STRENGTHENING THE EMU

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Towards a new-old paradigm of EU economic policy

Since the global financial crisis, economic growth in the EU has lagged behind the US and other global competitors. This persistent slow growth has been compounded by unanticipated shocks that have tested the EU's economic resilience. The COVID-19 pandemic and Russia's invasion of Ukraine have required significant responses to support economies and improve resilience. The EU faces formidable long-term challenges related to aging population as well as the need to digitalize and decarbonize its economy. At the same time, the negative impact from Russia's war against Ukraine and conflicts globally weaken economic growth and threaten to fragment the global economy. Challenges are further compounded by the US and China adopting protectionist measures to reduce critical dependencies and strengthen their strategic advantage in green technologies and digital capabilities.

In response to these challenges, the EU has introduced a new policy approach, which includes the creation of new financing instruments, relaxation of state-aid rules and introduction of new tariffs on imported goods. More recently, there have been calls for new EU-level industrial policies to tackle the challenges.

The reactionary approach to the polycrisis with increased protectionism and active industrial policy can drive EU off its course economically and politically. Instead, chosen policy tools should tackle Europe's key challenge of growing productivity gap with respect of other large economies. EU needs the most effective technological solutions to solve the challenges of decarbonization and digitalization under decreasing labor force. For the Single Market to work, the traditional EU economic policy paradigm of limiting state's role and allowing market forces to drive economic activities should be allowed to prevail. However, at the same time there is a need to contain EU's largest handicap: its tendency to over regulate.

At the moment Europe is lacking investments in high tech R&D. The relaxation of state-aid rules is an expensive and potentially fragmenting policy decision. It can adversely affect resource allocation and, consequently, productivity. Instead of subsidizing large incumbent companies, EU should encourage competition through re-levelling the playing field to allow growth oriented small and medium size companies to challenge the traditional players.

Furthermore, it is crucial to keep the Capital Markets Union on a right track. It should not be distorted by making it part of active industrial policy. Deeper capital markets would help retain the EU's most productive and fastest-growing firms and enable them to scale up into global companies, thereby driving the frontier of productivity forward.

State-intervention may be in some cases necessary. However, as a general principle, industrial policies should be limited to correcting evident market failures. This is because even well-intended policies can end up being poorly designed, often due to excessive political compromises. Uncertainty about the type of policies and their economic effects can deter firms from investing. As regards the role of EU public funds, they should be targeted to finance true EU public goods such as infrastructure that benefits all Member States.

Preserving the four freedoms as cornerstones of the Single Market is even more relevant now than before.

It is clear that the increasing trend towards protectionism as well as risks from geoeconomic fragmentation and geopolitical conflicts cannot be overlooked. Europe needs to be able to defend itself against aggressors irrespective of the nature of the threat. However, bringing back tariffs on wide set foreign goods in the name of economic security are likely to be reciprocated with similar levies on European exports, reducing benefits from economies of scale and comparative advantage. Instead of turning to protectionism under the pretense of economic security the EU should continue to support an open and rule-based system of trade and use this as an opportunity to build new trade partnerships.

To conclude, addressing the challenges facing the EU does not require a new policy strategy. Instead, we should continue to deepen the Single Market, refraining from policies that restrict competition and limit international trade. This approach is crucial for fostering prosperity and promoting overall well-being.

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A pragmatic approach to strengthening the EMU

Strengthening the Economic and Monetary Union is a universally accepted policy priority. Policymakers tend to agree that it is essential for enhancing Europe's competitiveness, boosting productivity growth, and improving the resilience of our economies.

However, while everyone seems to agree on the direction of travel, there is a divergence in views on what is the final destination of this journey.

In this context, we need to be pragmatic when considering the priorities for EMU deepening over the next 5 years. We should avoid delving into proposals that are not at this point viable given political differences and focus on areas where actual progress is possible. I see 3 key areas going forward.

First, it is critical to capitalize on the political momentum to advance the Capital Markets Union. Lack of substantive progress thus far has harmed EU competitiveness and growth potential, as EU capital markets remain fragmented along national borders.

We need a better and more efficient single capital market to ensure that European savings are used to finance the EU economy, particularly SMEs, start-ups, and growth companies. For instance, just in Lithuania, households hold 22 bn euros in savings, which constitutes financial firepower of ~30% of the country's GDP that could be directed to productive uses. To achieve this, we need attractive saving and investment instruments, as well as enhanced financial literacy among companies and individuals.

The CMU project should be a top priority for the next Commission and the cornerstone of a broader EU competitiveness agenda. We need decisive steps that would lead to a tangible impact on the real economy, particularly when it comes to structural issues like the convergence of national insolvency frameworks and supervisory practices. The Eurogroup March statement on the future of the CMU should serve as a blueprint for the next Commission's work agenda.

Moreover, we need to move towards the completion of the Banking Union. While the creation of the third pillar – EDIS – remains a politically challenging step to make, it is essential to overcome our redlines to reach an agreement, as an incomplete BU harms the functioning of the Single Market and may expose financial stability risks in times of stress.

Second, we must focus on enhancing the scope of the MFF as the main fiscal instrument of the EU. The Commission will table a new MFF proposal for 2028-2034 in July next year, which will kick-start the negotiation process.

The EU budget must have increased capacity to address common strategic challenges. We should admit that the current size of the EU budget (~1% of GNI) is insufficient.

A more ambitious approach is needed to ensure sufficient investment in strategic EU objectives, such as boosting defence capacities, enhancing competitiveness, and implementing the green transition. On top, we must ensure sufficient assistance for Ukraine, while preparing for future EU enlargement.

The EU budget, together with the EIB, should play a catalytic role in mobilising private financing as investment needs are far too high to be covered just by public funds.

The next MFF must have increased capacity to address strategic challenges.

Third, it is important to effectively implement the new economic governance framework, which has built-in incentives to foster much needed supply-side reforms.

Countries are already working on their fiscal-structural plans (FSPs), with some likely to request an extension of the adjustment period which will come along with the structural reform agenda. In this regard, it is crucial to kick-off the implementation of the new framework with credible and ambitious reform commitments that would boost growth potential and ensure fiscal sustainability in the long run.

While ownership is expected to be the primary motivation to follow the new framework, the Commission's role will be crucial in ensuring that the rules are fairly and equally enforced on all the countries. Moreover, annual monitoring will be equally important to ensure that reforms and fiscal targets stay on track. The Commission must be resolute in cases of noncompliance and should actively seek corrective actions employing all measures at its disposal.

In conclusion, the EU is in a situation where global economic and security challenges call for swift action, with the EMU at the forefront of policy priorities. The key goal moving forward is to ensure that structural conditions (completed CMU and BU) and sufficient EU financial resources (enhanced MFF, EIB) are in place to address these challenges in a fiscally sustainable manner.

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Enhancing the financial sector's contribution to EU strategic objectives

The EU is at a juncture and the Letta report is the latest call to action to improve its competitiveness in an increasingly challenging geopolitical and economic context, underscoring the urgency for a collective response. The investment needs are significant: ECB estimates point to an additional 5,4 trillion euros in 2025-2031 to address the twin transitions and strengthen military defense.

Public expenditure must play a significant role in spearheading the necessary investment and transformation, both at EU level, with the Resilience and Recovery Facility as a successful example, and at national level, but public resources alone will not suffice, as fiscal space remains limited. Mobilizing private capital, including through public and private risk sharing mechanisms, remains key. We need a collective effort for both banks and capital markets to play their part to ensure European companies can access the necessary funds throughout their different stages of development. We need more liquid and profound capital markets as well as strongly capitalized and active cross-border players providing credit across the EU for our entrepreneurs to be able to implement their projects and companies to grow and compete globally. The Banking Union (BU) and the Capital Markets Union (CMU) are mutually reinforcing projects to this end, but progress remains limited.

We need concrete steps for a financial union supporting EU competitiveness and strategic autonomy.

Banks play a pivotal role in intermediating financing in the EU, but the reality is that their focus remains national. Despite significant progress with the Single Supervisory Mechanism and the Single Resolution Mechanism, an incomplete BU limits the benefits of cross-border shock absorption. The new legislative cycle brings an opportunity to improve the crisis management framework, including through better access to common safety nets. to ensure sufficient funding in resolution, based on internal loss-absorption as a first line of defence but also on an efficient use of industry funds when needed, avoiding financial spillovers in case of bank crises and protecting the taxpayer. However, the current focus on national safety nets creates a risk of financial fragmentation and generates an unlevel playing field that undermines our internal market and limits private risk sharing across the EU. Ensuring that costs are borne at the same level at which supervisory and resolution decisions are taken is one of the many issues that must be addressed to achieve a more complete BU.

At the same time, access to more diversified and profound capital markets is crucial to financing investment opportunities in the EU. As the Letta and Noyer reports point out, the problem is not a lack of savings in Europe, since paradoxically European savings are funding the development of companies in other regions. What is key is to channel these savings to European companies, through the development of the CMU. And achieving this requires political determination to implement the package of measures reflected in the roadmap agreed at the Eurogroup and which, individually, one by one, may not appear to make a difference but, taken together, have significant potential of transformation. We must create attractive investment opportunities for savers, support companies' growth and set up an efficient supervisory architecture. And we must do so through concrete actions. Designing a European financial product able to mobilize European savings to companies and common investment priorities, streamlining and simplifying procedures for SMEs and accompanying them in the path to becoming listed companies through successful experiences such as the pre-market initiative put in place by BME in Spain, and undertaking the case by case analysis that can serve as the basis for providing stronger powers for European Supervisory Authorities for sectors and actors with systemic importance and cross-border activity are only some examples of effective steps to take. The EU also has many success stories in the use of public funds to leverage and channel private funds towards common priorities. The EIB in particular has a long-standing track record of crowding-in private investment through key experiences, such as the European Tech Champions Initiative to deepen Europe's scale-up venture capital markets, which have inspired in Spain the recent set-up of the Regional Resilience Fund, a fund of funds which is a critical part of the Spanish RRP and which should continue to inspire new initiatives at EU level.

The Commission and we, Member States, must move forward decisively on these concrete policy initiatives in the new cycle to enable our banks and capital markets to contribute effectively to the EU competitiveness and strategic autonomy.