Memo to the commissioner responsible for economic and financial affairs

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The European Union withstood multiple economic shocks during the last five years but the productivity gap between the EU and other parts of the world is persistent. Your tasks include management of some of the structural factors that can help close this gap. You have three main challenges for the next five years: ensure credible implementation of the new EU fiscal rules, encourage the reduction of current account surpluses if they reflect a savings/investment imbalance and encourage the implementation of country-specific recommendations.

You will need to maximise the value of the money that the EU invests, enforce implementation of rules and structural reforms and help prepare negotiations for the next Multiannual Financial Framework, in order to achieve the EU's strategic objectives.

Implement fiscal rules rigorously

Promote reform and deployment of excess savings

Focus the EU budget on investment

State of affairs

Economic outlook

Inflation in the euro area has declined continuously since its late-2022 peak. It is now forecast by the European Central Bank to be close to its 2 percent target, in both 2024 and 2025. However, inflation differentials persist within the euro area, leading to shifts in competitiveness that may require differentiated economic policy interventions. The scope for ECB interest rate cuts – and thus reductions in private-sector nominal borrowing costs, which were at a 15-year high before the start of the monetary easing phase – remains uncertain. Economic growth remains weak, as your services expect the EU economy to grow only 1 percent in 2024.

Unprecedented fiscal support provided during the pandemic and energy crisis is paying off

Unprecedented fiscal support provided during both the pandemic and the energy crisis is nevertheless paying off. The labour market is strong across the EU and inequality is contained. It remains to be seen whether there will be delayed effects on income inequality as fiscal support is withdrawn.

EU productivity lags the United States, but there is significant variance within the EU. Measured as GDP at purchasing power parity per hours worked, the gap compared to the US productivity level is modest in most western and northern EU countries, including Germany (7 percent below the US in 2023) and France (10 percent below the US in 2023).

The Recovery and Resilience Facility (RRF)

The start of your term coincides with the halfway point of implementation of the NextGenerationEU instrument and its centrepiece, the RRF. Disbursement of RRF funds at time of writing had reached about 40 percent of the total grants facility and 27 percent of the loan facility. However, by July 2024, EU countries had met only 20 percent of the milestones and targets in their national recovery and resilience plans. This raises the question of whether the initial timeline for accomplishments linked to RRF money was too ambitious.

European Semester

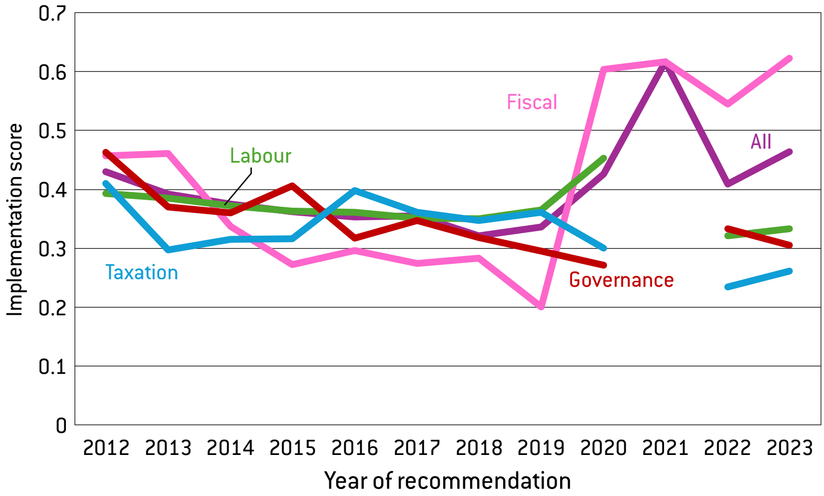
Within the European Semester, the coordination of fiscal policies has entered a new phase with the entry into force in April 2024 of an updated fiscal framework. During your term, the new rules will be implemented for the first time. The new framework requires technically complex debt-sustainability analysis, leaves room for interpretation and is likely to constrain needed public investment.

Macroeconomic imbalances persist in eight euro-area countries, with three experiencing excessive or potentially excessive imbalances. For six countries, no imbalances are identified and their vulnerabilities are presently contained. Sovereign debt levels have come down significantly since the pandemic, but are still high, comparable to levels seen in the aftermath of the euro crisis. The EU is re-experiencing current account surpluses, more than 2.5 percent of GDP (expected for 2025) relative to the rest of the world, while Denmark, Germany, Ireland, and the Netherlands will have surpluses in 2024 of between 6 percent and 10 percent of GDP. These excess savings are inconsistent with the large investment gaps the EU faces.

The implementation record of country-specific recommendations in some challenging areas did not improve

The overall implementation record of country-specific recommendations (CSRs) improved somewhat during the pandemic, partly because fiscal recommendations were given more prominence and some of those recommendations required measures countries were implementing anyway in addressing the adverse impacts of the pandemic. In some more challenging areas, including governance, labour-market and taxation reform, there was no improvement (Figure 1).

Figure 1: Implementation of European Semester country-specific recommendations



Source: Bruegel based on the European Commission CSR database. Note: scores assigned by the Commission: fully implemented = 1; substantial progress= 0.75; partial progress = 0.5; limited progress = 0.25; no progress = 0. Average across all countries for evaluated CSRs. Implementation after one year is reported. There were only fiscal CSRs in 2021. Governance is composed of civil justice, corruption, justice system, public administration, public procurement and concessions, quality of law-making, shadow economy and corruption, and state-owned enterprises.

Your services also monitor the €3 billion in macro-financial assistance (MFA) to ten candidate and neighbouring countries. Several of these countries are in geopolitically high-risk environments. Ukraine was recently granted a €50 billion Ukraine Facility from the EU. The ongoing conflict can make it difficult to implement many of the preconditions of the MFA and the Ukraine Facility. These programmes have an important role in the EU's enlargement strategy.

Challenges

You will face at least three major challenges:

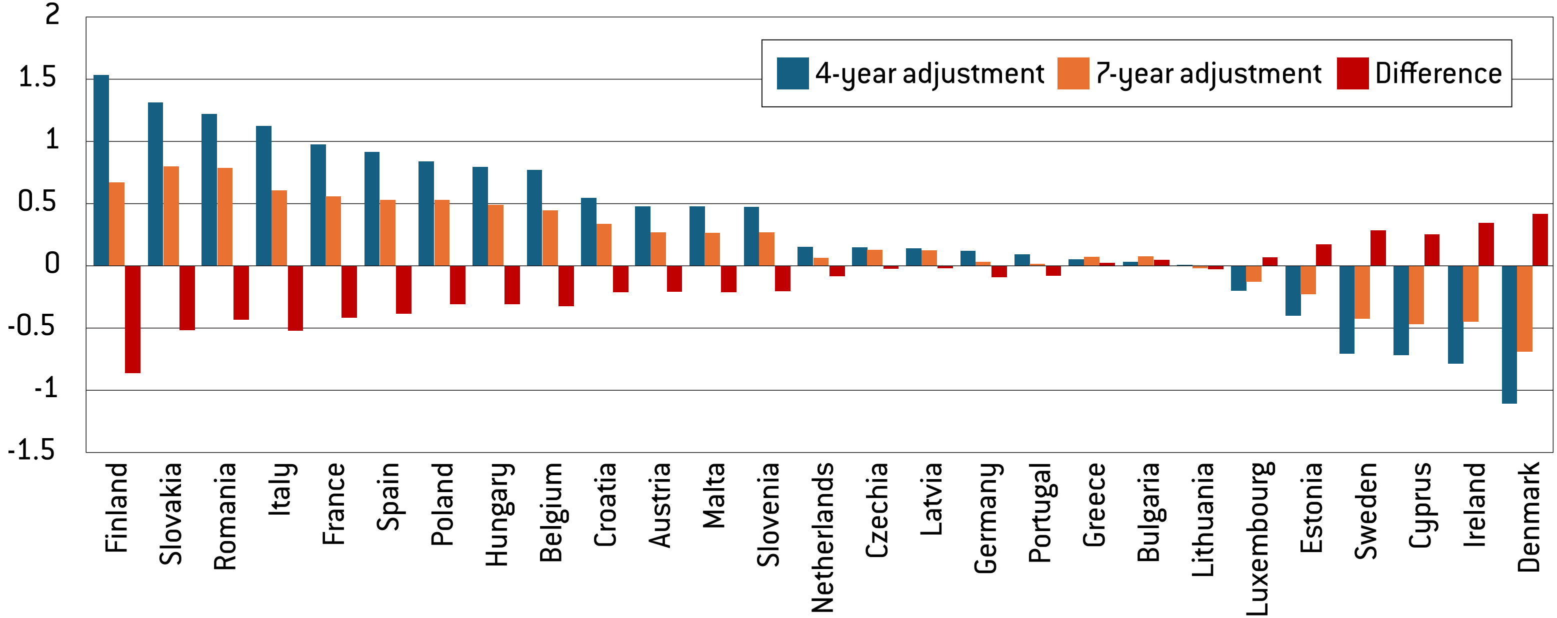
Ensuring credible implementation of the new fiscal rules

The credibility of the new fiscal governance framework must be established from the outset. Your predecessor set out fiscal "*reference trajectories*", against which countries will formulate their medium-term fiscal-structural plans and submit them in late 2024. You will need to evaluate the plans, and make recommendations on the adjustment paths of the eight countries with excessive deficits. Under the new rules, your room for discretion is limited but not eliminated. For example, you will be called on to propose whether the standard four-year adjustment period can be extended to seven years. This can have a major impact on annual fiscal adjustments (Figure 2) but can only be granted if countries propose investments and/or reforms which "*as a general rule taken altogether*" are growth-enhancing, supportive of fiscal sustainability, in line with common EU priorities, address European Semester CSRs and result in sufficient national investments. Your challenge will be to exercise this discretion in a way that preserves both the intent of the new rules and country ownership.

Complicating the smooth implementation of new fiscal rules, demands on fiscal policy may continue to grow

Complicating the framework's smooth implementation, demands on fiscal policy may continue to grow. The policy environment is highly uncertain (geopolitics, military, trade, fragmentation, elections outcomes), potentially requiring unexpected intervention. But equally importantly, EU countries collectively face an annual investment gap of at least €356 billion for the climate transition and €125 billion for the digital transition, for a total of €481 billion up to 2030. The gap is much larger if greater defence needs, the reconstruction of Ukraine and the health union are factored in. Closing this gap will require the efficient use of public resources and mobilising of private investment. Few countries currently have the fiscal space to meet these investment needs, and some challenges, such as climate damage and adaptation, could further restrict the available fiscal space. The new framework will constrain the increase in investments (Darvas *et al*, 2024). It will be a challenge for all policymakers to find the fiscal space to fill this gap.

Figure 2: Annual average fiscal adjustment requirements under the new fiscal framework (average annual change in the structural primary balance, % of GDP)



Source: Bruegel based on June 2024 AMECO dataset for macro variables, June 2024 market expectations for interest rates and inflation rates. Note: the European Commission's methodology was used. A positive number for the four and seven-year adjustments indicates that the country must increase its structural primary balance. Difference = the gap between the four-year and the seven-year average annual adjustment requirements. The six countries on the right side have either debt levels well below 60 percent of GDP (Denmark, Estonia, Ireland, Luxembourg, and Sweden), and/or large primary surpluses (Cyprus and Denmark), implying that these countries could implement fiscal expansions (ie reducing the structural primary balance) under the new fiscal framework.

Despite large investment gaps, the EU continues to send a large part of its savings outside its borders

Current account surpluses coexist with investment gaps

Despite large investment gaps, the EU continues to send a large part of its savings outside its borders. A 2.5 percent of GDP current account surplus forecast for 2025 represents about €450 billion. If the EU could use these excess savings, it could cover its climate and digital investment gaps almost in full. Solving this enormous inconsistency is both urgent and complex. You and all EU and national policymakers must identify the factors that hold investments back and provide incentives for investors to stay in Europe. The fragmented nature of the EU's single market, regulatory obstacles and imperfections of Europe's capital markets union are likely contributing factors, so you should work with other commissioners to remedy these issues. You will be required to contribute to setting EU strategic priorities and to designing an EU growth strategy. To this end, you must work closely with commissioners responsible for climate, energy, finance, digital economy, competition, research, single market and the EU budget.

You will also be required to identify sources of finance. Beyond national fiscal resources, the EU must look for other options. How can the right incentives be provided to keep savings in the EU and contribute to closing the gap? How can the EU budget be reformed, and/or national budgets coordinated, to provide for more efficient spending on projects that have EU value added? How can institutions, including the European Investment Bank and the European Stability Mechanism, be reformed and/or repurposed to engineer better financial inducements that will stimulate the private sector to play a more significant role? These are questions the next leadership team will have to address, and you will have to play an active role in answering them.

Improving country-specific recommendations (CSRs) implementation in the second half of the RRF

Your challenge will be to improve the implementation of CSRs that require structural reforms and fiscal recommendations that require difficult fiscal consolidation.

Country-level reforms are crucial for promoting member state competitiveness and resilience. Failing to reform, therefore, is an obstacle to EU economic progress. But there is another reason why the poor CSR implementation record is a challenge for your portfolio: it jeopardises the success of NextGenerationEU. Addressing CSRs was a requirement for the approval of national recovery and resilience plans (NRRPs), but assessments vary of how well NRRPs have incorporated the relevant CSRs, while governance, labour market and taxation reforms have been implemented poorly (Figure 1).

As you enter the second half of the lifetime of the RRF programme, your challenge will be to assess NRRP implementation objectively and nudge member states towards a successful close. The evidence so far points to delays, which will require an acceleration of implementation. A further problem is that exceptionally high inflation in the first two years after Russia's full-scale invasion of Ukraine has meant that costs associated with the implementation of projects have increased compared to initial plans. Under current provisions, national budgets bear the unforeseen burden of inflation-related costs. Depending on their fiscal space, this will be felt differently by different member states and may pose material risks to the success of national programmes.

Recommendations

You should push for changes to economic policies at national and EU levels to enhance economic sustainability, competitiveness and inclusiveness. Your tools to achieve these goals include the new fiscal framework, overseeing the macroeconomic imbalance toolkit, setting the right CSRs in the European Semester, steering discussions and seeking agreements within the Commission and with member states.

Raise investment in the next five years and beyond

The EU must find new ways to finance its investment gaps

In the next five years, the EU must find new ways to finance its investment gaps. Both public and private investment should be increased, and the public portion should include both nationally-funded and EU-funded components. You will have a central role in reconsidering the EU's investment-supporting instruments.

Ensure that InvestEU maximises EU value-added

Among existing EU tools, you should ensure that the projects supported in the remaining lifetime of the InvestEU programme (which uses €26.2 billion in EU budget guarantees to mobilise €372 billion in private investment from 2021 to 2027) have EU value-added and are in line with EU strategic priorities. You should also support EU countries in completing all planned investments in their national recovery and resilience plans by 2026, the RRF expiry date.

Use the CSRs and single market measures to help reduce current account surpluses

As part of the Macroeconomic Imbalances Procedure, you monitor current account developments yearly and aim to identify the reasons for such high inconsistencies between savings and investments in the EU. It will be crucial for the CSRs, the tool at your disposal, to focus on actionable policies that can make a material difference for the countries concerned.

You should work with other commissioners to detect the factors that drive investments outside Europe and remedy those deficiencies

Deficiencies in the functioning of the EU single market also likely inhibit the within-EU utilisation of European savings. Your colleague responsible for financial services will be working towards creating better conditions that will enable wider and deeper capital markets in the EU. Other parts of the Commission will attempt to improve the functioning of the single market by removing regulatory or other obstacles. You should work with these and other commissioners to detect the factors that drive investments outside Europe and remedy those deficiencies.

Promote private investments via an expanded role for the EIB and possibly the ESM

You must rethink whether financial institutions, including the EIB and the ESM, can also do more to attract private capital. While the EIB has increased its gearing ratio to expand its activities, the question is whether they can be reformed or possibly repurposed in this regard. This raises the issue of participation in more risky projects as a way of helping companies enter areas they would otherwise not pursue. It also raises the question of whether and how should the EIB increase its leverage ratio.

Similarly, the role of the ESM as an institution can also be rethought. There have been many discussions on ESM reform and there are ideas on how to use its firepower during calm times to help with, for example, finishing the banking union by providing a deposit guarantee (Tordoir, 2022). This would help increase the EU's resilience. On the other hand, one could go further and ask whether there is more that can be done to repurpose the ESM's €400 billion firepower, in the context of closing the investment gap when there is no EU country in distress.

Repurpose the EU budget within and beyond the Multiannual Financial Framework (MFF) to target investments

The next EU budgetary cycle will start in 2028 and there will be considerable pressure for more EU funding than the MFF has provided until now. You should contribute to the discussions on financing EU projects within and beyond the MMF, in two ways:

There is a rationale for closing some of the climate investment gap via the EU budget

- **Climate fund**
  Climate is a global, and also an European, public good. There is a rationale for closing some of the climate investment gap via the EU budget. Since increased climate spending will be needed for decades, the best option would be to increase the size of the MFF to create a new dedicated climate fund within it. Failing that, you should foster an agreement on a temporary (eg five-year), debt-financed new EU climate fund outside the MFF. The fund could provide grants and concessional loans directly to applicant companies (ie not pre-allocated to countries). Such grants and loans could be provided on a competitive basis. If the cross-country allocation is not directly related to national contributions to the fund, as was the case with RRF grants, then these allocations would not be counted as national debt and thus would not be constrained by the EU fiscal rules (Darvas, 2022). At the same time, you should progress with the new own resources debate as a way of securing means to finance the interest and repayment of such borrowing.
- **European Strategic Investment fund**
  A follow-up instrument for InvestEU should be created at a much larger scale within the MFF. We recommend the creation of a European strategic investment fund to pursue long-term

objectives consistently. The EU must pursue a structural approach to defining and financing its long-term strategic objectives. Currently, there is a lack of continuity in how the EU pursues investments. Programmes are finite and sporadic, with different funding sources and overlapping objectives. A new European strategic investments (ESIs) fund could come initially from a partly repurposed EU budget. Projects should be evaluated on how well they provide added value to the EU and contribute to its strategic objectives.

Operationalise the new fiscal monitoring procedures: evaluate how reforms contribute to growth and fiscal sustainability

You must develop an appropriate methodology to assess quantitatively proposed reforms and investments

You will need to assess national medium-term fiscal-structural plans, not only qualitatively but also quantitatively. To this end, you must develop an appropriate methodology and incorporate it into the EU's commonly agreed potential output projection methodologies. Except for labour-market reforms and measures related to the fiscal costs of ageing, the European Commission does not have a methodology that helps quantify the impact of reforms and investment on growth and fiscal sustainability. In particular, the Commission's forecasting methods do not capture the impact of reforms and investment on total factor productivity and the capital stock, unless these are expected to be felt in the first two years of the forecast; even in this case, these impacts are assumed to fade away (Darvas *et al*, 2024).

EU countries' fiscal plans can deviate from the Commission's reference trajectory if they provide "*sound and data-driven economic arguments explaining the difference*". Planned reforms and investments recognised to support growth sustainably would be an excellent justification for such deviations. Thus, the Commission must evaluate whether the trade-off between fiscal adjustment and the reforms assumed in a medium-term fiscal-structural plan is quantitatively reasonable. Having an accepted tool to do that will contribute to the credibility of your decisions.

Apply the excessive deficit procedure consistently

You will also have the scope to steer adjustment requirements for the eight excessive deficit countries. There is some ambiguity in the EDP regulation (Council Regulation (EU) 2024/1264), which creates a risk that the EDP will become a shelter for lower fiscal adjustment than what is required when the country is not subject to an EDP (Pench, 2024). You should make sure that debt sustainability, the primary objective of the new fiscal framework, is also required from EDP countries. Otherwise, the new fiscal framework will lose its traction right from the start.

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