PREPARING FOR NEXT STEPS TOWARDS BETTER GOVERNANCE IN THE EURO AREA

Jean-Claude Juncker, President of the European Commission

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Dear colleagues,

At our meeting last December, you charged me, in close cooperation with Donald, Jeroen and Mario, to prepare an Analytical Note on the current state of play of our Economic and Monetary Union and on the roots of the crisis. This analysis is meant to be the first step towards a Four Presidents' Report on the future of Economic and Monetary Union, expected by you for June.

I have worked very closely with the other three Presidents in the past weeks on the Analytical Note. I would like to thank those of you who have sent us valuable inputs (such as the Franco-German questionnaire, as well as the Italian and Spanish contributions). Your ambassadors (in the COREPER) and experts (at the Euro Working Group) have also had the opportunity to brainstorm about the issue.

Given the attention that the euro area is getting these days, you will understand that, on a specific request of Donald, we have chosen not to circulate the Note before this meeting. The Analytical Note will therefore be presented to you orally now and made available to you in writing after this meeting (tomorrow morning). We also have opted for a very factual text: any ground-breaking document would certainly have been misread at this point in time. In the current context, there is no such thing as an innocent analysis.

The purpose of the Analytical Note and of our discussion today is to start a process. Not to conclude it. This is an important lesson we drew from the previous Four Presidents' Reports back in 2012, of which Mario and I were already co-authors.

These were excellent documents, obviously, but the truth is that these were produced in a relatively confidential and diplomatic circle, very much under the pressure of events. This means that there had been little time for consultation back then.

In my view, there was at the time also too much focus on legal and institutional considerations. These are certainly important, but they must not preclude or even replace an economic and political analysis. We first need to agree on where we want to go and which results we want to achieve. It is only thereafter that we should discuss rules, Treaties, institutions.

This time, we want to do things in the right order: first, take stock and set out the facts, and then engage on this basis so that our final work is grounded on evidence and on a broad dialogue. My aim is to produce a fully-fledged report before our meeting on 25-26 June. We have a bit of time. I also believe we should give this process rather too much time than too little. If we want to have consensus at 28, we should take all the time needed to build this consensus.

What does the analysis of the Four Presidents tell you?

Our Analytical Note – it is 8 pages long which I will now sum up orally, and in my own words – tells the story of our Economic and Monetary Union so far. It discusses the nature and "raison d'être" of our EMU. And it says what went wrong, and put questions for the future.

We should not read this story by starting from the end: there have been better times than the years of crisis. And we should not be short-sighted either: some who have better times now may not be the ones who had better times in the past or will have better times in the future. We are all very much in the same boat, we need to learn our lessons and get our vision and ambition right.

As you may have seen from our Winter Forecast released last week, our growth prospects are improving slightly (also thanks to the action of the ECB). In fact, every

Member State should have positive growth this year. This is the first time since 2007. But the pace of recovery is still slow and our unemployment will take time to reduce.

The road so far

Looking back over the last 15 years, we can say that the first years of the euro, until 2007, were years of relatively strong growth and job creation (**slides 1 and 2**). But in many countries, these trends proved unsustainable and the crisis took its toll.

Overall, we still haven't regained our GDP level of 2007, and unemployment has reached very high levels: in fact, unemployment has been consistently above 10% in the euro area as a whole since 2010. Moreover, in the aftermath of the crisis, performances have diverged strongly and, also due to the enlargement of the euro area, our monetary union is now as heterogeneous as ever. This is a direct challenge to the convergence that our EMU is expected to bring and build upon. Let me recall: Monetary union was and is about strengthening our economies and making them converge. However, the crisis has at least partly reversed the positive effects of the first years of the euro.

But the crisis does not explain everything: it is now clear to everyone that the relatively good times in the first decade of the euro were hiding structural weaknesses and imbalances that pre-dated the crisis and were building up in several countries.

Think of real estate and construction "bubbles". Think of trends in unit labour costs – the price for work – (on **slide 3**), which is a good measure of the cost competitiveness of an economy. Several countries had gradually lost part of their relative competitiveness over the last decade and it took a lot of efforts to correct these trends in recent years. For the countries which have managed (look at Ireland, Spain, Portugal and Greece as good examples), the results – in terms of restoring current account balances – are now paying off.

Political leaders were not the only ones not seeing the risks. Also the markets were not as efficient as believed at the time of the signing of the Maastricht Treaty. As the chart on **slide 4** shows, from 1999 to 2008, the financial markets did no longer distinguish between Member States in terms of risk premium to be paid on their debt. Markets did not read the Treaties; they thought that our monetary union is in fact a federal state, and that everybody stands with and behind everybody. Some call this the "anaesthetic effect" of the euro, which has not helped our internal discipline. Others see this as underlining the need for more sovereignty sharing in economic and fiscal matters as the best way forward to stabilise our monetary union over time.

Whatever the right interpretation: the wake-up call was brutal. The financial crisis turned into a sovereign debt crisis threatening our monetary union as a whole. And the real economy and millions of citizens paid the price, with some countries more particularly hit. As we saw, unemployment has dramatically increased, notably in the programme countries, and given the characteristics of our labour markets, the younger generation was disproportionately affected. Youth unemployment rate is above 20% on average in the EU and is as high as 50% in some countries (**slide 5**). This is also why my Commission decided to relaunch the so-called Youth Employment Initiative two weeks ago. And we also know that with unemployment on the rise for several years, poverty and social exclusion have also worsened in many parts of Europe in a dramatic way.

At the same time, our levels of public and private debt have skyrocketed, and it will take years to succeed what economists call a financial "deleveraging" of our economies. In parallel, the conditions for growth are suboptimal in many parts of Europe as a result of increased financial fragmentation. Still today (as is shown on **slide 6**), our firms meet very different conditions to access credits and invest across Europe and our Union is still much more fragmented financially than it used to be the case.

What is wrong?

There are many reasons why the story or our monetary union so far is not as bright as it should have been. I will only highlight a few here.

First, the lack of respect for our common rules (table on **slide 7**). Do you know for how long your country has been subject to a so-called Excessive Deficit Procedure since the Stability and Growth was signed back in 1997?

Within the euro area, only Estonia and Luxembourg and, outside the euro area, only Sweden have never been subject to the Excessive Deficit Procedure. And as you can see from this table, for some, lack of respect for the commonly agreed fiscal rules is more the rule than the exception.

I make this point not to preach for the respect of the rules per se, but to underline the challenge of enforcement of agreed rules. As we know too well, the lack of fiscal consolidation during the better times of the last decade meant these countries had less room for manoeuvre to confront the crisis when it came, and this has threatened all of us as a result.

The same reasoning goes for structural reforms (**slide 8**). Here, our framework is "softer" - the European Semester, through which we (not just the Commission but also and chiefly the Council) issue recommendations for action annually. The charts – which have been put together by the services of the European Parliament – give you a certain impression of how little follow-up is given to EU-level recommendations at national level. Surely, we can and should do better, in our common interest! On the EU side, we can certainly help with more focussed and shorter country-specific recommendations; we can all learn from Donald's style in this respect. But without a stronger national will and ownership to implement reforms, our economic union will remain largely dead letter.

Our inability to reform and transform our economies until now also means that economic shocks have to be absorbed elsewhere, and this has a cost. We have seen the divergences in unemployment rates. But this is also visible in the balance sheet of the ECB (**slide 9**), which has evolved a lot over time, both in size and in composition, to enable the refinancing of private banks within the euro area. Mario will forgive me saying this among ourselves - I don't comment on the ECB in public – but this chart shows how relevant and necessary the ECB has been to act as a buffer for the crisis. This notion of buffer – and the necessary risk sharing that goes with it – is key in a monetary union.

The question however is whether it is really right to have Mario doing all this via the ECB balance sheet. At the moment, we have no other choice, and this is why I am grateful for Mario's impressive work. But if our monetary union were paralleled by a stronger economic and fiscal union, we could address imbalances in another way. And in my view this is where we should try to go over time.

I am saying all this not just for the beauty of rules, of institutions or even of the euro. I am saying this because a better governance is key to regain the economic ground we have lost in the world since the crisis (**slide 10**) and to rebuild the confidence of our citizens and political momentum behind our project (**slide 11**). Clearly, at the end of the day, we all have the responsibility to demonstrate to our citizens that they are much better off within our Union than outside. At the moment, this is not the feeling that is broadly shared across the euro area.

Where do we go next?

In a monetary union, we need not only to preserve but also to strengthen the adjustment capacities of our economies. At the same time, we need to become much better at understanding and managing our interdependence.

If we don't succeed, the risk is to combine the worst of two worlds: uncooperative and uncoordinated behaviours which drag us down and create "lose-lose" situations; excessively complex, rigid and one-size–fits-all rules which seek to compensate for the lack of trust between Member States and alienate our citizens further.

This would trap us in a "low growth, low employment, low inflation and low support" scenario, a scenario which we are all trying to overcome. We have started doing this with the Investment Plan for Europe, which you all have supported. We have started to adjust the fiscal stance of the euro area by making better use of the flexibility built within the existing rules of the Stability and Growth Pact. And the quantitative easing measures of the ECB and their effects on the exchange rate and on the financial system at large have started to bring us back on track of growth and jobs, even though the overall situation remains fragile.

It is the nature of every Union to strive for perfection, and no optimum currency area was optimum in one day, to the extent they exist. The main conclusion from the Analytical Note drafted by Mario, Jeroen, Donald and myself is – this will not surprise you – that our Economic and Monetary Union is far from complete. We have gone a long way since 2010 in trying to match our Monetary Union with a stronger Economic Union by reinforcing our governance, by establishing the European Stability Mechanism and by starting to build a Banking Union – we should acknowledge this and build on it. But there are still many lessons to draw and issues to explore about the scope, effectiveness and legitimacy of our Union. This is why we conclude the Note by putting a number of questions for public scrutiny.

We cannot and will not take all the steps at once. But we should have a clearer vision of where we want to go to create a more balanced and more solid Union - what I call a deeper and fairer EMU.

I see such common ground among us as essential precondition. I would also encourage all of us to see where we can make progress swiftly. Streamlining the European Semester, bringing about Capital Markets Union, completing the Digital Single Market and Energy Union – all this can help making our union functioning better and for the benefit of growth and jobs, without requiring major institutional changes. There are certainly short term improvements that can be achieved now, with a bit of common will. A renewed commitment to structural reforms in all Member States should be part of this.

Before the end of March, I will organise a meeting with your "sherpas" to deepen the discussion at 28 and to see where we could identify common ground for going further in the future. In parallel, I will engage personally with the President of the European Parliament and I will ask all the Commissioners, led by Vice-President Dombrovskis, to do the same with key actors at European level and with national Parliaments. I hope this important discussion can have the same echo in each of our Member

States and you can count on the availability of the Commission to engage in the debate. On the basis of the input received in this debate, I will prepare the drafting of the final report, together with the other three Presidents. And I am looking forward to discussing this important matter further with you at our meeting in June.