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Editorial

Europe and the crisis: how will this story end?

Dear Reader,

From its beginnings, the European project has experienced many twists and turns. The Greek debt crisis is just the latest bump in the road. And although it gives cause for concern, and perhaps even a degree of apprehension, at least this turn of events has provided several lessons for Europe. We have realised the need to strengthen economic governance in the euro area and EU, and to continue building the Single Market.

The Greek situation called for emergency action. Together with Member States, the ECB and the IMF, the Commission responded by putting together an unprecedented **EUR 110 billion financial support package for Greece**. As a result of these efforts, we expect the Greek economy to recover as of 2012.

In some respects, the Greek crisis has exposed the weaknesses in the European economy and Europe's economic governance, but the response by the EU authorities has also shown what we can accomplish when we work together.

Communication and the open exchange of views is another key to moving Europe forward. In this sense, the **11th Brussels Economic Forum** took place at the ideal moment. Participants held lively debates on the causes and consequences of the crisis, and the best way to spur economic growth in Europe.

Political leaders, academics, and business executives were nearly unanimous in their belief that deploying green technologies could help Europe to both **tackle climate change** and **achieve sustainable economic growth**. Global competition and a lack of financing were identified as challenges, however.

Many speakers said that Europe had performed well throughout the crisis, but warned that the crisis is far from over – with some speakers going so far as to say that the crisis had taken on a **"European dimension"**. Participants urged action to improve fiscal sustainability, productivity and economic governance.

Europe has already drawn lessons from the Greek case and other recent developments. On 9 May, the ECOFIN Ministers decided on the details of a comprehensive package of measures to preserve financial stability in Europe, including the European financial stabilisation mechanism, and made a strong commitment to accelerate fiscal consolidation, where warranted. Based on the Treaty and an intergovernmental agreement of the euro-area Member States, the mechanism provides financial assistance in the form of loans or credits to Member States in difficulties. In addition, the establishment of a **"European Semester"** for economic policy coordination and surveillance as proposed by the Commission in its 12 May Communication on "Reinforcing economic policy coordination" will give Member States the chance to discuss each other's fiscal policy plans when they are still proposals, before they are adopted by governments and parliament according to national constitutions. Moreover, enhanced euro-area surveillance (based on **Article 136** of the EU Treaty) would go beyond examination of budgets to include issues such as competitiveness and macroeconomic imbalances.

Despite recent turbulence, the single currency has retained its attractiveness, and the European Commission and the Council have now **cleared Estonia for membership of the euro area**. EU Heads of State and the European Parliament have also given their green light. Estonia will adopt the euro as early as January of next year. Commissioner Rehn, however, has stressed that the Estonian government needs to remain "vigilant".

As you can see, we have engaged in a vigorous spring cleaning of Europe's economies. And we continue to put the European house in order following the **G20 summit** held on June 26-27 in Toronto. G20 leaders agreed on a package of policies for exiting crisis measures, completing financial reform and supporting stronger, more balanced and more sustainable growth.

It's not yet clear how the crisis will end, but Europe will keep on learning and improving.

Marco Buti
Director-General
Economic and Financial Affairs DG

Financial support to Greece: the inside story

The unprecedented EUR 110 billion financial support to Greece is based on strict conditions, a comprehensive programme of reforms and continuous monitoring. Ultimately, the Greek economy will recover as of 2012, the deficit will return to sustainable levels while the government debt ratio will fall from 2014 on.

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On the eve of the economic downturn, Greece found itself in a weak position. Years of high growth based on unsustainable drivers had left the country with large external and public deficits. As a result, when the recession hit, falling tax revenues, combined with structurally weak budget discipline and widespread tax evasion, caused the deficit to jump to 13.6% of GDP. Public debt rose to over 115% of GDP in 2009.

Over the past decade, the Commission had issued frequent and public warnings on Greek government finances, the problematic state of the country's statistics, expenditure slippages and overoptimistic tax projections. Investors became concerned about the magnitude of fiscal challenges and the deep macroeconomic and structural problems of the economy. They started backing out of Greek bonds, and the whole economy started to suffer.

The rescue package

Following a request by Greece, on 2 May the Eurogroup, together with the ECB and IMF, agreed to activate stability support to Greece equal to an unprecedented EUR 110 billion. This rescue package supports an ambitious programme of economic policies for Greece which aims to address the twin challenges of restoring competitiveness on the one hand, and reducing the high government deficit and debt on the other.

The agreement with the Greek government is based on "conditionality", and its terms are detailed in a Memorandum of Economic and Financial Policies (MEFP) and a Memorandum of Understanding (MoU). The macroeconomic adjustment programme is comprehensive in nature, covering fiscal policy, structural reforms and the financial sector. A front-loaded, multi-year fiscal adjustment effort of over 10% of GDP (EUR 30 billion in measures up to 2014) is the cornerstone of the programme. This will reduce the deficit to well below 3% of GDP by 2014 and put the debt ratio on a downward path.

"It is a strong programme," according to Servaas Deroose, acting Deputy Director-General and

> *"The frontloaded nature of the fiscal adjustment efforts combined with far-reaching structural reforms will improve the medium-term growth potential of the economy."*
> *said Servaas Deroose, acting Deputy Director-General and leader of the task force on Greece within ECFIN*

leader of the task force on Greece within ECFIN, "because the fiscal adjustment is frontloaded, and the programme is supported by the appropriate external financing, ensures a fair burden sharing and is fully owned by the government."

Fiscal measures

The fiscal measures emphasise expenditure reductions, but given the size of the required adjustment no revenue or expenditure variable could be left untouched. Tax increases will also be needed. To ensure social equity, however, the most vulnerable in society will be protected and larger contributions will be raised from those who have traditionally not contributed their fair share.

The Greek government is also initiating a series of important structural fiscal reforms. These will boost sustainability by helping to strengthen control over revenues and expenditures. The pension system will be reformed; the public sector will be scaled back and modernised; and the tax system will be made more efficient and equitable. Effective controls will be placed on public spending and better reporting and monitoring systems will be introduced. Finally, a strong effort will be made to improve data availability and reliability.

Structural reforms

Structural reforms are essential because Greece is not only facing a fiscal crisis; it is also facing a competitiveness crisis. Greek competitiveness, both within the euro area and vis-à-vis the rest of the world, has deteriorated sharply over the past ten years. Inflation, poor productivity growth and an inefficient public sector have led to the accumulation of large external imbalances, a relatively closed economy specialising in low value-added activities and a growth-model that is over-reliant on access to credit and under-reliant on investment and exports.

In order to reverse this state of affairs, Greece will implement a comprehensive programme of structural reforms. Key markets will be liberalised, and the government will reform wage bargaining in the private sector and clamp down on undeclared work. A simplified remuneration system will be introduced in the public sector and the number of local administrations will be reduced. Establishing new enterprises will become easier and the EU Services Directive will be implemented to open restricted professions and liberalise network industries.

Banking and financial reforms

The Bank of Greece will implement intensified supervision, while the government will establish a Financial Stability Fund (FSF) to ensure the sector's capacity to finance the Greek economy.

Monitoring

Monitoring is a key aspect in the design of the whole programme. To monitor progress, the Commission, the ECB and IMF have established quantitative, quarterly and annual, performance criteria. The new Council Decision of 10 May under Articles 136 and 126(9) of the European Treaty also contains annual targets. Compliance will be gauged through quarterly reports and continuous assessment. Funds will be disbursed on a quarterly basis once the Commission is satisfied that Greece has complied with the conditions. The first tranche of EUR 14.5 billion, complemented by 5.5 billion euro from the IMF, was provided to Greece in May. A second tranche of EUR 9 billion is set for release in early September.

Organisation

Devising and monitoring the macroeconomic adjustment programme for Greece has required close cooperation between the Commission, the ECB and the IMF. Given its institutional role and the mandate it received from the Eurogroup, the Commission has a coordinating and leading role, and collaboration has been very smooth.

"The Commission, the IMF and the ECB have known each other well for a long time," says Deroose. "There are frequent dialogues among our staff and our views on what the state of the Greek economy was and what needed to be done were quite convergent."

The Commission also works with an interservice group involving other Commission departments. ECFIN's own Greece taskforce is small and focused, however. It consists of a head of unit and five staff members and reports to the acting Deputy Director-General Servaas Deroose. Experts are called in from other ECFIN units as needed.

Outlook

In the short run, the Commission expects that the fiscal consolidation will cause real GDP to fall by 4% in 2010 and 2½% in 2011. But taking bitter medicine early often guarantees a quicker recovery.

"I believe that the recessionary period that the economy entered in 2009 will be relatively short-lived," states Deroose. "The frontloaded nature of the fiscal adjustment efforts combined with far-reaching structural reforms will improve the medium-term growth potential of the economy."

The Commission projects that a strong rebound in private consumption and investment will lead to annual GDP growth of 1¼% in 2012 and above 2% in 2013.

An unexpected benefit of the Greek episode is that it has increased the consensus for strengthening governance within the euro area (the Commission has issued a Communication on "Reinforcing economic policy coordination") and raised awareness about the need to monitor competitiveness alongside fiscal policy.

Life has handed Greece and Europe a hard lesson, but one from which we can learn.

Further information

- ECFIN webpage on the financial and economic crisis: *http://ec.europa.eu/economy_finance/focuson/*

Coping with the crisis: beyond lifeboats

BRUSSELS ECONOMIC FORUM

Europe has managed its response to the crisis well, according to speakers at the 11th Brussels Economic Forum. But the crisis is far from over. The Union must now embark on an ambitious programme of reforms to improve fiscal sustainability, productivity and economic governance.

Herman Van Rompuy

"We stumbled but we did not fall," said Herman Van Rompuy, President of the European Council, in his keynote address opening the Brussels Economic Forum. He noted that Europe works under many political constraints, yet all through the crisis "the EU did what it promised and when it was needed."

Policy instruments were shown to be insufficient, however, so the EU had to improvise. "We built a lifeboat at sea," said Van Rompuy, "and anybody who ever tried knows that this is not easy."

Van Rompuy's positive assessment of Europe's response to the crisis was echoed by Commission President José Manuel Barroso, who said that in spite of the difficulties the EU had somehow managed to combine Community and intergovernmental measures. "We proved again that the EU is more than just an international organisation," said Barroso. "It's something that the Member States want to defend and project into the future."

José Manuel Barroso

The crisis enters a new phase

While acknowledging that Europe had performed well throughout the crisis, speakers at the Forum were quick to warn that the crisis was far from over. "We are not out of the woods," said Olli Rehn, European Commissioner for Economic and Monetary Affairs, in his remarks opening the Forum.

Even Europe's massive aid package for Greece had only had a "short-lived impact on the markets" admitted Elena Salgado, Minister of Economy and Finance for Spain, which is current holder of the EU presidency.

Richard Baldwin, professor at the Graduate Institute, said that the northern Atlantic banking crisis was "definitely not over".

John Berrigan, ECFIN director for macrofinancial stability, concurred. "There is quite a bit more to come in this crisis," he said, adding that there could be a "non-linear" path to recovery as the liquidity crisis behind the sovereign debt crisis could conceivably lead to another banking crisis. Marco Annunziata, chief economist with the Unicredit Group, observed that "there is now a specific European dimension to the crisis."

Sharon Bowles, chair of the European Parliament's Economic and Monetary Affairs committee, said that politicians had moved ahead at such speed with their reform proposals that there was now a big "disconnect" with ordinary citizens.

The unfolding of the crisis: causes and lessons learned

While the mood during the Forum was mostly sober, speakers did value the lessons we have learned. The crisis has underlined the importance of fiscal sustainability, for example. Ewald Nowotny, Governor of Oesterreichische Nationalbank (OeNB), lamented that good times were not used adequately for securing healthy public finances.

Olli Rehn

István P. Székely, director for economic studies and research with ECFIN, felt that the essential cause of the crisis was a misallocation of capital while Tim Adams, managing director of the Lindsey Group, attributed much of the crisis to leverage. "We cannot continue growing based on ever increasing leverage," he said.

Daniel Gros, director of the Centre for European Policy Studies, concurred. He said that as long as the European financial system remains over-leveraged, whenever there's a problem somewhere, it will immediately metamorphose into a systemic crisis. So the first order of business should be to make the financial system more resilient.

Governance, structural reform and the Single Market

Whatever its causes may have been, the crisis has revealed the need to strengthen EU governance and to identify new instruments to deal with divergences. And structural reforms also have an important role to play. Such reforms are needed to intensify competition and innovation, and enhance social and economic cohesion. Moreover, according to Barroso, "fiscal adjustments are more successful when combined with structural reforms." He underlined that "it is impossible, and indeed irrational, to separate the Stability and Growth Pact from structural reforms."

We proved again that the EU is more than just an international organisation. It's something that the Member States want to defend and project into the future.

said José Manuel Barroso, President of the European Commission

Mario Monti, president of Bocconi University and a former European Commissioner, underscored that going ahead with the Single Market is more important than ever and that it is "the topic on which all EU policy rests". He lamented that it is not a "sexy" topic, however, and that it is seldom perceived in a holistic manner.

Sharon Bowles

Dissenting voices

Not everyone agreed on the recipe for solving Europe's current challenges. Otmar Issing, president of the Center for Financial Studies, said that "better coordination is not the solution to economic governance, strict observance of rules is." Issing also stated that the transfer of taxpayers' money from a country with good standing in financial markets to one without is undemocratic and would stir opposition to European integration. Erik Nielsen, Chief Economist of Goldman Sachs, agreed, calling this "fiscal federalism through the back door". Daniel Gros said the key point was whether countries would actually be willing to say "no". Without knowing the answer to this question, Gros warned, we will face "one bailout after another".

Elena Salgado

Growing our way out of recession

While perhaps disagreeing on the approach, several speakers agreed that growth was the best way to escape the crisis, and mentioned the Europe 2020 strategy as an important blueprint for growth. Van Rompuy put it most plainly. "We cannot solve our budgetary problems without more economic growth," he said.

Joël Decaillon, Deputy General Secretary of the European Trade Union Confederation, stressed that "international competitiveness can be managed only if you have growth of your own". He also warned that "if you make things very precarious for wage earners in society, there will be political repercussions."

Philippe de Buck, Director-General of BusinessEurope, expressed scepticism regarding the Europe 2020 strategy, saying, "It's not in 2020 that you have to achieve something, it's now".

Mario Monti

Eric Bartelsman, a professor at the Vrije Universiteit Amsterdam argued that European companies need to adopt information technology more aggressively, and Philipp Schindler, a vice-president at Google, went a step further, arguing that "you cannot differentiate anymore between the digital world and the real economy because of the speed of consumer adoption." According to Schindler, Europe should be more open to the process of creative destruction.

The state of European integration

The growing power of citizens was a theme taken up by Van Rompuy as well. He noted that the dilemma of being a monetary union and not a full-fledged political union has become visible to the general public for the first time, and this will force governments to act. Van Rompuy warned, however, that "We have now reached a point where stumbling itself could be awkward. Therefore we need prudence as much as courage. The next steps will determine the fate of our monetary and economic union."

The euro photo competition: "The euro: what does it mean to us?"

On day 2 of the Brussels Economic Forum, Commissioner Rehn announced the winner of this photo competition for teenagers organised by DG ECFIN. The Portuguese team won with their picture as an appeal to countries to adopt the euro. It shows a young man crossing a bridge to an attractive, innovative land of opportunity, the euro area. More than 2,464 teams of 2-3 young people registered for the competition between January and March 2010, and 1,614 teams submitted entries. From the 27 national winning teams, seven finalists – from the Czech Republic, France, Germany, Hungary, Lithuania, Poland and Portugal – were invited to Brussels. They received their prizes from Commissioner Olli Rehn on 25 May. The photos by all national winners can be seen on the competition website: http://euroinphoto.eu/, and the overall winner can be seen on the cover of this issue.

Further information
http://ec.europa.eu/economy_finance/bef2010/

Tackling global warming:
an opportunity for Europe?

BRUSSELS ECONOMIC FORUM

Most stakeholders – political leaders, academics, and business executives – believe that deploying green technologies could help Europe to both tackle climate change and achieve sustainable economic growth. Global competition is intensifying, however, and a dearth of financing will make it difficult to scale up.

Tackling climate change is not just about saving the planet – it can make good business sense, said Commissioner for Climate Action Connie Hedegaard in her keynote address closing the first day of the Brussels Economic Forum.

Quick implementation of wise climate policies could help the EU save money by reducing fossil fuel imports, thereby improving energy security. Moreover, the right policies will keep the EU at the cutting edge of booming green technology industries.

"This is no longer just a niche," Hedegaard told the Forum. There are already 3.4 million jobs depending directly or indirectly on Europe's environmental industries, which account for 2.2% of GDP, more than either the pharmaceutical or aerospace industry.

The potential of green growth

Most – but not all – of the experts speaking on the first afternoon of the Forum agreed with Hedegaard, arguing that deploying green technologies could help Europe to both tackle climate change and achieve sustainable economic growth.

Carlo Carraro, President of Ca' Foscari University of Venice, said that the challenge is both to reduce energy consumption through energy efficiency and to modify the energy mix. Professor Claudia Kemfert of the Hertie School of governance said that we need infrastructure urgently because the energy system lags 10-20 years. Professor John Zysman of University of California Berkeley advised that long-term green growth could only come from redefining the energy system, while Professor Michael Hanemann, also of Berkeley, said that green technology will contribute to European growth in the medium and long run but that it is not a remedy for our current economic problems. Professor Dieter Helm of Oxford University doubted that green investment would increase growth, but agreed that it was needed to tackle climate change and its costs.

Business weighs in

The business community was more bullish than the academic community. Answering the question: "Is tackling global warming a business opportunity for Europe?" panellists overwhelmingly saw it as a huge opportunity.

Ivan Hodac, Secretary-General of the European Automobile Manufacturers' Association, observed that European automakers are already technology leaders in sustainable mobility, with average emissions tumbling over the past decade.

Laurent Blanchard, Vice-President for Cisco Systems Europe, said that the convergence of more traditional industries and information is creating huge opportunities. "This is not science fiction, this is reality," he said.

Jacques Delmoitiez, President of BASF Polyurethanes, claimed that abatement can be achieved in the building sector at relatively low cost using polyurethane, which is a highly efficient insulation material.

The 2020 targets: from 20% to 30%?

Participants disagreed slightly on the best means to grasp green growth opportunities. Christine Lins, Secretary-General of the European Renewable Energy Council, advocated raising the EU's 2020 CO_2 emissions reduction target to 30%. Delmoitiez and Hodac were both against raising the target, however. Hodac warned that "the EU must not open our market in such a way that production moves to China or Korea." Jennifer Morgan of the World Resources Institute (WRI) said that ironically American industry sees the 30% target as a threat because it could enable European industry to continue to lead the green technology field by compelling companies to innovate and invest.

Connie Hedegaard warned that keeping the reduction target at only 20% could make it difficult to meet much deeper targets set for 2050. Moreover, according to International Energy Agency figures cited by Hedegaard, every year of delayed investment in low-carbon solutions adds USD 500 billion to the cost of action. Hedegaard acknowledged, however, that "whether to move to a 30% target is a political decision for EU leaders to take in due course".

The global race is on

While European business and political leaders see potential in green growth, global competition is intensifying. "We are not as alone in the world as we used to believe," said Hedegaard.

China, for example, is now top of the league for wind power installations, while China and Taiwan are together the biggest photovoltaic

Biogas and other green technologies are transforming Europe's economy.

> *This is not a hippie or zero growth or anti-growth agenda...sustainable growth is and will continue to be the only kind of growth that the planet can afford.*
> *said Connie Hedegaard, European Commissioner for Climate Action*

Europe and the world need to massively scale up investments in projects such as this geothermal plant.

cell producers. "If we stand still we will lose our frontrunner status," said Hedegaard. She mentioned that China is undertaking the world's largest investment programme valued at USD 230 billion, and the US is investing USD 80 billion in clean energy, while the EU and bigger Member States are investing a relatively paltry EUR 25 billion.

Obstacles to green growth

Financing green growth is not a simple matter, however, according to speakers on the panel about "The financing and structural reforms needed to foster low-carbon growth". Tightening government budgets and difficulties accessing credit will lead to "major investment challenges", said Thomas Barrett, a director with the European Investment Bank. There had, he said, been a "significant collapse in the availability of funding". Yet according to Barrett, the ability to achieve results would require "full-hearted participation by the private sector".

Josué Tanaka, a director with the European Bank for Reconstruction and Development, said that scaling up would be the key challenge. He suggested that Europe focus on diversifying and blending sources of finance, on larger projects and on projects that lead to system changes.

Joëlle Chassard, a manager with the World Bank, said the financing needed to combat climate change would be "massive" – hundreds of billions of euros – of which only a tiny portion – around 5% – was currently available. "There is no silver bullet," she said. "The mitigation path for China will be very different from the mitigation path for Brazil."

Speakers agreed that funding climate action faces new challenges. Some renewable solutions, Barrett said, were "inordinately expensive". While raising finance from banks was likely to be an "uphill struggle" there was some optimism that new, shared financial instruments could be found to keep policy on track and the EU at the forefront of the great green revolution.

Promise undiminished

Hedegaard remained optimistic. While recognising that the economic and financial crisis is the number one priority in Brussels, the Commissioner said there was not necessarily a trade-off between going green and maintaining growth in the traditional sense.

She pointed out that in her native Denmark, decisions made back in the 1970s to diversify away from fossil fuel imports and improve energy efficiency have since led to roughly stable energy consumption without negatively affecting growth.

"This is not a hippie or zero growth or anti-growth agenda," Hedegaard said. "It's to provide the basis for continued growth in the future…and sustainable growth is and will continue to be the only kind of growth that the planet can afford."

Further information
http://ec.europa.eu/economy_finance/bef2010/index.html

Reinforcing economic policy coordination in Europe

Twenty years of hard grind reducing government debt have been wiped out in less than two. Crisis-related lower tax revenues and a GDP drop beyond expectations are widely seen as the major reasons for this situation. But a proposal for a new system of early budget coordination among governments called a "European Semester" could prevent such crises from emerging in the future.


© iStockphoto

The worst economic crisis in a generation has caused a surge in public deficits: from close to balance in 2007 to an estimated 7% of GDP on average this year. That is more than double the 3% maximum the Treaty lays down.

By next year debt levels are expected to reach 84% of GDP in the European Union and 88% of GDP in the euro area: a far cry from the 60% ceiling set down in the EU treaty. And that's without even mentioning Europe's ageing population: a potential time bomb. High levels of debt, if not brought down in time, have the potential to wreck economies.

Greek crisis shakes EU confidence

Greece's sovereign debt crisis brought home to many just how urgently solutions were required. In Greece, years of lax fiscal policy, misreporting of statistics and inadequate government action combined to create a wave of market instability that threatened to undermine not only Greece but also other euro-area countries. Emergency EU support was required to ensure the country's solvency.

The scale of the crisis and the suddenness with which it engulfed the entire EU has led to much soul-searching among politicians and regulators. What went wrong? With hindsight it became clear governments did not take advantage of the good economic times to reduce their debt. In certain Member States there was a failure to realise tax revenues were flowing in thanks to essentially unsustainable booms, particularly in housing, construction and financial services. When these booms faded and then moved into reverse gear, revenues collapsed and revealed gaping holes in national budgets.

With the objective of ensuring these oversights never recur, the European Commission in early May published a set of proposals. Most apply to the whole of the EU, though a more stringent approach was foreseen for the euro-area countries.

The European Semester

The core measure centres upon the creation of a "European Semester" – a period of policy coordination covering both fiscal policies and policies designed to reform capital, labour and product markets under the Europe 2020 strategy early in Member States' budget cycles. Rather than assess the impact of national budgets after they have been agreed, Member States should be given the chance to review each other's budgets when they are still proposals, before they have been implemented, as well as integrate the budgetary implications of policies undertaken under the Europe 2020 strategy.

"Coordination of fiscal policy has to be conducted in advance, in order to ensure that national budgets are consistent with the European dimension, that they don't put at risk the stability of the other Member States. This can be done in the framework of a European economic semester," said Olli Rehn, EU commissioner for economic affairs. "For the euro area it means deeper and broader surveillance."

Alongside this totally new form of peer review it was decided there would be a new focus on the relationship between government deficits and debt. In cases where governments were considered to be making inadequate efforts to reduce debt during the good times, they could be required to make interest-bearing deposits.

Macroeconomic imbalances in euro-area countries are to be subjected to closer scrutiny. A peer review system already exists within the Eurogroup, though under the new Commission proposals it would be turned into a watchdog with more teeth. Euro-area surveillance (based on Article 136 of the EU Treaty) would go beyond examination of budgets to include issues such as competitiveness. A scoreboard would be created reflecting key indicators such as unit labour costs, employment and asset prices. The scoreboard would act as an early-warning system; worrying trends would become evident early.

"Europe has dealt with the immediate emergency. Today, the Commission sets out what we need to do to strengthen Europe's economic governance," said Commission President José Manuel Barroso. "I am confident that Member States are determined to follow suit on our proposals to reduce the risks resulting from our interdependence for the benefit of our citizens and demonstrate our willingness to protect the euro as a most important asset of the EU."

THE DEBT EXPLOSION

While staggering in size, the current increases in government debt are not without precedent.

A number of European countries saw similar increases following the oil crises of the 1970s and during the 1980s.

The problem, however, is that the increases seen thirty years ago were never fully reversed. This time around, governments were in many cases already highly indebted when the crisis kicked in. This time, Europe's ageing population will make it even more difficult to bring debt back to sustainable levels. Expenditure on pensions and health care is certain to rise.

Fiscal strategy is coordinated at EU level via the Stability and Growth pact, but without additional policy action, average debt in the EU is predicted to rise well above 100% of GDP by 2015 and could reach 130% of GDP by 2020.

The situation of course varies from country to country. Bulgaria and Sweden are forecast to show no or only a small increase in debt as a share of GDP between 2007 and 2010. Ireland, Spain, Latvia and the United Kingdom could on the other hand see increases of over 30%. Large differences also exist in terms of government deficit.

The EU's excessive deficit procedure was in 2009 activated for a shocking 17 Member States (Greece, Latvia, Lithuania, Malta, Poland, Belgium, the Czech Republic, Germany, Italy, France, Spain, Ireland, the Netherlands, Austria, Portugal, Slovenia and Slovakia).

Member States in May backed the proposals' principles. The detailed implementation now needs to be sorted out.

A long-term plan

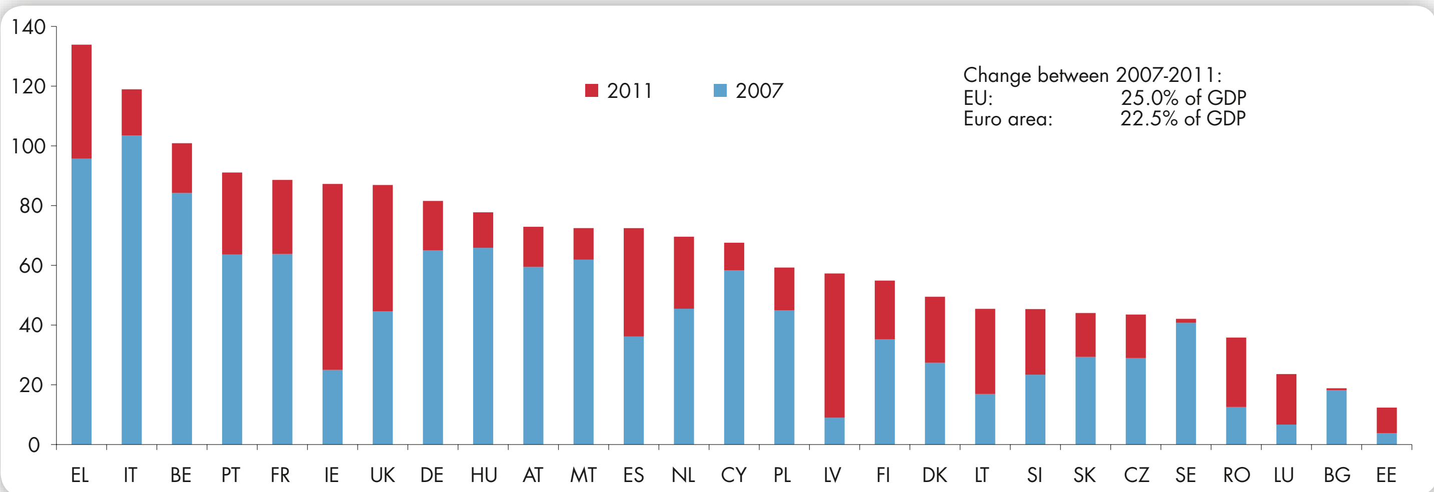
While staving off the immediate emergency was the priority, the Commission emphasised at the time that a long-term vision was required. The creation of a permanent crisis resolution mechanism was mooted.

Rules would be laid down for handing out financial support for countries in extreme distress. Debt would be issued by the Brussels executive, though fund payments would be conditional upon governments taking the necessary measures to extricate their economies from the crisis. A similar mechanism already exists for non-euro-area Member States.

The way forward

Given the speed with which crises develop, the Commission suggested the new measures come into force as soon as is practically possible. The first European Semester could begin as early as next year.

Public debt in EU Member States, 2007-2011 (in % of GDP)



Source: European Commission

Public debt across the EU is set to explode, as this graph shows. But measured as a percentage of GDP, the extent of this explosion varies from Member State to Member State. Ireland, for example, will see a large increase, whereas Sweden should emerge relatively unscathed by 2011.

Estonia on track to become 17th euro-area member

After a detailed economic and financial study the European Commission has pronounced Estonia ready to join the euro area.

The final decision was taken by the EU finance ministers who approved the Commission's recommendation on 13 July 2010. Estonia will therefore become the 17th country to adopt the single currency as early as January next year. EU Heads of State and Government and the European Parliament have also given their green light on widening euro-area membership.

Estonia stood out among countries examined by the Commission as part of its biannual convergence report, which looked at a number of key economic indicators in order to assess the progress on the road to euro adoption. The European Central Bank also published its own convergence report on the same date: 12 May.

Eight other countries – Bulgaria, Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden – were for a variety of reasons found to be not yet fit to join. All are committed to adopting the euro when they meet the conditions.

"Estonia has achieved a high degree of sustainable economic convergence and is ready to adopt the euro on 1 January 2011. We commend Estonia for its long-standing commitment to prudent policies," said Olli Rehn, EU Commissioner for Economic and Monetary Affairs. Enlarging the euro area once again (there were eleven members when it was launched in on 1 January 1999) also sent out a "strong signal about the euro area", he said: "It underpins the role of the euro as a medium-term policy anchor and confirms that sustained policy efforts and a long-standing record of stability-oriented policies generate concrete results."

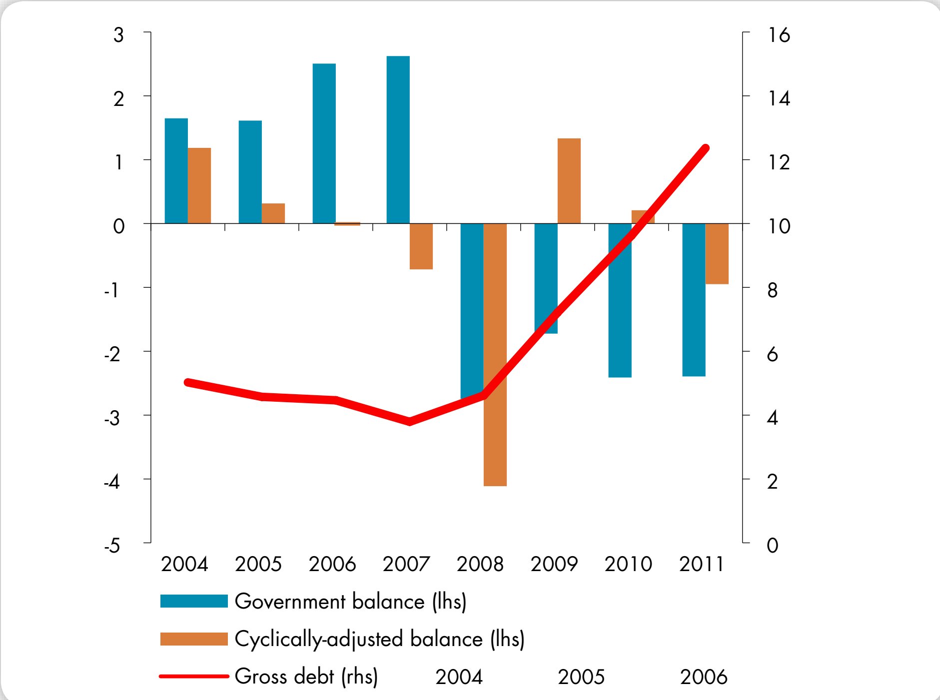
The Commission's report found Estonia's inflation rate compared well with that of the three best-performing EU countries. Its government borrowing and debt were well within the defined limits, while the currency, the kroon, had enjoyed a long period of stability in relation to the euro. National monetary laws were judged compatible with those of the EU.

Final effort still required

While the finish line for euro adoption is now closer, this is however not the end of the road as far as sound economic policies are concerned. Commissioner Rehn pointed out that in order to perform well within the euro area, the Estonian Government needed to remain "vigilant" and react early and decisively to correct any sign of build-up of macroeconomic imbalances and/or losses of competitiveness. Between now and the day of euro adoption, the government must also "speed up its practical preparations to ensure that the changeover takes place smoothly", he said.

The Commission's assessment of Estonia's readiness was based upon criteria laid down in the Maastricht Treaty. The criteria stipulate: that inflation should be within 1.5% of the three best-performing EU countries; that annual government borrowing should not exceed 3% of GDP and accumulated debt 60% of GDP; that average long-term interest rates should be no more than 2% higher than the three best EU performers; and that the exchange rate should have been stable within the exchange rate mechanism. National laws, especially those ensuring the independence of the central bank, must also be brought in line with EU law.

Estonia – Government budget balance and debt (in percent of GDP)



Source: European Commission

The Estonian Government's track record in the field of public finance has been impressive even during harsh economic times. This graph shows Estonia enjoyed government balance surpluses until 2007 which helped it to enter the crisis in a comparatively strong fiscal situation. Thanks to a major fiscal consolidation effort implemented in 2009, the government deficit was very limited, despite the sharp contraction in GDP. Public debt remains extremely low by EU standards though it is forecast to increase over the next two years.

Further information

- Estonian euro changeover: *http://euro.eesti.ee/EU/Prod/Euroveeb/*

G20 leaders discuss economic and financial reform

Leaders from the world's top 20 advanced and emerging economies (the G20) met in Toronto at the end of June for a crucial meeting on the future of the world economy. A strong push for fiscal consolidation and the rebalancing of the global economy, a bank levy and financial reform made for a packed agenda.

At the June 26-27 summit a package of policies was put together to supporting global recovery as well as strong, balanced and sustainable growth going forward.

The first and foremost challenge for leaders was to ensure confidence so that the global recovery will not be derailed. They expressed strong support for the determined actions taken by the EU to safeguard stability and growth in Europe. In an important change of tone in the G20, world leaders agreed on a set of principles for exiting the extraordinary policy measures taken to stabilise the economies during the crisis, recognising heightened concerns over "global fiscal sustainability" – in other words, government debt.

World leaders faced a complicated task in Toronto. On the one hand, there are signs of economic recovery, especially in Asia, from which the EU will no doubt benefit, but on the other hand aggregate global domestic demand is looking much gloomier. Leaders in the end agreed on the importance of a coordinated approach at global level that combines carefully calibrated and growth-friendly fiscal consolidation with following through on fiscal stimulus, tailored to national circumstances. Those countries with serious fiscal challenges need to accelerate the pace of consolidation. Participants agreed to specific minimum targets for deficit reduction and the stabilisation and reduction of debt.

Work also continued on reform of financial markets worldwide. Without a global deal there is a risk that differing sets of rules will spring up in different regions. This could result in increased uncertainty which could jeopardise the global recovery. Ahead of the summit the EU put forward its own comprehensive reform programme on subjects such as bank capital requirements, remuneration, non-cooperative jurisdictions, accounting standards, and complex products such as derivatives.

Commenting on the Toronto summit, European Commission President José Manuel Barroso said that "The EU came to Toronto with a European decision that Member States would introduce systems of levies and taxes on financial institutions. We welcome that our partners agreed to make the financial sector participate in the costs of repair, resolution and prevention and recognised the bank levy as a useful instrument".

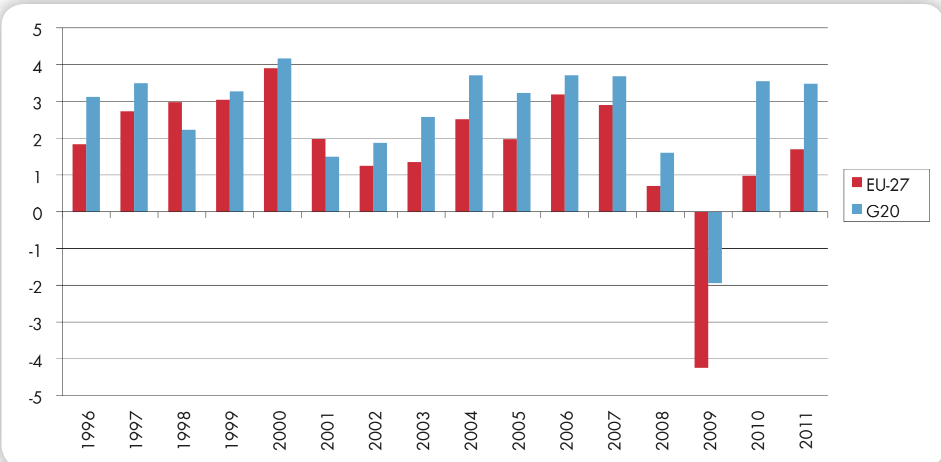
There was not universal support for such a new levy on financial institutions across the G20, but the participants agreed on common principles to ensure coordination, taking into account individual countries' circumstances. The revenues raised could help repair the banking sector or fund resolution. Sometimes referred to as a "stability levy", it should make excessive risk-taking less attractive. The levy, the EU argued, could be put to use in the context of "resolution measures": in other words, the funds would be used to ensure that a bank failure is managed in an orderly way.

Intense preparatory talks on reform of financial institutions such as the International Monetary Fund took place before the summit. A key issue was to ensure the Fund continues to have sufficient resources, and will implement credible reforms to improve its effectiveness and legitimacy.

While the headlines from the summit focused on a small number of high visibility priorities, other, equally important objectives were also tackled. The EU was keen to ensure rising unemployment does not lead to protectionism. Leaders agreed to continue to resist protectionist pressures and refrain from raising trade and investment barriers, and agreed on the need to complete the Doha Development Round of negotiations.

A lot of the debate was highly technical. An issue discussed at the summit which has been extensively reported on in the press is the scale, scope and timing of the increases in capital and liquidity banks will need to hold in the future, as well as the leverage to be allowed. The goal remains simple: greater stability for the global financial system.

GDP growth in Europe and G20 countries



Source: European Commission

The crisis has been particularly hard on the EU, as this graph shows. Non-EU countries within the G20 already enjoyed higher levels of growth before the downturn. When the crisis hit they were less affected. Forecasts suggest that emerging market countries' growth will again outstrip EU growth when economies recover.

Further information
http://ec.europa.eu/external_relations/g20

In brief

European Council adopts Europe 2020

European leaders meeting in Brussels on 17 June adopted Europe 2020, the new 10-year strategy to promote smart, sustainable and inclusive growth. Focusing on the strategy's five quantified headline targets, over the coming months Member States will discuss how specific policies can be mobilised to unlock the EU's growth potential, starting with innovation and energy policies. Investment in research and development could be raised to 3% of GDP. This autumn, each of the 27 EU Member States will have to present in Brussels their national goals for adopting the strategy and the means to achieve the goals.

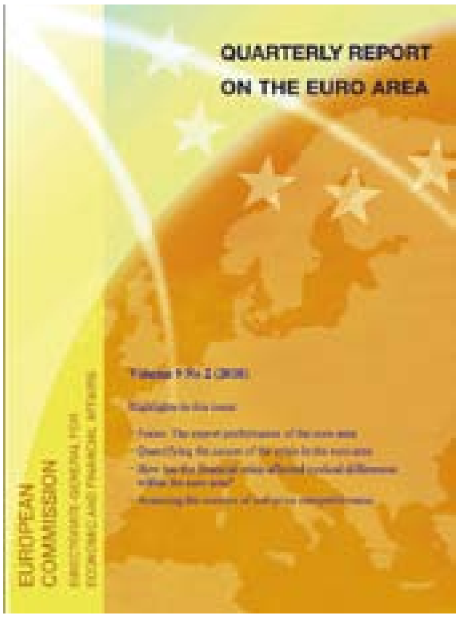
Herman Van Rompuy sets out economic governance agenda to European Council

On 17 June, Herman Van Rompuy, President of the European Council, presented the first progress report of the Task Force on Economic Governance which he chairs. The report is based on four main objectives: reaching greater budgetary discipline through the Stability and Growth Pact, reducing competitiveness divergences, establishing an effective crisis mechanism and strengthening institutional cooperation and coordination. Detailed proposals include a peer review of Member States' budgetary plans, a redesign of the sanction mechanism, greater focus on public debt levels, freeing national statistical offices from political influence, and competitiveness surveillance using indicators. "Before, we were looking at Member States' fiscal positions through the keyhole of the annual deficit, whereas we now all want to use the bay window of their economies", Van Rompuy said.

Excessive deficit procedures for Cyprus, Denmark and Finland

The Ecofin Council of 13 July examined the European Commission's conclusion on the existence of excessive deficits in these three countries and recommendation for deadlines for their correction to be set. Seeing this recent turn from general government surpluses to deficits as a sign of the severity of the crisis, the Commission emphasised the need for fiscal consolidation. Since fiscal consolidation needs vary per country, the Commission recommendations on deadlines and fiscal measures reflected these differences.

Commission report discusses challenges of ongoing world trade recovery



The second 2010 quarterly report on the euro area, released on 24 June, reviews the euro area's export performance and discusses the likely impact of the crisis on its export capacity. The assessment is reasonably upbeat. Euro-area exporters have performed relatively well in the years preceding the crisis and better than generally acknowledged. This reflects a relatively solid presence in fast-growing markets such as Russia and new EU Member States, a strong competitive position in some fast-growing sectors such as pharmaceuticals, machinery and transport and continuous efforts to improve product quality. Exploiting the opportunities offered by the ongoing recovery in world trade will, however, require a number of important medium-term challenges to be tackled. These include a shift of the driving force of world trade from advanced to emerging economies in Asia and Latin America and a potentially lasting negative effect of the crisis on demand in some important euro-area trade partners.

Green Paper elicits input on pension reforms

DG ECFIN, along with the Employment and Internal Market DGs, published a Green Paper on Pensions on 6 July. As the EU population ages, many countries are reforming their pension systems, and the recent financial and economic crisis has highlighted certain problems. The EU has, therefore, decided to review its work in this field. With this consultation, the Commission invites comments from all stakeholders about what the EU can do to help ensure that pension systems are efficient and secure for the future, so that they deliver adequate pensions in a sustainable manner. Changes to EU law may then be proposed at a later stage. The Green Paper does not question Member States' prerogatives in pensions and it does not suggest that there is a single "ideal" one-size-fits-all pension system design. Some common themes need to be addressed in a coordinated way, however, such as the functioning of the internal market, the requirements of the Stability and Growth Pact, or ensuring that pension reforms are consistent with the Europe 2020 strategy.

2010 Report on Public Finances highlights need for fiscal consolidation and strengthened surveillance

Events in spring 2010 have exposed the urgent need to address the fiscal challenge in the euro-area and the EU. High and rising public debts raised concerns about governments' solvency, and as a result, sovereign risk premia shot up to unprecedented levels in several euro-area Member States. The 2010 Report on Public Finances in EMU issued on 15 June presents recent budgetary developments, examines developments in fiscal surveillance and draws lessons for debt reduction strategies. It also investigates the link between macro-financial and budgetary risks.

The UK economy, post-recession – same as it ever was?

Leading academics and analysts as well as policymakers convened in Brussels on 29 June to discuss the economic performance of the UK economy during the decade up to and including the economic and financial crisis. Workshop participants drew conclusions about the short-term recovery prospects and the longer-term UK economic outlook. They evaluated the UK economy's structural features and growth prospects, as well as current fiscal and financial sector issues. The event was rounded off by a 90-minute panel discussion about defining or re-defining the UK's position in the EU and global economy.

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

July 2010

Labour market review

DG ECFIN's annual "Labour market and wage developments" report will analyse the impact of the financial crisis on the labour market, focusing on the interaction with key macroeconomic variables. It will describe the contribution of inflows and outflows to the dynamics of unemployment in all Member States during the crisis. Although it concentrates on developments at EU level, it also examines the situation in individual countries, the policy measures taken to minimise the impact of the crisis and the challenges ahead.

August 2010

Travelling euro exhibition opens in Estonia

The Commission's travelling exhibition on the euro opens in Narva, Estonia, at the Astri Keskus Shopping Centre on 18 August, as part of the information campaign preparing Estonian citizens for the euro changeover on 1 January 2011. The exhibition can be seen in Tallinn at the Science Centre AHHAA Foundation from 20 September and at the Lounakeskus Shopping Centre in Tartu from 4 November. The interactive exhibition, with touch screens as well as traditional exhibition panels, provides simple information about the history and workings of the euro, and includes a special section for children.

September 2010

"What Future for Financial Globalisation?" Joint conference of the European Central Bank and the Journal of International Economics

Frankfurt am Main, Germany, 9-10 September

The current financial crisis is challenging the belief that financial liberalisation and integration are universally beneficial for economic growth and development. While many emerging markets have experienced rapid integration with advanced countries through trade, they have lagged behind in terms of financial liberalisation and deepening. This asymmetry may have contributed to rising financial and real imbalances in the global economy and to an increase in leverage and risk-taking among financial institutions.
www.ecb.int/events

Interim forecast

Scheduled for 13 September, this biannual report will update the latest fully fledged forecast (published in May) with new data for the EU's seven largest Member States and updated key indicators for the EU and euro area as a whole.

Annual Statement and Annual Report on the Euro Area

This annual report will discuss how economic policies at euro area and Member State level should be geared towards meeting the specific challenges that the euro area faces as a single economic entity. The statement highlights the main policy and political messages.

October 2010

2010 Annual Meetings of the International Monetary Fund and the World Bank Group Washington, DC, 9-11 October

Commissioner Olli Rehn 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.

Quarterly report on the euro area

The third 2010 issue will be published on 5 October. Its focus section will discuss the structural factors that facilitate current account adjustment in the Economic and Monetary Union.

November 2010

Autumn economic forecast

DG ECFIN's next full-scale economic forecast, due out at the beginning of November, will be an important opportunity to evaluate the pace and evenness of economic recovery.

G20 Summit Meeting Seoul, Korea, 11-12 November

Building on agreements made at the last summit in Pittsburgh, the G20 will redouble its efforts in 2010 to help the world make a successful transition from global recovery to stronger, more sustainable and balanced growth.

DG ECFIN's Annual Research Conference 2010

Brussels, 22-23 November

The global financial crisis and its fall-out have reignited the debate about the roles of governments and markets. This year's debate, "Governments and markets after the crisis: Finding a new balance", examines new approaches to the governance of markets between the extremes of free-market fundamentalism and government interventionism. The conference will explore new paradigms in areas such as the architecture of financial systems, international trade and exchange rate regimes, intra-EU adjustment mechanisms, and the design of modern welfare state arrangements.

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.

- What is the growth potential of green innovation? An assessment of EU climate policy options
- The Chinese pension system – First results on assessing the reform options
- Does capacity utilisation help estimating the TFP cycle
- Assessing the Competitive Behaviour of Firms in the Single Market: A Micro-based Approach
- Support schemes for renewable electricity in the EU
- Heterogeneity in money holdings across euro area countries: the role of housing

The Economic Adjustment Programme for Greece

Occasional Paper 61

A joint EC/IMF/ECB mission visited Athens from 21 April to 3 May 2010 following a request for international financial assistance from Greece.

On 2 May the mission concluded a staff level agreement for a joint euro area / IMF financing package of EUR 110 billion and supporting economic policies. On the same day the Eurogroup agreed to activate stability support to Greece via bilateral loans centrally pooled by the European Commission. On 9 May the IMF executive board approved a Stand-By Arrangement.On 18 May 2010, the euro area Member States disbursed their first instalment of EUR 14.5 bn of a pooled loan to Greece, following a disbursement of EUR 5.5 bn from the IMF.

This report by European Commission staff provides an overview of the challenges faced by Greece, discussions with the authorities, and the objectives and design of the economic and financial programme.

Occasional Papers

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

- The pre-accession economies in the global crisis: from exogenous to endogenous growth?
- Labour Markets Performance and Migration Flows in Arab Mediterranean Countries: Determinants and Effects
- The EU's neighbouring economies: emerging from the global crisis

Economic Briefs

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

- Distance says it all? What the global crisis tells us about the resilience of Mexico and Brazil

Country Focus series

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

- Finland: adjusting to an ageing population

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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