DISCUSSION PAPERS

EUROPE'S ECONOMIC PRIORITIES 2010-2015

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1
Introduction

The Spanish Presidency of the European Union (EU) during the first semester of 2010 will come at a crucial time. Institutionally, it will coincide with the start of the second Barroso Commission and, hopefully, with the implementation of the Lisbon Treaty and the introduction of a number of important reforms. Economically, it will happen when the crisis recovery will still be shallow and important decisions will need to be taken to assure it becomes both stronger and sustainable. In short, it will come at a time when the European Union will be faced with choices that will shape its future for years to come.

Given the stakes for the European institutions, Bruegel, the Brussels-based European think tank, has recently released a volume of memos which, though formally addressed to the new European Commission, concern all actors and institutions involved in economic policies at the EU level[1]. The following text reproduces, with minor editorial changes, the foreword (entitled here "Main Messages") to the volume as well as the memo to the president of the European Commission, both co-authored with Jean Pisani-Ferry, Bruegel's director.

1 André Sapir (editor), Europe's Economic Priorities 2010-2015: Memos to the New Commission, Bruegel. The memos were published on 1 September 2009, two weeks before the confirmation of José Manuel Barroso as president of the new Commission by the European Parliament. They are therefore addressed to the "new Commission" rather than to the "second Barroso Commission".

2
Main Messages

There is now a distinct possibility that this crisis will be remembered as the occasion when Europe irretrievably lost ground, both economically and politically. Economically, there is a risk that, by compounding lingering demographic and economic problems, the crisis will result in a spiral of near-stagnation, rising public debt and declining innovation performance. Politically, the EU is at risk of being blamed for having fostered a liberalization agenda in the past rather than being praised for having promoted a coordinated response to the crisis when it struck. Although Europe should be part of the answer to current economic woes, there is currently no appetite for bold European initiatives.

For these reasons, the new European Commission will have an exceptionally difficult task. At a time of retreat into the national sphere and disenchantment with the EU it will need to fight in defence of commonly agreed rules, to propose new solutions, to redefine the European narrative, and to make the EU an effective player in a fast-transforming world. If the Commission succeeds, it may turn the crisis into an opportunity. If it fails, the EU may become less relevant.

The stakes are therefore high, and priorities will need to be set from day one. The Bruegel memos are intended as a contribution to setting these priorities. They do not cover the whole range of policies, but focus on the most important economic questions at the EU level. It is impossible to boil down their findings to a few bullet points. However two common themes emerge.

The first theme is the need for balance between the focus on tackling the crisis and holding a firm line on long-term challenges, which in turn have a domestic and an external dimension. Internally, the Commission must tackle head on the growing economic and social tensions between individual member states. Externally, it must ensure that Europe is a coherent rather than a fragmented actor both globally and regionally in its own backyard.

The second theme is that the times call for courage. More than its predecessors, the new Commission will be faced with the need to ward off economic nationalism and put critical choices straight to the member states and the citizens of Europe. The risk of economic, social and political relapse is just too high for a low-profile strategy to be an acceptable one.

3
Memo to the President of the European Commission

For a quarter of a century each European Commission has been defined by a paramount achievement, often in connection with a major treaty change: the first Delors Commission is remembered for the single market; the second for the Maastricht Treaty; the Santer Commission for the launch of the euro; the Prodi Commission for the big enlargement to the East; and the 2004-2009 Barroso Commission will, it is to be hoped, go down in history for taking the initiative on climate change and getting the Lisbon Treaty ratified.

Each of these attainments was a step forward for Europe. Should the new Commission set itself, and propose to the peoples of Europe, a similar goal? Or should it rather accept that it will be fighting mainly to preserve past achievements and set itself the goal of limiting the slippage? This is the main question the president should ask himself while preparing for the next five years.

3.1 The Challenges

In thinking about the agenda for the next five years it is appropriate to depart for a moment from current discussions and assess what Europe's priorities were prior to the crisis. Its main challenges were essentially long term. They concerned a number of tectonic changes that started at the end of last century and which are likely to have a profound impact on the twenty-first century: globalisation and the (re)emergence of China and India as leading economic and political powers; the erosion of Europe's traditional comparative advantage in human capital and the need to foster the development of a knowledge-based economy; the ageing population and its consequences for European societies and public finances; the return of mass migration; energy security; and the need to take decisive measures to fight climate change. At regional level, the challenges for a largely reunified Europe were to carry through enlargement and redefine its relationship with its neighbours. At global level, it was to behave as the soft but effective power it claimed to be.

These were daunting challenges, but mostly ones that naturally called for a common European response and were perceived as such by public opinion. To take only a few examples, there was no need to be a federalist to accept that climate change and mass migration had to be tackled at European level, or even that only the EU could weigh enough in international negotiations with the new giants. The EU's slow-moving governance apparatus also provided an appropriate basis for balancing the inevitable short-termism of elected governments and the need to respond to long-term challenges.

Over the past ten years the European Union has started to provide structural responses to these challenges. Enlargement has been a major achievement. On some fronts (the knowledge society, migration or climate change) the jury is still out, as commitments need to be followed by acts, but at least the agenda has been clearly set. On others (ageing, energy security, neighbourhood, external representation), there has barely been any move to date, but at least the questions have been raised.

In brief, prior to the crisis Europe had a clear agenda, some progress had been made towards defining and implementing it, and much more was still needed. There was also a clear strategy for the Commission president: to focus on the challenges one by one, seize the intellectual high ground, set out the risks, outline policy responses, and build coalitions for common European solutions. At a time when there was palpably little appetite for major institutional initiatives, this was a practical, results-oriented approach very much in the spirit of the famous "small steps" method.

The crisis has brought six major changes in this landscape. First, it is making the long-term challenges faced by Europe even more acute. At global level, convergence between emerging and advanced countries will doubtless accelerate as the negative growth impact of the restructuring of the financial sector is likely to be felt more in the latter than in the former (which can still rely for a while on traditional sources of growth based on imitation). This will affect the global power balance —in fact it has been redefined already— but also strengthen the need for structural adjustment in Europe, especially in the old member states. Simultaneously, public debt in these countries is set to increase significantly, precisely at a moment when the effect of ageing on public finances is starting to set in as baby-boomers retire. This will compound pressures linked to globalisation and have serious implications for Europe's social models at a time when they are already strained by the return of mass unemployment.

Second, the crisis is calling into question one of the EU's recent successes. The growth model of several of the new member states, which relied on massive capital inflows, suddenly looks problematic. The potential for catching up remains generally good but the path towards it is much less assured and those of the new member states who financed present consumption with foreign savings will need to reassess their economic strategy fundamentally. International Monetary Fund (IMF) intervention within the EU for the first time in three decades highlights the seriousness of the situation and Europe's limited ability to address its own difficulties. In some of the new member states, the dramatic revision of growth prospects may even end up shaking the existing consensus in favour of European integration.

Third, extensive state intervention to assist sectors in distress is creating tensions between the logic of European economic integration and the logic of national political accountability. Governments that strive to prevent financial or corporate bankruptcies are accountable to their citizens for the use of public funds and insist that they be used domestically, but this is in contradiction with the very principles of EU integration. The integrity of the single market is, and is likely to continue, being threatened by sectoral state support schemes during the crisis. The most glaring problem lies in the banking sector, which has become heavily dependent on national budgetary support that is often accompanied by trade-distorting measures. But the problem also lies outside the financial sector. It is most acute in the automobile sector, where national intervention is designed to preserve national jobs, often at the expense of jobs elsewhere in Europe, but it could spread to other sectors.

Fourth, the crisis is exposing fault lines in the current European governance system. To start with, policy integration in the financial sector lags behind market integration and it has become evident that the coexistence of pan-European banks and purely national supervision is unsustainable. As the Turner review commissioned by the UK government puts it, “sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration”. The problem is being addressed through enhanced coordination, but a sticking-plaster solution won’t suffice. A related fault line is that of crisis management: at the height of the financial crisis in October 2008, the EU was able to get its act together but this was largely done outside the institutional framework. What this episode exposed was that the EU has an elaborate crisis-prevention system but no built-in crisis-management capability. It is no accident that the European Central Bank (ECB) is the only EU institution to emerge strengthened from the crisis so far: it is a full-fledged, unrivalled decision-maker in its field. The dilemma the EU faces is that the crisis has highlighted a need for further reform of its economic governance, involving more policy centralisation in some fields, while there is in fact no appetite for such reforms, let alone for devolving more powers to Brussels.

Fifth, the crisis risks calling into question the very legitimacy of the European Union. Over the past twenty years EU integration has mostly been associated with liberalisation (although perceptions differ from country to country). Yet the crisis is widely (and rightly) perceived as a major failure of financial liberalisation, responses to which cannot consist of mere tinkering with regulation. The situation calls instead for a major redefinition of the relative roles of governments and markets, certainly in financial markets and perhaps even in other areas. This begs the question as to whether such increased public intervention will take place at the member-state or EU (or even global) level. Ultimately the issue is, therefore, whether the potential backlash against liberalisation will produce a collateral backlash against the EU. Indeed a backlash against the market could indeed easily turn into a backlash against the very bedrock of European economic integration, the single market. Or will the EU be part of the redefinition of the relative roles of states and markets? This question leads in turn to the issue of governance reform, and the response that is provided to this question could have considerable consequences for the EU itself.

Sixth, a remarkable feature of the reaction to the crisis so far is that the international community has responded to it with a strengthening of global governance. This has helped maintain the integrity of international economic relations while alleviating the effects of the shock in the hardest-hit countries. The EU, which sees itself as a natural champion and a laboratory of global governance, strongly supports the process initiated with the first two G-20 summits. Yet assuming this spirit of global coordination proves durable, it will not be without difficulty for the EU, which is only partially equipped for acting as an effective global player and more than often behaves as a “fragmented power”. A lasting revival of global governance —and the redistribution of global institutional power this would necessarily imply— would expose the weaknesses of European external representation and governance and could become a double-edged sword. For the larger member states, coordination at G-20 level could become a substitute for coordination at EU level. Whether the EU ends up as a player or a taker in the global governance game may have crucial implications for its future.

3.2 The Strategy

The first task of the new president will be to deal with the consequences of the crisis through a series of initiatives. First, as guardian of the treaty the Commission has a duty to police the existing EU rules. This means combating infringements to competition rules and the single market, and implementing the Stability and Growth Pact to trigger the necessary budgetary adjustments. Second, the new Commission will also have to see through the ongoing legislative process introducing the new framework for EU financial supervision. Third, the Commission will have to work closely with our foreign partners to fulfil the promise of world leaders meeting in L'Aquila in July to complete the Doha Development Round in 2010, which remains our best insurance policy against the risks of protectionist responses to the economic and social consequences of the crisis. The other priority task for the next few months will be to deliver on the EU's commitments on climate change control and to secure similarly ambitious promises from our foreign partners so as to ensure the success of the UN Climate Change Conference to be held in Copenhagen at the end of this year.

But demanding though these tasks will be, the new president cannot afford to confine himself to planning for the next few months. The challenges we have described above clearly suggest that the stakes for Europe in the next few years will be high and that they call for a transformational agenda. Lack of ambition for Europe would in effect not appease, but rather vindicate, the anti-European forces that have emerged in recent years, and entail the risk of jeopardising the European project itself.

Yet, at the same time, it must be recognised that no one is contemplating a major institutional initiative, let alone a new treaty change, so whatever will be done needs to take place essentially within the framework of the Lisbon Treaty —assuming it is ratified by the time the new Commission takes office.

The solution to this dilemma lies primarily in leadership. The duty of the new Commission will be to define the challenges, set out the choices and propose the common responses Europe needs. At a time when each and every head of state and government will be overwhelmed by domestic problems, the Commission president cannot expect them to come up with ideas and initiatives for the collective good. Their consensus is unlikely to provide useful guidance. Boldness will be needed and it is unlikely to come from them. It will need to come from the new Commission president and his colleagues. He should therefore be ready to fight for ideas and take the necessary risks.

The new president will have to redefine the EU narrative in a transformed context. Citizens need to know what is the *raison d'être of* the EU, i.e. what it is about and what it stands for. The outgoing Commission has had some success in defining what the EU is about: with its initiatives on climate, energy and migration it has been able to recast Europe's role in an age of globalisation. On the other hand, it has not been successful in demonstrating what the EU stands for: it had to backtrack on the services directive, proved inconsistent on financial liberalisation and was unable to define what a renewed European social agenda might consist of. As the old alliance of convenience between free marketeers and federalists has largely run out of steam, a new compromise needs to be found that allows citizens of various cultural and political backgrounds to identify with Europe. Ideas have been proposed, such as Mario Monti's call for a new balance between liberalisation and redistribution. The new president will need to find the words that capture the idea he intends to recommend but, more importantly, he will need to reach out to member states, the European Parliament and civil society to build consensus on and elicit support for his proposals.

Leadership will also be needed to put in place a coherent post-crisis economic strategy. No matter how serious the immediate problems, the Commission will need to focus its action and that of national governments on the long-term challenges. This will imply pressing national governments to avoid immediate moves that jeopardise common longer-term goals, but also defining and implementing measures that will strengthen growth potential and avoid the stagnation trap that threatens Europe's future. To this end short-term responses need to be consistent with long-term goals. This is not the case at present with, on the one hand, a series of immediate, short-term initiatives and, on the other hand, a Lisbon Strategy which is losing the little traction it once had.

The new Commission president should take the initiative and propose to define and implement for the next five years an economic revival package consisting of:

- A programme to restore the sustainability of public finances.
- A blueprint for recovery in the new member states and for euro-area enlargement.
- A plan for exit from exceptional crisis-management action.
- A European Growth and Employment Programme.

The details of the first two proposals are presented in the memo to the Commissioner for Economic and Monetary Affairs[2], so we focus here on the last two.

The exit from exceptional crisis-management measures involves many technical dimensions that are better dealt with by specialists. But there is one dimension that the new president should concentrate on: the extent to which these policies need to be coordinated. In banking, the loose character of coordination has been highlighted by the absence of a European process of triage involving consistent balance-sheet assessment and stress-testing, which puts the single market at risk. He should emphasise that while member states remain responsible for providing financial support there is a need for a common solution to Europe's banking problems. Similarly, unless the Commission takes the initiative in helping to restructure an automotive sector suffering from overcapacity (owing not only to new competitors but also to rising oil prices and concerns about climate change), national intervention could severely damage the single market. In both cases exceptional measures do not require permanent transfers of sovereignty, but rather an explicitly temporary common response.

2 Written by Jürgen von Hagen and Jean Pisani-Ferry.

The crisis risks significantly and permanently reducing the EU's potential output. There is also a serious danger of a reduction in long-run potential growth rates, as the crisis is likely to result in a more restrictive financial regime less conducive to innovation. Together with weakening demographic conditions and the higher tax rates implied by the deterioration of public finances, such developments would turn Europe into a permanently low-growth area incapable of attracting, or even retaining, the most productive personnel and companies.

Countering these dampening forces will require a new European Growth and Employment Programme —as such, the successor of the Lisbon Strategy— which could rely on some of the features of the Lisbon agenda, in particular the lynchpin role of a competitive single market for boosting productivity growth and of well-functioning labour markets and social conditions for improving employment performance. In addition, and in contrast to Lisbon, the new programme would need refocusing and a stronger EU component in selected fields. Candidates include: financial markets, which were neglected in the Lisbon Strategy and remain an essential catalyst for investment and innovation; the knowledge triangle, and in particular higher education, where Europe can build on the success of the Bologna process and take initiatives in line with the European Research Area concept enshrined in the Lisbon Treaty; and green growth, where the EU needs to make its climate commitments the basis for a sustainable economic development strategy.

In designing the new European Growth and Employment Programme for the period after 2010, the new Commission president will be confronted with one major difficulty. He will not have any new money to rely on since government finances are stretched to the extreme. Luckily, he will have an opportunity to improve the EU budget: in 2005, the European Council agreed on the principle of carrying out and in-depth budget review. This review initially planned for 2008/2009 has been postponed until after the entry into force of the Lisbon Treaty. The president should conduct this review as soon as he takes office and put forward without delay proposals for an immediate revision of the EU budget. The new economic situation calls for new spending priorities. Postponing changes until the start of the next programming period in 2014 would be a sign of misplaced inflexibility. Consistent with the European Growth and Employment Programme he should therefore propose a revision of the EU budget effective in 2011.

Last but not least the Commission's economic strategy must continue building on the efforts of the previous Barroso Commission to shape globalisation. The emergence of new global powers requires a rethink of global governance to ensure that all the essential players have a stake in the process and are effectively engaged in it. This concerns not only traditional areas and institutions such trade and the World Trade Organization (WTO) or international finance and the IMF, but also new areas such as climate change. The combination of a global crisis-inspired spirit of cooperation and of a US administration that is sympathetic to multilateralism offers a rare opportunity for progress. To play its role, the EU should first overcome its "fragmented-power" syndrome and reform its internal governance in order to speak more effectively in international economic fora. A situation in which the EU has a seat at the G-20 but is not considered a legitimate voice by its own members is untenable. There are means to improve upon the present situation even in the absence of governance reform. For instance, the participating EU countries could speak with one voice within the G-20 by delegating to one of them the responsibility for presenting the

European position on a particular topic. Second, the EU should stop playing rearguard games and spell out its conditions for accepting a significant *diminutio capitis* in international fora.

Although the global agenda should be one of the priorities of the new president during the months and years ahead, it should not lead him to forget that Europe also has crucial regional responsibilities. Our neighbourhood is potentially highly volatile and requires more focused attention on our part, especially in view of the destabilising repercussions of the crisis. Despite some recent progress, the EU’s neighbourhood policy remains unfit for purpose. This partly reflects an uncertain or ambiguous stance towards enlargement, partly the fact that two important pillars of our interaction with neighbouring countries —energy security and migration— remain largely outside the scope of effective common EU action. These shortcomings will need to be remedied.

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