECFIN seminar examines Austria and its eastern neighbours 6 years after EU enlargement

The seminar, held on 12 March, looked at competitiveness, labour market and financial market issues. Owing to close ties in foreign trade and investment in Eastern Europe, Austria's current account has swung from structural deficits in the past to stable surpluses. It has maintained a strong competitive position through sustained wage moderation under well-functioning social partnership. Austria's share of foreign labour is one of the highest in Europe, but it has been less successful in attracting highly qualified personnel and making full use of immigrants' productive potential.

Further Balance of Payments help for Latvia and Romania

The EU disbursed on 11 March the latest instalment of a EUR 3.1 billion loan to Latvia agreed in January 2009 as part of a EUR 7.5 billion multilateral financial assistance package to help deal with the effects of the economic and financial crisis. At the same time, it disbursed the latest EUR 1 billion of a EUR 5 billion loan to Romania. The payment came after the European Commission positively assessed the Latvian and Romanian authorities' compliance with the required economic policy conditions attached to the Memorandum of Understanding (MoU). Supplemental Memoranda of Understanding (SMoU) were signed in February.


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Camdessus report on EIB proposes strengthening EU external lending

On 24 February the Commission and the EIB welcomed a report on the EIB's external financing activity by a committee of 'wise persons' chaired by former IMF Managing Director Michel Camdessus. It proposed an extra EUR 2 billion in EIB loans for projects that further the fight against climate change. The current EIB external mandate for lending beyond the EU's borders provides for a maximum of EUR 25.8 billion under EU guarantee for the period 2007-2013. The report also suggested longer-term options to consolidate the delivery of financial aid in support of EU external policies. The Commission will submit a legislative proposal for amendments to the current mandate within the next few weeks, drawing upon the report.

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

April 2010

Fifth ECB Conference to focus on 'Central Bank statistics: What did the financial crisis change?' Frankfurt am Main, 22-23 April

The conference will address new developments in the demand for ESCB statistics for financial stability and macro-prudential purposes, central bank and G20 statistical initiatives to meet the new challenges, and the role of statistics in central bank communication. It will be attended by senior officials and executives from the European Parliament and Commission, international institutions, central banks, financial institutions and national governments.

G20 Ministerial Meeting Washington, DC, 23 April

G20 Finance Ministers and Central Bank Governors will meet to prepare for the G20 Summit meeting to be held in Toronto, Canada, 25-27 June. Issues on the agenda will include the state of the world economic recovery including exit strategies; a first assessment by the IMF on the G20 growth programmes; financial sector reform; and the reform of the International Financial Institutions.

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 the International Monetary and Financial Committee of the Board of Governors of the IMF while the EU Commissioner for Development attends the World Bank/IMF Development Committee as an observer. In the latter, a range of issues related to governance reform of the two institutions, poverty reduction, international economic development and finance will be discussed.

DG ENTR Conference on industrial competitiveness Brussels, 26 April

The Commission's Enterprise DG is organising a high-level conference on 'The role of policy and markets in difficult times: What have we learnt, where do we go?' It will discuss the options for a recovery and entry strategy, as well as the European Growth Strategy (Europe 2020) and the Commission's approach to competition and industrial policy. José Manuel Barroso, Joaquín Almunia, Antonio Tajani, Nick Reilly, Mario Monti, Xavier Sala-i-Martin and Wolfgang Münchau are among the participants. More information under 'events' on the DG ENTR website.

May 2010

Spring Economic Forecast, 5 May

DG ECFIN's next full-scale economic forecast will reveal whether the anaemic recovery has gained strength. The February interim forecast indicated that the longest and deepest recession in EU history had come to an end with real GDP in the EU starting to grow again in the third quarter of 2009 – though it tailed off in the fourth quarter. It projected that the economy would expand by a feeble 0.7% in both the EU and the euro area in 2010, though weaker housing investment, continuing balance-sheet adjustment in all sectors, and rising unemployment would dampen growth.

Convergence Report, 12 May

2010 will see the publication of a new convergence report by the Commission 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. This year's report will form part of the basis for the Council's decision on Estonia's euro accession in July. The last Convergence Report was issued in 2008.

EBRD annual meeting, Zagreb, 14-15 May

The EBRD is owned by all 27 EU Member States, several non-EU countries, the European Union and the EIB (overall there are 61 shareholders, plus the EU and the EIB). The Board of Governors, composed of shareholders' Governors including Commissioner Rehn, will meet to make decisions on the key strategic issues currently facing the Bank in the context of its Fourth Capital Resources Review including on a proposal for a significant capital increase for the Bank.

Brussels Economic Forum 2010 'Strategies for a post-crisis world: enhancing European growth' Brussels, 25-26 May

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.

June 2010

EIB Annual Meeting Luxembourg, 8 June

The EIB Board of Governors, consisting of the Finance or Treasury Ministers from the 27 EU Member States – the Bank's shareholders – will discuss the annual report of 2009 and the future activities of the Bank. The Commission is represented by Economic and Monetary Affairs Commissioner Olli Rehn.

Quarterly Report on the Euro Area

This edition of ECFIN's regular report will focus mainly on the export performance of the euro area and other trade-related aspects. However, the recent crisis will continue to be an important subject of analysis. It will also look into the effects of the crisis on Member States' economic performance and the DSGE as a tool to analyse the sources of the crisis.

G20 Summit Toronto, Canada, 25-27 June

World leaders agreed in Pittsburgh in September 2009 that the G20 would become the premier forum for international economic and financial co-operation. The G20 summit in Toronto will take place back-to-back with the G8 Summit to be held on 25-26 June in Muskoka (Canada). The Toronto summit will be prepared by a G20 Finance Ministerial meeting in Busan, Korea on 4-5 June. The main items on the agenda are expected to be the recovery and exit strategy; a review of policy options/different growth scenarios under the framework for growth; financial market reform; and the reform of the IFIs. South Korea will host a second G20 summit in November.

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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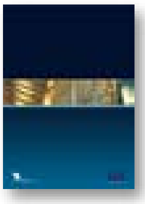
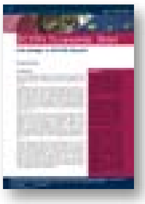
Recent research and analysis by DG ECFIN



Economic Papers

The European Economy Economic Paper series has an analytical focus.

- Options for International Financing of Climate Change Mitigation in Developing Countries
- EU labour market behaviour during the Great Recession
- Unexpected changes in tax revenues and the stabilisation function of fiscal policy. Evidence for the European Union, 1999-2008
- Market Integration and Technological Leadership in Europe
- Business Cycle Synchronization in Europe: Evidence from the Scandinavian Currency Union
- An indicator-based assessment framework to identify country-specific challenges towards greener growth



Economic Briefs

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

- Exit strategy: is 1937/38 relevant?

Country Focus series

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

- Decomposing total tax revenues in Germany
- Italy's employment gap: the role of taxation
- The Polish banking system: hit by the crisis or merely by a cool breeze?

Occasional Papers

The European Economy Occasional Paper series has a more policy-oriented focus.

- Cross-country study: Economic policy challenges in the Baltics

This study reviews the economic transformation in Estonia, Latvia and Lithuania from the early years after they regained independence to the current downturn. It focuses on macroeconomic and budgetary developments and policies, real and financial integration with the rest of the EU and medium-term challenges. Policy lessons are drawn for small open economies undergoing rapid real and financial convergence, notably the positive contribution which pursuing prudent policies over the medium term can make, including during times of crisis.

A decade of strong growth gave way to an unsustainable credit-led boom in 2005-2007 that fuelled private consumption and investment in non-tradable sectors. The resulting downturn was considerably exacerbated by the global crisis, with the three countries facing different challenges arising from earlier policy decisions. Latvia found itself in balance-of-payments difficulties and had to turn to assistance from the EU and IMF; while Estonia's earlier prudent fiscal and financial policies created a buffer against the international turmoil. Lithuania managed to regain access to international financial markets, backed by its significant consolidation and medium-term reform efforts.

Looking ahead, the policy response needs to keep promoting internal and external adjustment while supporting sustainable recovery and growth. The success of re-launching growth will depend on how effective policy measures are in restoring a sustainable fiscal position and a sound financial system, improving competitiveness, fostering innovation, allocating production factors efficiently, and creating an attractive environment for inward investment.

For in-depth information on Commission initiatives, sign up to Single Market News, DG Internal Market's quarterly magazine, and the single market e-Bulletin.
http://ec.europa.eu/internal_market/smn/index_en.htm

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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