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NOTE

from:	Council (Ecofin)
to:	European Council
Subject:	Council (Ecofin) contribution to the 18-19 June European Council: Report on European Economic Recovery Plan

Delegations will find attached a Council (Ecofin) report to the 18-19 June European Council on the European Economic Recovery Plan, as adopted by the Council (Ecofin) on 9 June 2009.

Encl.:

European Economic Recovery Plan – Report to the 18-19 June European Council

Introduction

- The European Council in December 2008 adopted the European Economic Recovery Plan, calling on Member States to take stimulus measures to underpin economic activity and increase their efforts to implement the structural reforms and long term policy aims envisaged in the Lisbon Strategy. Given the depth of the crisis, remaining uncertainties and the nature of the measures taken, continuing multilateral surveillance is important.
- While this note focuses on national recovery measures, these are accompanied by important efforts at the European level, through the different European funds, the EIB, an expanded balance of payment facility, the temporary adjustment of the state aid framework and central bank actions.

Economic situation

- The EU economies are experiencing the deepest and most widespread recession in the post-war era and are expected to contract substantially in 2009. However, the ambitious policy actions taken by governments and central banks since last autumn contributed to dampening the downturn and have prepared the ground for a recovery next year.
- According to the latest Commission's forecasts, GDP is expected to contract by 4% this year in both the EU and the euro area. Almost all Member States are expected to post negative growth rates this year. Labour markets are hit hard by the crisis; employment is projected to contract by about 2.5% this year and by a further 1.5% in 2010. Unemployment is projected to rise to close to 11% in the EU by 2010. Inflation is expected to decelerate further in the coming months, temporarily entering negative territory in 2009, before returning again to levels in line with price stability over the medium term.

- Member States with large and open financial sectors are hit more severely by the crisis, as are economies that are more export-oriented and those with large or specialised manufacturing sectors. Diverging starting positions – including fiscal positions and the existence of macro-economic imbalances such as bubbles in the housing market, large debts in foreign nominated currency, large current account deficits and/or weak competitiveness positions – started to affect some Member States before the crisis and aggravated its impact. In addition, they affect long-term growth prospects. Member States with a combination of the above-mentioned factors face the toughest short and medium term challenges.
- Against this background, the budget deficits are set to more than double this year in the EU (to 6% of GDP up from 2.3% of GDP in 2008). A further deterioration in the budgetary outlook is to be expected in 2010.
- The decline in economic activity should stop over the course of 2009 and growth should progressively turn positive in 2010. Meanwhile, there are substantial uncertainties regarding the economic outlook and risks remain sizable.

Budgetary policies

- Active budgetary policies are sustaining economic activity this and next year. The overall budgetary support, provided by discretionary measures and the impact of large automatic stabilisers, is estimated at around 5 percentage points of GDP in 2009-2010. Discretionary fiscal stimulus measures adopted by the Member States make up 1.8% of GDP over the two year period. Member States have thereby fully responded to the fiscal policy component of the European Economic Recovery Plan. The response has been appropriately differentiated according to the specific situation of individual Member States and overall it has balanced the needs for stimulating the economy in the short term and at the same time allowing a credible strategy for return to sound and sustainable public finances to begin being prepared. With the economic and budgetary outlook forecasted by the Commission in early May further budgetary stimulus would not be warranted and attention should shift towards consolidation, keeping pace with economic recovery.

- In these circumstances, a large majority of Member States are likely to be in excessive deficit and thus subject to the excessive deficit procedure (EDP). Rising deficits, low growth, as well as implemented support to the financial sector, feed through into debt developments and gross debt is also expected to increase substantially, by one third in only two years, from about 60 % of GDP in 2008 to about 80 % in 2010. To date, the Council has placed four more Member States in EDP, and addressed recommendations which take into account current exceptional uncertainties and country specific impacts of the crisis.
- The Stability and Growth Pact (SGP) provides the appropriate framework for ensuring the sustainability of public finances and for anchoring future exit strategies. It contains the necessary flexibility which allows consolidation measures to be implemented in time frames consistent with the recovery of the economy thus ensuring sustainability, consistency and credibility of our policies. In line with the SGP, Member States are preparing comprehensive consolidation strategies and several have already spelt out or are in the process of spelling out in detail their plans for returning to sound budgetary positions. High priority has to be given to ensuring the long-run sustainability of public finance. There is a clear need for a reliable and credible exit-strategy, inter-alia by improving the medium-term fiscal framework.
- Medium-term financial support has been provided, together with the IMF, to non-euro area Member States facing balance of payment needs and pursuing programmes of fiscal, financial and structural adjustment.

General assessment of structural policies in the EERP

A tailor-made approach to recovery

- As Member States face specific policy challenges, they need to act in a coordinated but not in a common manner; a one-size-fits all approach would not work. For example, there may be a trade-off between demand support on the one hand and sound public finances and competitiveness on the other. Small open economies tend to focus on the latter for example through wage moderation while economies in which domestic demand dominates have more justification for supporting consumption and investment. However, Member States have one thing in common, and that is the need to implement structural reforms with a view to increase factor productivity and to strengthen the resilience of the economy in a sustainable manner,
- In this note, recovery measures are assessed against the following general guidelines and criteria based on the framework developed by the European Council:
  - Measures should be effective and efficient. They should aim to produce immediate effect (be timely) and they should be aimed at the companies, sectors or persons most affected by the crisis (be targeted). Reasons for public intervention lie in countering identifiable market failures and containing the overshooting of the correction set in motion by the crisis. An insufficient reaction could lead to wasteful labour shedding and the destruction of otherwise viable and sound companies, loss of knowledge and skills, and a reduction of productive capacity far beyond a normal cyclical adjustment.
  - Measures should be compatible with long-term goals such as structural economic growth, sustainable public finances and energy and climate change goals. Recovery measures that do not contribute to long-term policy goals should be strictly temporary.
  - Measures should be compatible with the internal market, state aid and competition rules and not create negative spill-overs for fellow Member States.

Assessment of short-run impact

- Member States have strongly intervened in the financial sector to strengthen banks' solvency and their capacity to supply credit to the private sector. Nevertheless, the EU banking system is still under considerable stress and credit remains tight. Stabilising the financial sector is an important precondition for recovery.
- Recovery measures so far are generally timely and targeted. However, the effectiveness of some measures requires further monitoring, especially those aimed at fostering access to finance and sustaining private R&D as their impact is not yet evident.
- So far, measures are generally in line with internal market and state aid rules. The guidance given at the EU-level by the European Economic Recovery Plan and the actions by the European Commission including the framework on support to the automotive industry, appear to be successful and have prevented national stand-alone behaviour. Further coordination might be warranted if the crisis lasts longer and more support measures introduced.

Consistency with long-term goals

- Recovery measures generally appear to be designed in a manner consistent with long-term priorities under the Lisbon Strategy. The challenge now is to ensure that temporary measures are indeed reversed as the economy recovers. There have been no large rollbacks of past reforms or a repetition of major policy errors from previous crises.
- At the same time, only a few Member States took the opportunity to significantly invest in greening their economy, improve framework conditions for innovation or improve the efficiency of benefit systems.

- While the crisis has forced adjustments in economic imbalances in a number of Member States, including sometimes significant wage adjustments, many of the underlying structural problems remain. In general, tackling underlying competitiveness weaknesses or causes for housing bubbles has not featured prominently in the design of recovery packages.
- Member States that already performed well in an area often continue to implement reforms in the same field: innovation leaders have tended to further increase R&D expenditures and countries with large current account surpluses have been more likely to take measures to increase price competitiveness. This implies that the crisis could lead to larger divergences in the EU.
- Focus of further measures should increasingly turn to structural reforms and to improving the longer-term performance and growth potential.

Assessment by policy area

Measures to support businesses and sectors

- Stabilisation of the financial sector is a crucial precondition for recovery. Trying to alleviate the credit and trade finance constraints for businesses, Member States have particularly focused their support measures on improving access to finance. At this stage it is difficult to assess whether the measures will actually have the desired effect. Close monitoring of credit conditions and of the impact of these measures remains crucial.
- Several Member States have put substantial financial support towards the automotive and construction sectors, encouraging demand and sustaining employment in the short-run. These measures should be temporary to prevent crowding-out the private sector from resuming normal activities when conditions stabilise, and to ensure sometimes overdue adjustment in sectors. Restructuring should be supported by the adaption of workers' skills towards other sectors of work.
- More Member States should consider introducing measures to structurally improve the business environment (e.g. better regulation and reduction of administrative burden) and the promotion of entrepreneurship as a useful and low-cost addition to recovery packages.

Measures to support investment

- Most Member States have invested substantially in physical infrastructure and energy efficiency. This will have potentially large effects on demand and on sustaining employment in the short run although public investment should not be seen as a substitute for private investment.
- Bringing forward already agreed and assessed investments is more likely to be both effective and efficient and this appears to be the case in many instances. To ensure a timely implementation, more Member States should consider simplifying administrative procedures.
- Member States where the construction sector was oversized already before the crisis, should allow restructuring to happen. This should be a condition for providing public support to the sector.
- The overall green component of investment is not very high. Some Member States invest significantly in measures specifically aimed at energy efficiency, while many others do not have this focus in their investment packages, which could be considered a missed opportunity. Where green measures are directly supported, the positive impact of public intervention is maximised where measures are technology neutral.
- R&D measures account for a limited share of recovery measures and one should not expect a high contribution from such measures to stimulate demand in the short run. However, these measures can contribute to restoring long-term growth in the EU and preventing a loss of innovative capacity for the future. It is positive to note that R&D measures concentrate on alleviating the financial constraints on businesses. Given the severity of the downturn, it should be closely monitored whether measures are indeed sufficient to prevent a collapse in private R&D. Member States should continue strengthening framework conditions for R&D.

Labour market measures and measures to support household incomes

- Member States should take care that a temporary increase in the number of unemployed does not result in persistent lower employment and higher unemployment as the related costs are high for both the people concerned as well as for the economy as a whole. Measures include taking action in the areas of short-time working allowances, job placement and training, and tax and benefit systems.
- Many Member States have successfully prevented labour shedding through short-time working agreements and allowances. The schemes are often complemented with measures supporting employability and guiding people towards new jobs. Such schemes must be temporary to make sure that sectors facing long-term difficulties are restructured and that people are not kept in unsustainable jobs.
- Many Member States have strengthened active labour market policies and increased training opportunities and incentives. While these are important measures to help workers adapt their skills towards new jobs, they should not be seen as a silver bullet against unemployment, and Member States should not refrain from taking additional measures such as addressing insider-outsider issues and improving the incentives to work in tax and benefit systems.
- Member States appear to have learnt lessons from policy errors in earlier crises. Especially, they have not fallen into the trap of trying to reduce labour supply to prevent substantial rises in unemployment, e.g. through open-ended reductions in working time or by fostering early retirement.
- Many of the measures introduced in the field of tax and social contributions will foster employment. It is important to remain vigilant that those measures in the area of the labour market that do not contribute to structural growth (such as public employment schemes and measures that decrease incentives to work) are reversed.

- There seem to be very few measures aimed at improving the efficiency of benefit systems. Once recovery sets in, such measures will be crucial to make sure that the growth potential of the EU can be maintained and fiscal sustainability restored. As part of their exit strategies, Member States should devise reform strategies for key elements of their benefit systems.
- Some Member States have implemented policies to help to contain wage increases. In others wage moderation is needed to address competitiveness concerns.
- Many Member States take measures targeted at increasing households' purchasing power. The effect on domestic demand of these measures may to be smaller than might have been expected, as a larger part of the stimulus is saved due to the uncertain outlook.