A Union of opportunity, empowerment and protection

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Content:

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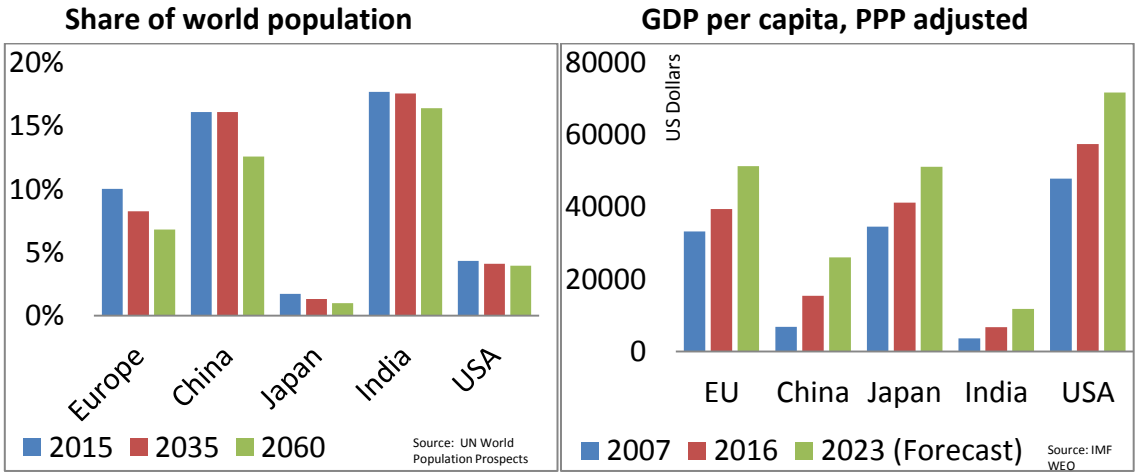
I. Scrolling back - the big picture

This section provides a back mirror view on the economic and political issues that have marked the last 10-20 years. Some of these were expected, for example that the economic interaction at a global scale - supported by new technologies, financial integration and trade liberalisation - would continue to intensify. At the same time, looking from the perspective of today, some of the negative repercussions were not grasped, notably that the forces of "globalisation" in the broad sense opened up growing economic and political divides both in Europe and at the global arena.

Over the last decade, the EU has held up well its strong role in the international economy, weathering major global shifts. Against the backdrop of (i) the rise of the BRICS, in particular China, over the past three decades, (ii) the impact of technological change greatly enhancing interconnectivity and (iii) its internal crisis in the euro area following the great recession, Europe is still an important player in the world economy. Although small in population, the EU remains rich per capita, with an open market, competitive firms, investment-friendly environment and a stable currency. The EU has negotiated comprehensive trade deals with important partners and the Single Market with its 500 million people is the most highly integrated economic area in the world and a major destination for foreign investment. Europeans enjoy overall standards of living that are among the highest in the world with prosperity broadly shared among its people as inequality, albeit higher than 30 years ago, is still relatively low by international standards.

Figure 1: The economic weight of the EU - small in population, but rich per capita



Despite this positive picture, the benign view of the benefits of globalisation has underestimated some related side effects. "Globalisation" as a catch-all for increasing trade, global supply chains, financial integration and capital market liberalisation has been economically beneficial. At the same time, one must acknowledge that globalisation critics do have a point. Concerns about the negative impact on inequality and claims that it adversely affects fundamental socio-political values, such as national identity and

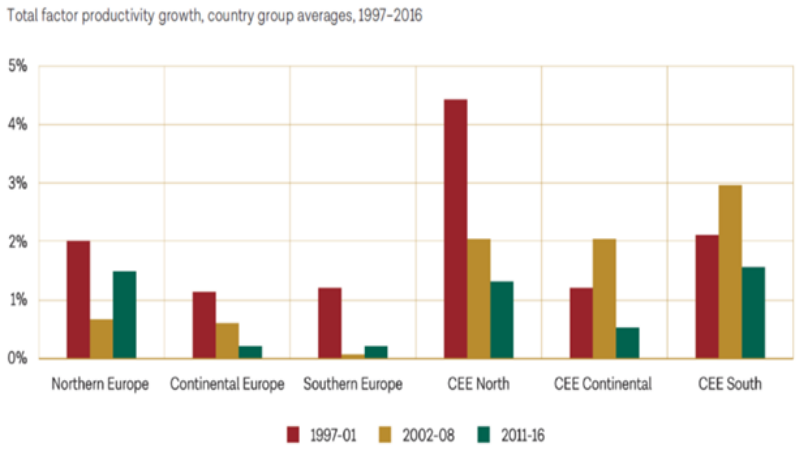
sovereignty, should not be too easily dismissed. Indeed, the post-1990 wave of globalisation and market integration has differed in many respects from previous episodes. First, it extended well beyond the traditional spheres of trade in goods to services, in particular unbridled liberalisation in finance, and to harmonisation of regulations behind the border such as investment rules, product standards, patents and copyrights etc. Secondly, it strongly interacted with skill-biased technological progress raising interconnectivity, thereby supporting off-shoring, relocation and outsourcing of economic activity and the build-up of integrated value-added chains. Thirdly, dynamic agglomeration and network effects have accentuated the spatial divide in the location of economic activities, with laggard regions increasingly at risk of falling in stagnation traps. And, obviously, the emergence of the BRIICS, in particular China, has been a game-changer in the world economy. Increased trade has been a by-product of these developments, but the main defining features have been financial globalisation and the creation of flexible mobile international production networks configured according to international cost arbitrage, including taxation and other aspects of national regulatory autonomy.

In consequence, the balance of gains and pains from globalisation in the advanced economies has undergone significant shifts. The gains have been strongly tilted to the multi-national firms, international finance and skilled labour. The positive pay-offs for mobile factors and high skilled has enhanced dynamic agglomeration effects, but increased regional and income disparities, resulting in the convergence process slowing and a stagnation in median income due to "winner-takes-it all" dynamics. Increased competitive pressures have resulted in higher market flexibility, but at the same time have led to incidents of negatively affecting fair working conditions in the market. An often uncritical view of downhill capital flows nourished the liberalisation of capital movements, resulting in large flows to emerging markets and the euro area periphery, while leaving before the crisis the systemic risk from unbridled financial markets unaddressed. These evolutions have introduced new fault lines in the economic and political order, with a perceived and real loss of control vis-à-vis big business and the financial sector. At local and even national level, exercising enforcement and discriminatory power has become more difficult and has limited the room for re-distributional manoeuvre. Reinforced by the legacies of the economic and financial crisis and the migration challenges, a decades-long process where national economies became more and more entangled and interdependent at both the international and regional level faces increasing strains. An integration process that has been the bedrock of a half-century of peace and economic development can no longer be taken for granted.

European economic integration has resembled many features of a "globalisation at the regional level". The fall of the iron curtain triggered two main developments: (i) the sharing of monetary sovereignty and creation of the euro; (ii) the enlargement of the EU towards Central and Eastern Europe. The cheerleaders' view was that it would bring Europe closer together – economically and politically. Economically, it has held true to some extent, but in the euro area, hopes for an endogenous move closer to an optimal currency area have not

been fulfilled. Allocation and agglomeration effects have resulted in structural divergences and imbalances rooted in traditional national preferences. When the global financial crisis exposed underlying imbalances and design gaps in the construction of EMU, the ensuing crisis extorted a heavy toll of political, economic and social costs. At the same time, the possible political tensions and dividing lines have been underestimated or treated with benign neglect, leading to a loss of trust between Member States (North-South creditor/debtor divide) and vis-à-vis the EU institutions.

Figure 2: Enlargement – the great convergence machine



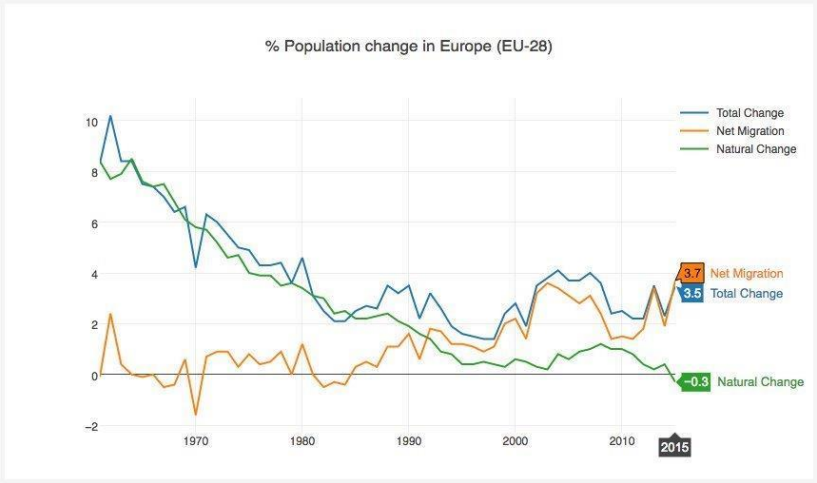
Source: Based on data from the AMECO database of the European Commission.

The enlargement of the EU towards Central and Eastern Europe has been the second defining element of European political and economic integration over the past decades. In an economic sense, the EU has indeed worked well as "a great convergence machine", with enlargement triggering substantial productivity gains in Central and Eastern Europe and income convergence of the poorer new Member States closer towards EU average levels. The rapid integration process of economies with fairly different income levels has been significant, extending into tensions related to labour mobility and the hotly debated deficiencies in governance and unfinished institution-building. Together with the transfer of national autonomy and decision rights to EU institutions, nationalist-identity driven sentiments have been fuelled in both some "new" and "old" Member States, opening up an East-West political divide.

Migration and the influx of refugees and asylum-seekers have been economically manageable, while the political impact has been deep. Net immigration has become more important for population change than the natural change. While in the past immigration was primarily driven by economic motives and family reunification, in the last few years Europe has experienced a surge of asylum seekers, in particular from war-torn countries. In addition, some EU countries have seen significant inflows of EU citizens taking advantage of their freedom of movement rights, while emigration away from Central and Eastern Europe has created labour shortages and affected its demographics. With the difficulties to manage

these developments at the domestic and European level, this has strengthened populist movements and propelled migration flows into the most divisive policy topics in today's Europe, confirming for many a view of centrist elites detached from the concerns of ordinary citizens. Thus, under the catchy slogan of "taking back control" a powerful narrative against further deepening of integration has developed. The most visible marker has been the decision by the UK to leave the EU and for the first time in the history of the EU the integration process has gone in reverse with a Member State leaving the Union.

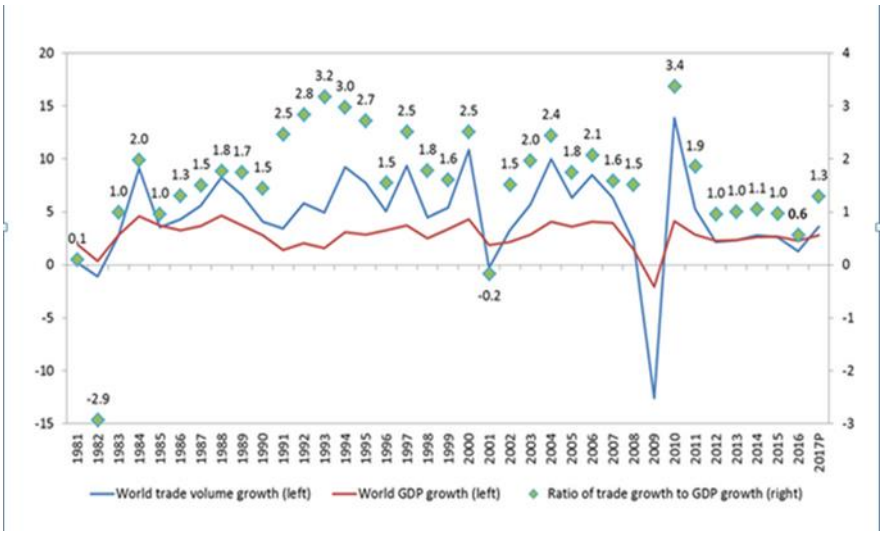
Figure 3: Composition of population change



Source: Eurostat

Frictions have appeared also at the global level where the multilateral rules-based order that the EU has contributed to create since the end of the II World War is increasingly fragmented. Multilateralism should be seen as a tool to deliver global public goods and internalise spillovers. In the aftermath of 2008, the concerted actions of the G20 members to stimulate their economies and refrain from protectionist measures were crucial to avoid another Great Depression. The global economy returned to positive growth already in 2010. However, since 2010 economic conditions became increasingly divergent and governments had different readings of the challenges ahead and of the policies to adopt, which led to a suboptimal global policy mix. As a consequence, after 2010 global growth and trade expansion remained constantly below pre-crisis trends. From 2011 to 2015 the value of international trade grew less than 2 per cent per year, a rate considerably lower than its long-term trend. Trade growth in 2017 became robust again, but recent trade tensions means that trade growth now depends on policy choices, especially by the US. Moreover, considerable external imbalances have appeared at the global level, with advanced economies and emerging economies having swapped place. Emerging countries now have, on aggregate, current account deficits. Large current account imbalances can be found among advanced economies, with on one side the large Euro area surplus with and on the other side a persistent US current account deficit. These developments imply fragilities for emerging economies and rising trade tensions between advanced countries.

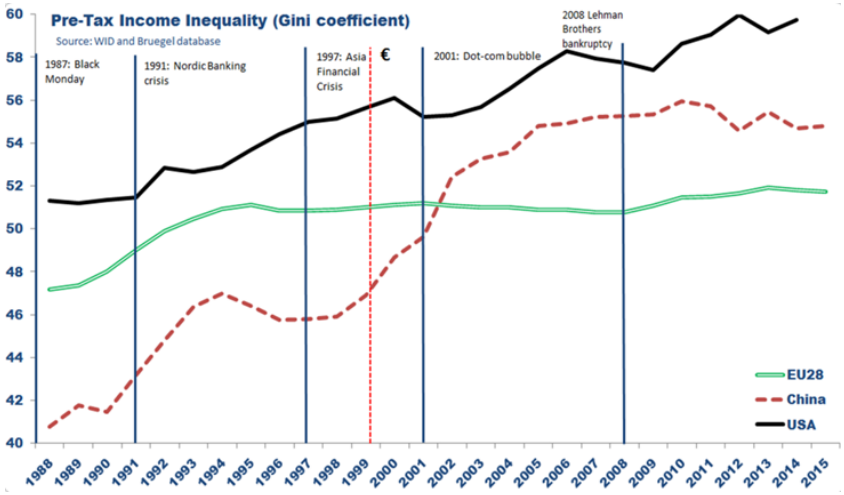
Figure 4: World Merchandise Trade



Source: WTO Secretariat for trade, consensus estimates for GDP

At the global arena, the economic and financial crisis led to institutional, financial and social fragmentation. In the years that followed the crisis, a multiplication of institutions with overlapping mandates and no clear roadmap for cooperation have been observed. For example, new Multilateral Development Banks were created in Asia (the Asia Infrastructure Investments Bank) and by the BRICS countries (New Development Bank). Regional Financing Arrangements became more prominent in solving crisis situations alongside the IMF. The international financial system witnessed sings of financial fragmentation as cross-border banks claims fell. This process was more pronounced in Europe than elsewhere with a significant reduction of cross-border financial flows after the crisis in the Euro area. This fragmentation has now been reversed in terms of prices (bond yields) but not yet in terms of quantities (capital flows). Intra-Euro area financial flows instead decreased considerably after the crisis and the trend has not yet fully reversed, in spite of the ongoing economic recovery. Under President Trump, the US has been hardening its positions and shown signs of disengagement in the G7, G20 and the WTO. The UN Paris Agreement on Climate Change has been abandoned by the US President, who also have stepped up protectionist trade measures that do not tackle the root causes of the market distortions. The increase in income inequality at global level points to what some call global social fragmentation, but hides important differences across countries. In emerging economies inequalities are higher but they have slowly been reduced over the past 30 years. Conversely, in advanced EU economies and the US have seen income inequality increasing.

Figure 5: Income inequality



Source: World Income Database and Bruegel Database

In summary, twenty years into the existence of the Euro, three decades after the fall of the iron curtain, and with a six decades long perspective on the Treaty of Rome, the EU has achieved an unprecedented degree of political and economic integration establishing an area of peace and prosperity for its citizens. From a bird-eyes' perspective, the EU came together in a Europe broken beyond description by war; and despite its fair share of set-backs and shortcomings, it has shaped the continent, contributing to more human flourishing, and more social care than at any time in European history. With its institutions that enable Europeans to work together and understand both its differences and its communalities, the EU should be well-equipped to live up to the challenges ahead in a positive manner. However, at present the EU is facing a strong undercurrent opposing further integration, even introducing creeping disintegration, and a growing inclination towards zero-sum policies which run the risk of self-fulfilling outcomes, economic stagnation and, perhaps most importantly, the erosion of liberal democracy. It will require the joint efforts and political determination of all those who desire an open, liberal, and inclusive order to shape a Europe taking the high road into the future.

II. Big trends - charting the future challenges

This section looks ahead towards 2025, distilling what appear to be the defining challenges ahead. It presents the cyclical and structural medium-term growth outlook in three different scenarios. Against that background, an EU economic policy perspective for the next five years is provided, looking for its raison d'être: "what is the Union for?" In terms of economic policy priorities, charting a way forward along three dimensions will determine the EU's ability to support the resilience of its economy and the convergence in living standards: i) growth and productivity, ii) deeper EMU and iii) a Union that provides opportunities, empowers and protects.

II.1 The defining challenges ahead

The medium-term structural challenges for our societies - already visible before the crisis - have not gone away. Now that the urgency of the wake of the crisis is gone, it is time to prepare for medium-term challenges, both those that are a continuation of on-going shifts in the interconnected world economy and new shifts that the next decade is likely to have in store for us in terms of technological, societal, geo-economic and demographic developments. The challenges are numerous. External and internal security is clearly essential for overall peace and stability, representing a common public good for Europe's citizens. Preserving a rules-based international economic order is of paramount importance, also to deal with the fundamental challenges of climate change and migration at the only level they can be effectively addressed. Macroeconomic stability is an obvious precondition for sustainable growth, safeguarding against the risk of systemic crises by sound policies and stabilisation instruments that are compatible with long-term sustainability. Achieving a more inclusive pattern of growth by better matching efficiency with fairness is indispensable as well, because the growth process cannot enjoy sustained democratic support if its benefits – including those arising from rapid technological progress - are reaped by a privileged few or excessively unequally distributed, including from an intergenerational perspective. In the same vein, EU's internal convergence in living standards and regional cohesion need to be reignited to address the undercurrent of slow-burning disintegration.

It is more than likely that the coming years will witness multiple risks of fragmentation of the international economic order. The international economic governance is increasingly fractioned, marked by the gradual disengagement of the US turning into a case-by-case disruptor on the back of rising trade protectionism, climate change negation, backtracking on financial regulation and isolationist policy choices. On the other hand new global players are emerging. An increasingly knowledge-powered China is rapidly moving up the value-added scale but without a clear commitment to a liberal and rules-based order. Emerging economies are rising fast and could become important EU allies in the future. New institutions such as multilateral development banks and the emergence of stronger regional financing arrangements are entering the centre of the global stage. For all of these reasons, preserving status quo in the international global order is not in the cards and an evolution of the international geometry in the years to come seems inevitable in the search for a way to

re-anchor global stability. A multilateral, rules-based system is a public good and simply putting international cooperation in reverse would imply to forego its beneficial sides and enter into dangerous zero-sum terrain. Common economic policy challenges remain, such as demographics and migration, climate change, the protracted slowdown of productivity in advanced economies and widening inequalities that nourish disenchantment with the international division of labour. While these challenges have deep economic implications, they intersect strongly with identitarian concerns and populist forces, making it harder to provide the answers with traditional economic policy steps.

The effectiveness of the international order will also determine how the fundamental challenge of climate change, pollution and environmental degradation is tackled. The impact of man-made climate change is very fundamental and affects the basis of our life and economy. Research on future scenarios predict climate change will have a dramatic effect with knock-on effects for many communities and sectors that depend on natural resources, including agriculture, fisheries, energy, tourism and water, and could lead to climate-change induced migratory pressures. Addressing climate change and environmental degradation will be pressing work to be done internationally and at home. Fighting climate change requires action from all countries across the world. Transition to a low-carbon society is feasible, but requires innovation and investments. To make the transition, the EU would need to invest an additional €270 billion (or on average 1.5% of its GDP annually) over the next 4 decades, but derived benefits for Europe's economy would accrue thanks to the development of clean technologies and low- or zero-carbon energy, spurring growth and jobs. It will make the EU less dependent on expensive imports of oil and gas, and it will bring other benefits, e.g. to health through reduced air pollution and to the drag on scarce resources like energy, raw materials, land and water.

Managing migration flows from outside the EU and the economic and societal integration of people with diverse backgrounds is likely to remain a major challenge. The economic policy strategy at national and EU level should face up to the challenges that continued migration flows are likely to pose. The short-term economic and fiscal impacts of migration are not unmanageable. However, the strategic challenge lies elsewhere. Migration flows are likely to pose longer-term challenges to labour market policies and social and education systems. Public finances will be in the receiving end: putting in place policies that lead to labour market integration will determine the impact on the long-term sustainability of public finances. Moreover, poisonous dynamics have eaten into the political trust among Member States and imply a tangible risk of a gradual disintegration of Schengen, which in economic terms is a cornerstone of the internal market. And arguably, better managing migration will be a prerequisite for the necessary political consensus and citizens' acceptance of carrying forward difficult reforms that are needed to modernise our economies.

Europe will need to nurture the development and diffusion of new technologies in an inclusive manner. The important task for Europe, as for all advanced economies, is to create useful new ideas and innovation. Achieving this will require not just a flourishing environment for bright people, but also well-designed property rights and government support for fundamental science and breakthrough technologies. They will reshape the way we live and, in particular, the way we work. Indeed, developed countries may be on the verge of very disruptive technological change. Robotics and machine learning have improved productivity and Artificial Intelligence is advancing into finance, transportation, defence, and energy management. The Internet of Things is facilitated by high-speed networks and remote sensors to connect people and businesses. In all of this, there is a possibility of a new era that could improve the lives of many people.

Yet amid these promises, rapidly changing technology will impact on the world of work with increasing participation challenges, stemming from risks of skill-biased technological change and a widening digital-robotic divide. Further increasing varieties of work and life careers offer clear upsides for the individual and society, yet more choices may perhaps come at the price of further rising vulnerabilities and putting strains on established welfare systems. Researchers at the OECD focused on “tasks” as opposed to “jobs” and estimated that 14 percent of jobs are highly automatable and another 32 have a significant risk of automation. Although these job loss estimates are below those of other experts, the OECD concluded that “low qualified workers are likely to bear the brunt of the adjustment costs as the automatibility of their jobs is higher compared to highly qualified workers". While some dispute the dire predictions on grounds new positions will be created to offset the job losses, the risk of significant workforce disruptions should be taken seriously. This includes the risk of job polarisation, where technology could lead to rising demand in well-paid skilled jobs, which typically require non-routine cognitive skills, and rising demand in low-paid least-skilled jobs. At the same time, demand for ‘middling’ jobs, which have typically required routine manual and cognitive skills, may fall. This 'hollowing out' of typical middle-class jobs could narrow the basis for financing the welfare state.

To reignite a sustained convergence of economic and social performances across EU Member States calls for investing in people and ideas as a key element to achieve a more inclusive pattern of growth. This requires structural reforms to modernise our economies, break the trend of a protracted decline in productivity and make them more resilient. Numerous reforms have been carried through to boost long-term growth and job creation and to protect our citizens and businesses against new economic setbacks. In the light of demographic and technological change, the agenda is both well diagnosed and unfinished. A proper structural reform agenda includes paying attention to the social impact of reforms. This will be no less demanding in the years ahead, since the welfare state is set to remain under pressure. Reforms so far are not sufficient to ensure the sustainability of health care and pension systems in view of the impact of demographic ageing and in a number of Member States, earlier reforms are called into question. Sharing the benefits of growth is at

the heart of Europe's economic model, and a stronger capacity to grow should goes hand-in-hand with a Europe that provides opportunity and protects by investing in people and ideas and adapting markets and institutions in a way that secures inclusive growth. Promoting growth-enhancing structural reforms remains a major priority. There is a continued need to facilitate high quality investment in physical and human capital. Investment should be supported, also by improving the business environment, strengthening the quality of public administration, addressing sector-specific bottlenecks (e.g. in relation to financing) and address obstacles specific to investment in intangible assets. But the role of the state in how it funds investment should also be rethought. The dominant model of private sector ingenuity funded through market mechanisms – with the help of subsidies where deemed desirable – neglects the important benefit that a new long-term industrial policy can yield in terms of creating lasting conditions for the development of strong innovative industries and products. A long-term perspective with active state participation will also mean benefits as well as costs coming back to the public sector, and social issues replacing short-term economic benefit as a critical decider in what is funded. In parallel, the developing the capacity to grow means fostering investment in human capital and ideas, prioritising education and training, fostering innovation systems, strengthening activation and inclusion policies and rethinking tax-benefit systems. Future technological progress underscores the need for determined policy action in time, both to equip the younger cohorts to take advantage of new opportunities and to mitigate the risks of a stronger stratification along social and demographic characteristics.

II.2 Bright for now, but not forever – the economic outlook towards 2025

II.2.1 Current situation and assumptions

This section sets the scene for the cyclical and structural growth outlook over the coming five years. It also clarifies the assumptions for the subsequent discussion of some scenarios.

In mid-2018, the euro area and EU economies are in a rather solid expansion, even though its pace has slowed down a bit. Fundamentals for continued growth in Europe are robust. Investment benefits from well-filled order books, high capacity utilisation and low financing costs. Consumption is expected to remain underpinned by the good labour-market performance and an expected acceleration of wages. These elements motivate the baseline of the spring forecast.

The double-dip recession has not had a permanent negative impact on the economy (hysteresis), even though some crisis legacies continue to linger. Fairly strong employment growth and a fast reduction of unemployment have been distinguishing features of the recovery that started in 2013, contrasting with recoveries from earlier recessions. The labour force participation rate has increased by 2 percentage points between 2008 and 2017, to 73%. The NAWRU (non-accelerating wages rate of unemployment, a measure of the unemployment rate that can be sustained without inflationary pressures) is now lower than before the crisis, reflecting substantial labour market reforms. By 2018, labour markets

have become increasingly tight in a number of Member States. However, there are also still indications of crisis legacies, e.g. the elevated number of workers who are involuntarily on part-time, the ongoing deleveraging and high level of non-performing loans in some Member States. It has also taken long for investment, which dropped very sharply during the crisis, to recover roughly to the share of GDP that prevailed in the early 2000s.

The output gap is now closed. DG ECFIN's estimations of potential GDP indicate a closure of the output gap in the euro area and the EU in 2017-18. Other international forecasters (Eurosystem, IMF, OECD) come to similar results. The uncertainty surrounding real-time estimates of the output gap is large and well documented. However, high capacity utilisation rates and indications of tightening labour markets appear to underpin the output-gap assessment. The remaining underemployment indicates just enough slack for the economy to continue growing at rates above potential for some more quarters (including all of 2019 according to the spring forecast).

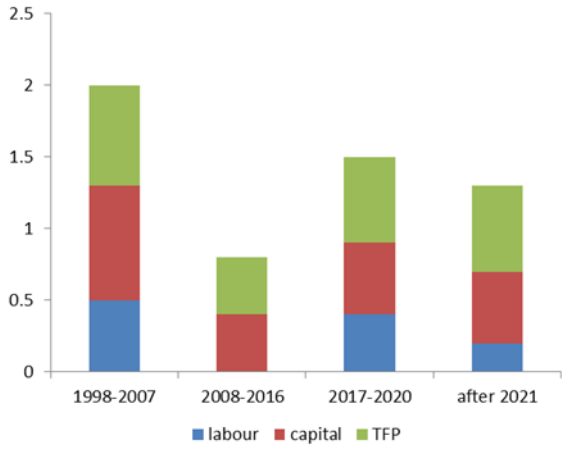
A cyclical downturn before the end of the next Commission's mandate is very likely. Downturns are hard to forecast. Looking at past experience, in the five economic expansion phases in the euro area since 1970, following the closure of the output gap GDP continued to grow above potential for another 3-4 years and then dropped. However, economic expansions do not simply die of old age. Downturns usually have identifiable triggers such as the bursting of asset price bubbles, (too) strong monetary tightening or external shocks (e.g. on oil prices)**.** Within the euro area, the risk of credit-fuelled asset-price bubbles or overheating forcing the ECB to a sharp tightening seems still far off. However, an overheating US economy boosted by pro-cyclical fiscal policy might push global benchmark interest rates sharply higher in the coming years and thereby end the expansion also in the euro area (see scenario 1 below).

Also shocks stemming e.g. from geopolitical risks, commodity prices or policy mistakes in the EU or outside could trigger a downturn. Maintaining macroeconomic stability in the wake of high uncertainty and new risks is an obvious precondition for inclusive growth, safeguarding against the risk of systemic crises. While the global economy is enjoying a broad-based recovery, significant downsize risks loom over the medium-term horizon. Asset prices have been buoyant on the back of unprecedented monetary accommodation by advanced-economy central banks. US stock prices are at an all-time high. Investor risk appetite has grown markedly in recent years, with an intensified 'search-for-yield' going hand in hand with high financial assets flows back to emerging markets and overall financial volatility close to an all-time low. This implies a risk of "too-good to be true" economics, which via sizeable financial market spill-overs potential can trigger tighter global financial conditions, turmoil in emerging markets, feed protectionism or interact with non-economic factors such as geopolitical tensions. The occurrence of these risks at a time of high uncertainty is non-negligible. More difficult to predict and guard against are tail risks, which could materialise. As potential unknown unknowns, such "black swan" events do usually not feature in risk assessments but could be very disruptive to advanced economies. By nature,

tail risks have a very low likelihood of occurrence but possible high impact. Besides economic risk factors such as disorderly defaults and asset price collapses, there is a wide range of non-economic tail risks such as political (e.g. trade war), geopolitical (e.g. military conflict in the EU neighbourhood) and technological incidents (e.g. cybersecurity) that would have the potential to instil macroeconomic instability.

Structural growth prospects for the medium term have improved somewhat. Potential GDP growth has recovered somewhat after dropping sharply in the crisis. From 2% on average in the pre-crisis period (to some extent reflecting overinvestment), potential growth fell to 0.3% in 2012 in the euro area. It is estimated at 1.5% for the period from 2018 to 2020 and set to decline to roughly 1.3% in 2021 and 2022. Productivity growth has been on a decreasing trend already before the crisis and has dropped further during the recession. It is set to recover somewhat. However, demographic ageing is putting a cap on potential growth going forward. In addition to these cyclical and structural features, an assessment of the economic outlook for the next six years needs to take into account the state-of-play with respect to macroeconomic imbalances, resilience and political as well as socio-economic forces.

Figure 6: Potential GDP growth and contributions, euro area



Source: AMECO

Macroeconomic imbalances in the EU have been reduced, and there is still limited evidence of overheating; but debt remains too high for comfort. As compared with the pre-crisis period, the current economic expansion does not coincide with widening current account deficits in economies with higher growth rates. This bodes well for the durability of the growth momentum, as there is relatively little risk that the ongoing growth spurts are grounded in foreign borrowing based on excessively optimistic expectations about future growth. Although some pockets of possible overheating in house prices are visible especially in the Baltics, Ireland, a number of Nordic and Eastern Member States, the dynamics of household debt are relatively contained, and the credit cycle appears to lag that of house prices, which in a number of countries are recovering from possibly undervalued levels following the post-crisis adjustment. Resuming nominal growth is helping deleveraging,

which is accelerating and currently taking place in most countries, for what concerns private, government and foreign debt. Yet, debt levels remain above those that were generally observed in the pre-crisis period. This is a vulnerability that makes the economy less resilient to shocks, since the room for absorbing negative income shocks via savings is reduced, as is the space available to fiscal authorities to run counter-cyclical policies in bad times. The transition from an incomplete and fragile recovery to a more robust expansion has been achieved only recently. There has not been much time so far to recover macroeconomic policy space.

Monetary policy is constrained by the 'zero lower bound' on interest rates and technical limits to QE. After years of highly accommodative monetary policy, a number of technical constraints (e.g. issuer limits on asset purchases) or adverse effects (e.g. much lower negative interest rates may become counterproductive) may limit the space for further monetary stimulus. Furthermore, policy space will likely be re-built only very gradually. ECB policy rates are probably rather close to their effective lower bound and unlikely to increase rapidly in the next few years given the subdued outlook for inflation. The market-implied policy rate is expected to be only about 100bps higher in 5 years' time. This is considerably less than the increases observed during the previous two tightening cycles. In fact, estimates of the natural rate of interest have decreased (amid high uncertainty) since the start of the crisis and are only picking up slowly leaving less room for cutting rates even once they will have reached their equilibrium level. As to QE, net asset purchases under the current programme are anticipated to end in December 2018. Significant net asset purchases beyond this date would require substantial adjustments to the parameters of the existing programmes since in particular further public sector purchases would in most jurisdictions (including Germany) be hindered by the accumulated stock of securities already being at or close to the 33% issuer limit. Sizeable space in terms of sovereign bond purchases may likely take up to 10 years to be rebuilt (also depending on the length of the reinvestment period). The ECB would retain some unconventional policy space related to purchases of private sector assets, the provision of long-term funding to banks (LTRO/TLTRO) and forward guidance on policy rates. Further (but limited) cuts of the deposit facility rates may also be technically feasible given that the current negative rate of -0.40% has not led to an increased demand for cash and a deterioration in the banking sector profitability. However, the available monetary space is likely to remain considerably more limited than on the eves of the global and euro area crises.

Fiscal policy space is very unevenly distributed and limited in several countries by high or very high public debt, in the absence of a central stabilisation function. High debt has adverse effects on GDP growth per se and reduces the leeway for dealing with negative demand shocks. There is some progress at the aggregate level. The debt-to-GDP ratio in the euro area has fallen from above 94% in 2014 to 89% in 2017 and is projected to decrease further. At the same time, this picture reflects favourable macroeconomic conditions, such as firm economic growth for around four years now in a context of historically low interest

rates, rather than underlying fiscal adjustment from Member States. However, the aggregate debt picture may be misleading. At present, fiscal space is unevenly distributed across Member States. By 2019, 12 EU Member States are expected to achieve their respective MTO, while a couple of countries, including some of the largest economies, will still fall short of their MTO by 2021 according their Stability and Convergence programmes. In short, some Member States that have no fiscal space are currently attempting to use it instead of restoring it for the next downturn; others that have fiscal space are unlikely to use it fully. The lack of fiscal space in some countries would limit the scope for accommodating policy action to counteract a possible cyclical turnaround, prompting them to add a fiscal consolidation shock to the initial macroeconomic shock. But this lack of fiscal space, especially if associated with high debt, may be a source of risk per se now, if markets start restricting the access of sovereigns to finance in a context of progressive roll-back of QE.

Despite improvements in recent years the architecture of EMU remains incomplete, and it is partly untested. The earlier a downturn sets in, the more these factors will constrain the policy leeway to react adequately to it. The absence of a centralised stabilisation function reduces the fiscal policy space available to a number of member states. This leads to increased risk associated with the current debt levels in the case of a macroeconomic shock. The introduction of such a function would open up the space for dealing with future shocks, particularly in the near future. On the banking side, banks have decisively built up capital buffers on the back of supervisory scrutiny and market pressure, while asset quality has been improved. However, the new EMU architecture is incomplete and also untested (e.g. BRRD and MREL) in the event of a large shock. The bank-sovereign nexus is still not tackled with banks' home bias very significant in a number of countries. The recent market reaction in Italy has highlighted that banks' asset prices and investor sentiment can be significantly and suddenly impacted by political uncertainty. If ill-timed and without sufficient calibration or transition periods, some reforms could add to vulnerabilities, e.g. concentration or capital charges on sovereign debt. The substantial growth of the less regulated shadow banking sector (such as exchange-traded funds) could expose the financial sector to sudden shocks with a lack of market liquidity (and e.g. algorithm trading and herding behaviour as further propagation factors).

The international and European political outlook has become more uncertain, and policy space appears reduced. For the sake of the present analysis, we stake out the political environment with a number of assumptions. Among the policy forces set to shape the next six years are the implementation of Brexit and the prevalence of inward-looking policies. (1) We assume that Brexit will be non-disruptive. It is set to have costs as the existing economic integration between the UK and the EU27 is partly unwound, but the process is assumed to be managed in a smooth way. (2) It is likely that at least one further Member State will adopt the euro within the mandate of the next Commission. (3) In light of economic, demographic and political trends in Europe's neighbourhood, we assume migration pressure

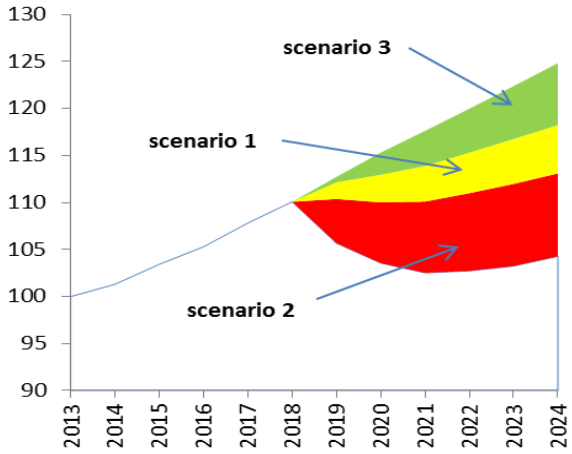
to remain constantly high. (4) We assume inward-looking and myopic ('populist') policies to maintain their attraction over the coming years in the EU and internationally. The domestic and short-term orientation of policies is assumed to weaken world trade, the multilateral structure of global economic governance as well as policy-makers' will and ability to invest political capital into cooperative solutions in the EU (e.g. on migration policy, EMU deepening, the MFF or even the implementation of the SGP).

II.2.2 An outlook for the next five years in three illustrative scenarios

This section discusses three scenarios for the growth outlook up to 2025. Macroeconomic forecasts for the medium term are very difficult. On the one hand, cyclical developments can be projected with reasonable confidence only for about one to two years ahead, with uncertainty levels rising strongly from year 2 onwards; on the other, taking trend growth as the medium-term forecast would omit the cyclical swings of the economy and therefore any future scenarios would need to allow for a sensible transition path from the cycle to the trend.

The scenarios presented here illustrate a range of possible outcomes: (1) an 'ordinary' cyclical downturn aggravated by the lack of policy space; (2) a euro-area or EU crisis; and (3) a Goldilocks expansion.

Figure 7: Euro area GDP under three illustrative scenarios (index, 2013 = 100)



Source: AMECO, own calculations

These scenarios are presented with roughly estimated (subjective) probabilities under the assumption of unchanged policies. However, being in a particular scenario is likely to trigger a policy response. For instance, the experience of a protracted downturn could lead to a beneficial policy response leading into a more benign scenario. On the other hand, the absence of an adequate policy response in the same situation could lead to much worse outcomes. In other words there are no strict boundaries between these scenarios, and events could tilt outcomes one way or the other. This should be kept in mind, even though it is beyond the scope of this note to describe all possible policy-dependent paths.

Scenario 1 – Ordinary cyclical downturn

In the absence of external shocks or internal policy mistakes, the next downturn could still be several years away. With GDP close to potential, unemployment nearing pre-crisis levels and other crisis legacies fading, the euro area and EU economies have completed the recovery. While tightening labour markets and high capacity utilisation indicate that a moderate downshift of growth is likely this year and next, there are no major macroeconomic tensions or signs of overheating for now. Later phases of the upswing would typically be characterised by increasing wage growth, inflation and credit growth, prompting a tightening by the central bank and a slowdown. The amplitude of the slowdown would in turn depend on the size of the imbalances that will have built up, the strength of the policy reaction and its transmission to the economy. Needless to say, all these elements are subject to uncertainty.

But accidents might happen on the way. Outside the EU, the US twin deficit is set to be exacerbated in the coming two years or so by the pro-cyclical fiscal policy. Debt levels are high in the global economy making it vulnerable to higher interest rates as major central banks are already engaged in a tightening cycle. Geopolitical events could disturb commodity prices or international trade. Within the EU, policy mistakes are also not to be excluded (as evidenced by the recent episode in Italy). In sum, the likelihood that the European economy is hit by an external or internal shock before its business cycle properly matures is non-negligible.

Limited policy leeway and deleveraging needs would aggravate the downturn. The earlier a downturn materialises, the less macroeconomic policy space will have been recovered. As argued above, the limiting factor is fiscal space in Member States with high debt. A lack of fiscal leeway could make the downturn deeper and more protracted. Moreover, as nominal growth dips, deleveraging becomes simultaneously more urgent and more difficult, weighing further on growth. Under this scenario, the euro area / EU as a whole might avoid recession, but policy constraints and deleveraging pressures would lead to a protracted period of low growth: a '1% economy' with subdued growth and inflation, and further accumulation of wealth in the hands of a few. Assuming unchanged policies, we estimate the likelihood of ending up in this scenario at about 60%.

However, this scenario is not sustainable without adaptive policies. This is a scenario of protracted low growth in which countries with high public and private debt are particularly affected due to the lack of fiscal space in an incomplete EMU and deleveraging pressures. Member States' GDP growth would diverge again, contributing to political tensions across countries. The need for tight fiscal policy in a context of low growth would favour the persistence of inequality within countries and contribute to populist tendencies. Although the recent recovery has been employment-rich, there are widespread concerns about the quality of the jobs that have been created (low-paid, temporary and involuntary part-time). In a protracted downturn, job insecurity would further fuel the rise of populism. In the absence of adaptive policies, this scenario would over time lead to a euro-area or EU crisis.

To make this scenario sustainable, macroeconomic policy support from the European level though monetary or common fiscal policy would be required. The issues of restructuring Member States' debt, breaking the still prevailing bank-sovereign nexus and moving non-performing private debt off bank balance sheets, would also be back on the table.

Scenario 2: Euro-area or EU crisis

Concerns about the viability of EMU or about further EU exits could trigger an existential crisis. Recent bond market tensions on the back of political uncertainty in Italy can serve as a warning that the prospect of a euro-area crisis may be dormant but has not gone away. The main difference to the scenario of an ordinary cyclical downturn is a sustained surge of sovereign bond spreads reflecting risk of default and re-denomination – and at the same time making such extreme outcomes likelier. The banking sector would again come under pressure: Banks holding large amounts of bonds of their own sovereign would incur losses and see their collateral melting away amid possible rating downgrades. Re-denomination risk could lead to a squeeze of market funding and ultimately a run on deposits.

The European economy would enter a deep recession. Investment would collapse in this scenario; deleveraging would be massive and abrupt. NPLs could start soaring again (from still elevated levels in some countries). The lack of fiscal and monetary policy space and a euro-area wide shock absorption mechanism would be more relevant than in the baseline scenario; and divergence across Member States would be stronger. The integrity of the euro area would clearly be at risk. Tools have been developed during the sovereign debt crisis to handle such a situation (see box), but they require a strong and shared political will to defend the integrity of the euro area.

If a bank loses access to Eurosystem refinancing due to lack of eligible collateral or rating downgrades below investment grade, the NCB can provide Emergency Liquidity Assistance against a penalty interest rate. This requires collateral (but the rules may be relaxed) or a guarantee, and the institute must be solvent (respecting capital ratios or have a credible recapitalisation plan). It should, however, be noted that large scale (i.e. system-level) ELA provision could be constrained by the ECB Governing Council if it was judged to be interfering with its monetary policy stance.

Any need for recapitalisation of large parts of the banking sector might require a public asset management company for NPLs, a (banking-sector) assistance programme (as in Spain) or an ESM programme. In the case of IT that raises issues of 'too big to save,' 'too big to fail.' Also, the possibility for the ECB to activate Outright Monetary Transactions (OMT) requires conditionality linked to a macroeconomic adjustment programme or a precautionary programme (ECCL). (Note that political sensitivities might interfere both on the side of using the OMT and on the side of accepting a programme.)

The non-linear impact of external events could also trigger a crisis. Even in the absence of a trigger within the euro area, interrelated external risks, non-linear impacts and contagion could also bring about much worse outcomes. It does not necessarily take a large initial shock to produce this. An event leading to risk-off mode in international financial markets could prompt investors to re-assess legacy risks such as high debt levels, still structurally weak banking sectors and limited fiscal policy space in Member States. This could push sovereign spreads up enough to enter a vicious circle, especially if domestic banks are not able to compensate through their purchases the exodus of international investors.

East-West and South-North tensions could harm the EU enough to jeopardise its political cohesion. Tensions have gradually emerged over recent years concerning migration policy, the EU budget and the rule of law, to name only a few dimensions. Such tensions are not new to European integration (earlier decades saw e.g. the 'empty chair' and the UK budget rebate). There is however a perception that they are currently exacerbated by the kind of domestically-oriented and myopic political discourse that has led to Brexit. Although approval of the EU has increased in the EU27 since the UK referendum, it is not excluded that over time other Member States would see a brighter future outside the EU.

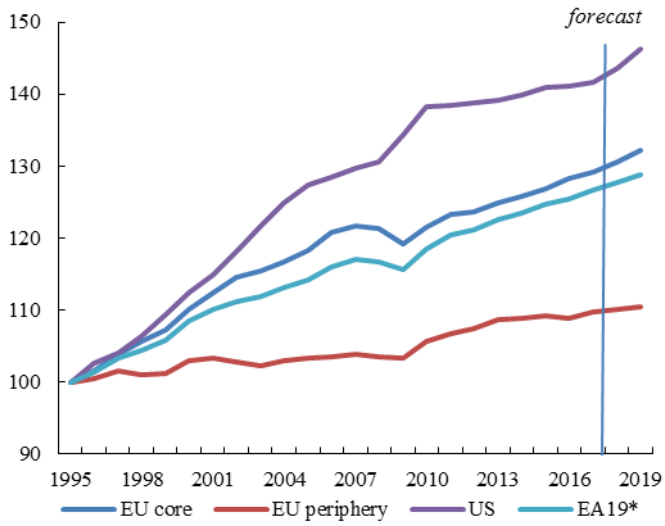
Assuming unchanged policies, we estimate the likelihood of a euro-area or EU crisis in the next few years at about 35%. But, as stressed above, also the inadequate handling of a period of low growth could over time push the euro area into such a crisis.

Scenario 3: Goldilocks expansion

A sustained expansion that is 'neither too hot, neither too cold' (as in the tale of Goldilocks) would require the absence of disturbances and an unlocking of productivity. Fundamental growth drivers in the euro area are robust. In the absence of shocks and policy mistakes, GDP growth could continue at rates close to potential for several years without overheating (as has been the case in the US since the output gap there closed in 2015). Note however that at current potential growth rates, that would mean GDP growth at about 1½%.

Reforms might boost productivity growth. In the past years, labour-market and pension reforms have contributed to a remarkable increase in participation rates and reduction of the NAWRU in the euro area. It is thinkable that productivity-enhancing reforms could in turn lead to faster convergence towards the technology frontier. In the pre-crisis decade, hourly productivity grew much faster in the US than in Europe. This indicates that there is leeway for catching up even without pioneering new technology.

Figure 8: GDP per hour worked by region (index, 1995=100)



The adoption of new technologies could push the technology frontier further out. The apparently lacking productivity impact of general-purpose technologies such as the internet of things and artificial intelligence is hotly debated. Should the optimists be right, the full impact of such new technologies will gradually materialise over the coming decades, pushing productivity growth higher from its currently subdued level. Potential GDP growth could then increase well above the 1½% that currently appears to be the upper limit, and actual growth could accompany it. This scenario is very unlikely to materialise spontaneously. In the absence of a major policy effort, we put its probability at not more than 5%.

In summary, there is substantial likelihood that by 2025 the EU is likely to be feeling the effects of the so-called "1% economy": around 1% growth, 1% of the population owning an increasing proportion of total wealth and a Union budget capped at around 1% of GDP. The long-term growth rate of potential output will be impacted by negative demographic trends and unspectacular productivity growth. Low trend growth and a continuation of low core inflation in the euro area, with subdued wage developments given the level of unemployment would make the private and public debt burden more difficult to manage and trap the economy in lacklustre performance. To low growth and potentially low inflation, one may add the challenge of 1% of the population owning an increasing proportion of total wealth, with attendant social ills. And from a different angle, the challenge of delivering substantially more at the EU level under an MFF capped at or just above 1% of GDP may be on the optimistic side.

II.3 An economic policy perspective for the next five years

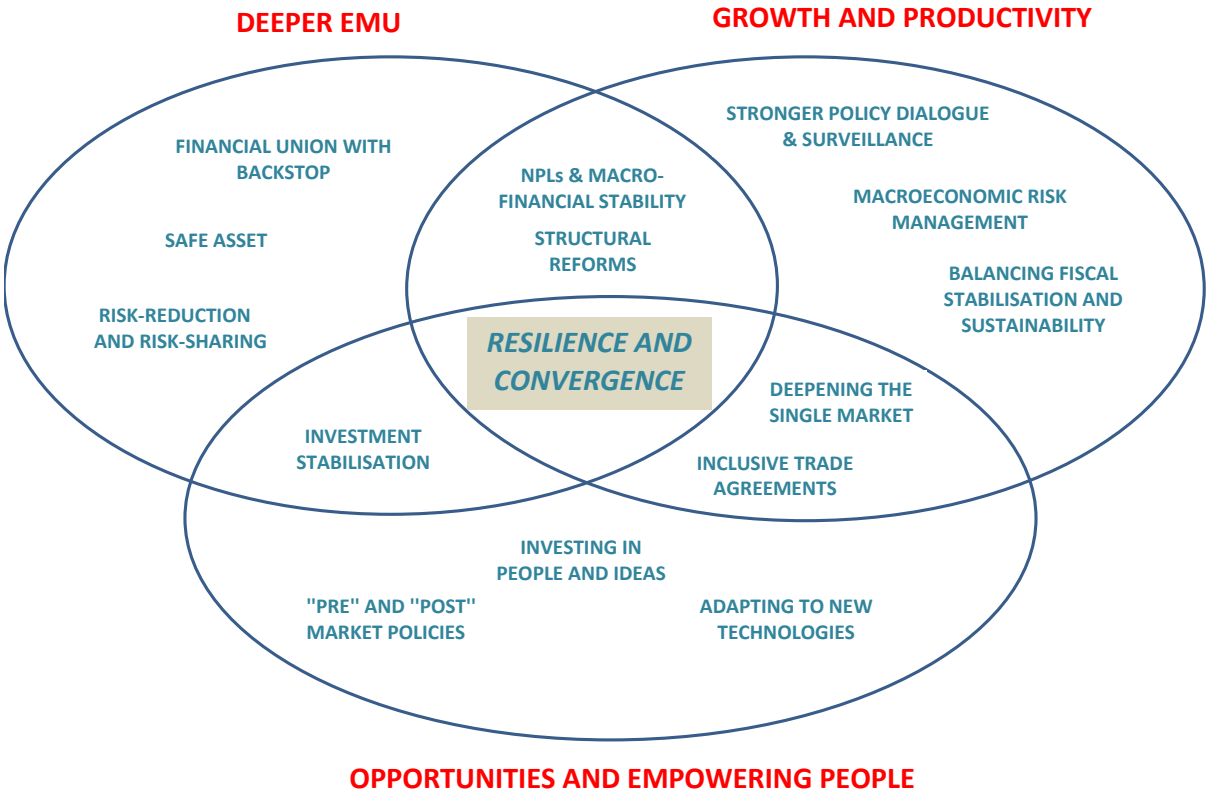
On current trends, the central economic policy scenario for the coming years is less glowing than one would hope. Although a revitalisation of the Franco-German alliance gives hope, it is unlikely that this will be sufficient to overcome deeply entrenched differences. In terms of the institutional architecture, the "carrying on" scenario as outlined in the Commission's White Paper may well apply in 2025. This would mean largely incremental improvements in the functioning of the single market and of the euro area, with a capacity to deliver that does not match expectations, and decision-making processes that remain complex to grasp. While Member States have committed to taking important institutional steps such as completing the Banking Union, there is strong resistance to follow through. Moreover, even an ambitious Franco-German agreement may not be enough to break the "identitarian" divide between West and East and the responsibility/solidarity divide between North and South. Without a decisive breakthrough Europe's economic policy making will remain trapped in the "ultima ratio" syndrome, postponing critical choices until they become inescapable under the pressure of the markets.

In setting out its vision for 2025, the Union needs to provide a coherent answer to its raison d'être: *what is the Union for?* Where in previous decades the European policy agenda has been propelled along by big projects, such as the single market, the adoption of the euro or enlargement to Central and Eastern Europe, there is no comparable engine of momentum at present. It is also not likely that another such top-down project can or should emerge: the days when leaders forged ahead with grand plans, aiming to pull the electorate behind, are not in vogue. Instead, the EU leaders have given preference to an approach of forging progress through tangible projects in policy areas that address the real concerns of citizens and be clear about what the EU can do, and what is for the Member States to do, in order to make sure that promises are delivered on. This vision – seen by some as pragmatic and by others as not ambitious enough – develops around the core principle that 27 Member States can deliver more together for their citizens than separately when addressing challenges that affect all Member States in a globalised world. This is the way in which sovereignty – economic and political – can be exercised today at the European level and in a global context.

Together with the nation state, the EU is accountable to citizens for creating the conditions that enable them to live meaningful lives, to protect them from threats and to provide their children with the opportunities to make the most of their abilities. In order for the EU to do this, it should be willing to set its policy focus onto areas that have a direct (as opposed to indirect) impact on people's lives, and approach policies holistically: it is no longer sufficient to e.g. promote open trade or technological progress and treat the attendant downsides for some groups and regions as none of the Union's business. For this reason, charting a way forward for a Union that provides opportunities and empowers people is a key priority. By the same token, the Union should continue to centre its policy

agenda to 2025 on addressing citizens' concern about their future economic prosperity, what type of jobs and remuneration they will have and how to maintain economic stability at times of rapid change. Furthermore, in designing and executing the necessary policies, it should be clear why common action at the Union level is considered, for example making it tangible why and in what ways a deeper EMU is indispensable to make the economy resilient. It is on the basis of these three axes of economic policy priorities that the EU's ability to support the resilience of its economy and the convergence in living standards will be determined.

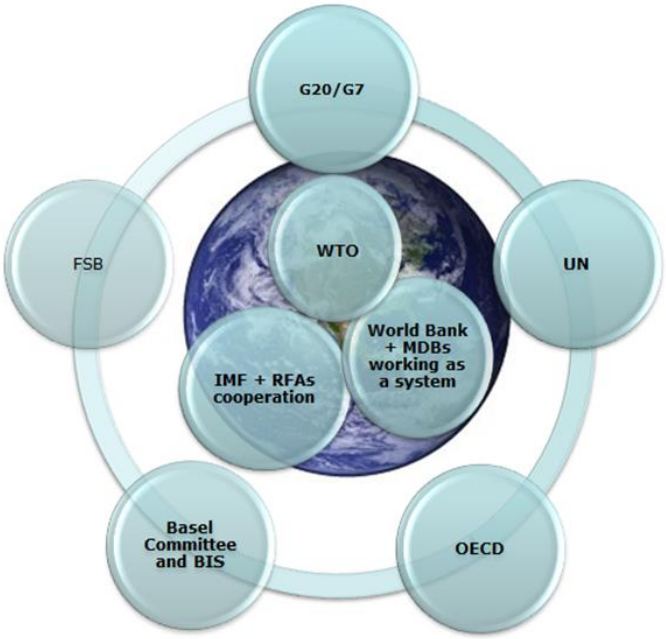
Figure 9: What is the Union for - an economic policy perspective



The fact that the world is more interconnected than it has ever been is an essential framework condition for the EU's economic policy priorities. It is neither possible to address important global challenges in an isolated manner nor to rely on the status quo of international economic governance. Globalisation and integration across borders has led to great overall benefits in terms of economic growth, and has also led to increased spill-overs between countries and regions. The rise of technology has added to this effect – we are now closer and more interdependent than ever before. The effects of this new proximity are not just economic. An increasing number of policy challenges require solutions across borders, if they are to be effective. With further rapid changes ahead – from robotisation and the application of new technologies – it will be important that the EU provides the means and tools for the member states to confront common challenges together. Institutionally speaking, this means making global institutions work more effectively together. In particular, the Bretton Woods Institutions need to update their business models. For example, the

multilateral development banks need to work together more as a system. There is a need to integrate the new institutions that have been created since the crisis and more concrete cooperation is necessary between MDBs. The G20 should provide leadership and strategic direction to the system of MDBs.

Figure 10: Reconstructing Global Governance

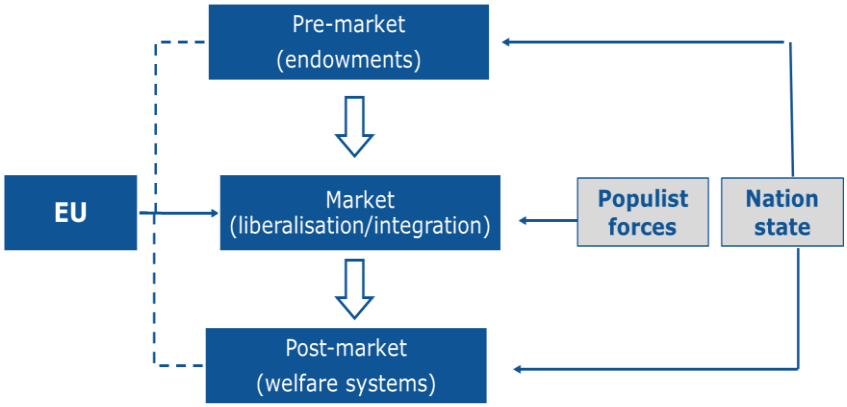


The increase in populism is testament to many citizens' feeling that the topics that are important to them are not reflected in the mainstream political discourse. Focussing on the topics that drive these political movements should be a priority. Actions by this Commission show that, by addressing the source of popular frustration, the EU can not only make a difference but can turn populist energies into positive political momentum, e.g. LuxLeaks, Apple etc. contributing to a renewed drive in tax cooperation. The EU level economic policy for the years to come should develop a strong programme in areas where corporate or elite interests may not have been sufficiently subject to checks and balances, and where joint action is needed for meaningful breakthroughs. The Commission should also not shy away from addressing the more challenging issues associated with anti-establishment movements, difficult though they may be. The thorniest issue going forward may be the challenge posed by migrationary pressures from third countries. The challenge of delivering a single migration policy should not be neglected out of fear of rocking the boat because policy action at national and EU will shape the longer-term economic repercussions. This includes protecting the EU's borders, fighting illegal immigration and continuing to build partnerships with neighbourhood countries, which can help to contain refugee and immigration inflows into the EU. At the same time, developing a better system of controlled immigration inflows, not least to attract bright talents from abroad, and

combatting educational and spatial segregation of those that have come to Europe is likely to be a defining challenge.

In order to regain its legitimacy the EU can no longer content itself with policies solely concerning the market; it must stand ready to address "pre" and "post" market policies. In areas relating to inequality and the welfare state, Member States are traditionally seen as the only responsible. The EU is identified with the market dimension of policymaking and rarely with providing opportunities (pre-market) or evening out inequalities (post-market). It is untenable if the EU is to be seen purely as agents of globalisation and there are cases when it is demonstrably more effective to act at the Union level, e.g. in areas of labour market and social policies that have a direct bearing on the functioning of the single market. Taking a stronger role in the pre-market and post-market dimensions requires a clearer voice on identifying the policies that are needed, in tandem with taking the debate about which level of policymaking should be empowered to act and the means that are commensurate with the role that Europe can play. The EU should no longer shy away from taking a role in tackling inequality and addressing the completeness of the protection offered by the welfare state(s). These are issues that matter to people at their core, and that are needed to support ongoing economic success.

Figure 11: Pre-market, market and post-market policies in the EU and Member States



Far-reaching change will be required in the pre-market, the market, and the post-market to ensure fair opportunities for all. Fostering investment in people and ideas, ensuring adjustment and adaptability for inclusive growth, and making the EU social model(s) future-proof by moving towards more efficient and inclusive taxation structures and benefit systems will be essential. In particular, given new spending requirements in a number of areas, such as environmental protection and security and defence, a re-think of the way public revenues are generated may be required. An indicative list of possible sets of actions is given in figure 12. The EU has a potential role in the various areas, including in some cases by developing delivery modes directly to the citizens.

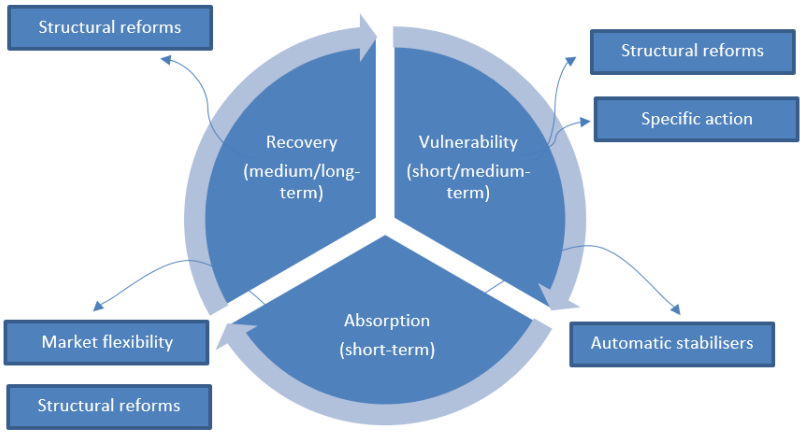
Figure 12: Inclusive growth - reloading Europe's prosperity model

PRIORITY AREA	SETS OF ACTION
Fostering investment in people and ideas	• Strengthen activation and inclusion policies offering lifelong training and re-employment services • Prioritise education and training, including early childhood intervention; reduce drop-outs • Foster innovation systems, R&D and the smooth diffusion of technological progress • Ensure universal and fair access to health care
Adjustment and adaptability for inclusive growth	• Strengthen industrial relations and collective bargaining structures internalising negative external effects and promoting work-place productivity • Embrace open markets and the reallocation of factors of production towards its most productive use • Support adaptation and address displacement costs related to globalisations and technological change • Tackle labour market segmentation, establish better social protection for non-standard employment
More efficient and inclusive tax-benefit system	• Establish/optimise inclusive minimum income schemes • Use tax policy to impact market income distribution : shift taxation away from labour, broaden tax bases, increase the progressivity of taxation structures • Optimise tax incentives for labour market participation and productivity growth • Ensure fair and sustainable person systems in view of a changing world of work

The economic context is now one of growth, but it will be necessary to set the right conditions for growth to be sustained over the medium term. Economic growth is currently strong, but the good times may last longer, its benefits may spread wider and the trend lines may improve only if measures to sustain this are put in place in time. This will require tackling long-standing challenges, which are well-diagnosed in the European Semester both for the EU as a whole, the euro area and individual Member States. Some of these economic priorities were clear before the crisis, such as the ageing of the population which is weighing on growth and social security systems. Others have emerged in the last ten years, not least the intertwined priorities of reigniting a sustained convergence of economic and social performances across countries and enhancing the resilience of Member States and the EU economy.

Structural reforms to strengthen economic resilience act on the institutional and economic environment to make it better able to weather an economic shock. Economic resilience refers to the ability of the country to withstand a shock and recover quickly after it falls into an economic downturn. Resilience can be characterised along 3 main aspects: vulnerability (whether and how strongly a given shock hits the economy), absorption capacity (the ability of an economy to cushion the direct impact of a shock, minimizing immediate output and job losses) and recovery (the ability to return to the previous status or to ensure the reallocation of productive resources). Depending on their nature, *vulnerabilities* can be tackled by dedicated actions or they may need to be tackled by a more comprehensive change in the way the economy functions through a structural reform. For example, an imbalance requiring a structural reform is wage distortions (reform of the labour market). The *absorption capacity* of an economy is determined by short-term market as well as public actions. An economy will absorb shocks better if, for example, its financial markets are diversified enough that they automatically spread risks or if its labour market automatically adjusts labour costs. They are however possible only if the right structural reforms were undertaken early enough. If an economy has in place the right structures and policies to tackle its sources of vulnerability, it would be able to absorb a shock relatively smoothly. However, it may still not be able to return to *recovery* of its previous status quo in terms of productivity, employment and general welfare. If an economic shock changes structurally the characteristics of the markets, the economy may need to readjust its productive resources in a different way than its previous status quo in order to be able to recover.

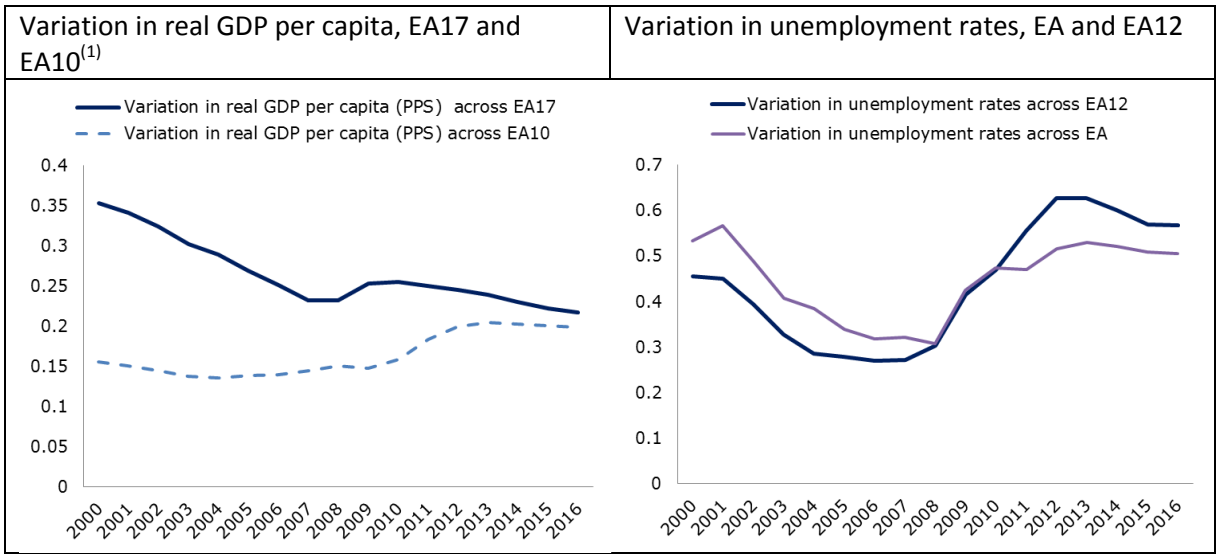
Figure 13: Economic resilience and structural reforms



As a matter of macroeconomic risk management, steps to reduce the likelihood and impact of bad events should be seen as precautionary. It is very unlikely that the current expansion will continue over the time horizon of the next Commission without at least a cyclical downturn. A flaring up of the euro area crisis or a crisis of the EU cannot be excluded either. Reducing the potential impact of such events requires - in addition to structural reforms - the range of actions including the early restoration of fiscal and monetary room for manoeuvre. At first glance, the situation of public finances in the EU and the euro area appears favourable. In aggregate terms, public deficits decreased by around half a percentage point of GDP in 2017, to 1.0% of GDP compared to a peak of 6.6% of GDP in 2009. That said, the continuing reduction of public deficits in 2017 is largely attributable to the improvement of cyclical conditions and lower interest rates and the picture varies significantly across Member States. On the one hand, a majority of Member States posted an improvement in their structural balance. On the other hand, a number of Member States saw a non-negligible a deterioration of their structural positions. Over the medium term, fiscal sustainability risks remain elevated in a number of Member States. Medium-term debt projections show that if Member States' fiscal plans were fully implemented, additional fiscal consolidation measures totalling close to 0.3 percentage point of GDP in the EU would still be needed over the next five years to bring the debt-to-GDP ratio to 60% by 2032. However, in a number of Member States, the needed additional measures would be much more significant and the current economic expansion is an opportunity to reduce excessive levels of debt and re-build fiscal buffers to be able to tackle possible future shocks. This notably concerns some large euro area Member States that face sustainability challenges due to their excessive levels of public debt or implicit liability related to population ageing.

We should draw the lesson of how weak resilience has had significant and persistent effects on income and employment, thereby hampering the convergence process. Real convergence of living standards and income levels is central to achieving the Union's objectives of economic and social cohesion and full employment. In the first 10 years of EMU, significant growth in real income occurred and the euro area members with initial lower living standards caught up in terms of GDP per capita. The crisis that started in 2008 has adversely affected the convergence process. The situation has improved in the last years, though only very moderately. Unemployment rates also became more even across euro area countries before the crisis hit, but showed stronger differences after the crisis. Since 2013, unemployment rates started again to vary less across countries, but differences remain well above pre-crisis levels. The differences in economic structures help to explain these developments in real convergence. Those parts of the euro area with more efficient product and labour markets fared better throughout the crisis. Convergence towards resilient economic structures supports real convergence and makes it sustainable over time. The concept of social resilience is also particularly important to strengthen the resilience of an economy. Structural reforms are also crucial in this respect, e.g. those related to human capital, education, skills, but also to the development of innovative employment and social protection systems that combine flexibility and security.

Figure 14: Variation in real income and unemployment (degree of convergence)



Notes: (1) Figures excluding IE and LU.

The promotion of sound policies does not lessen the need to complete the EMU architecture, which is overdue and needed to secure its coherence and stability. As part of a strategy compounding risk sharing and risk reduction (e.g. NPLs), the restoration of fiscal policy buffers at Member State level should be complemented by the set-up of a central fiscal stabilisation capacity aiming at absorbing large shocks. The persistent divide on completing banking union – hopefully now in the process of attenuating with the joint declaration of France and Germany - shows that twenty years after irrevocably fixing national exchange rates, the euro area countries continue to have radically different views on the basic conditions for a well-functioning EMU. Many of the flagship achievements of previous decades, from the single market through the common currency to border policy, were left so far incomplete – and in that, they contained the seeds of their vulnerability when crisis came.

Restoring the stability of the EMU edifice requires, as a first order priority, the establishment of a backstop for the Single Resolution Fund and a meaningful stabilisation function. The proposals presented in the MFF, based on a vision of how budgetary functions essential for the euro area and the EU can be developed within the framework of the EU's public finances, and the ongoing work on a backstop for the Banking Union through the EMF/ESM are key to the success of EMU. As further priorities, the development of an EU Treasury in the broad sense, a safe asset and a European Deposit Insurance Scheme is central. Many of these initiatives have governance and institutional ramifications, which are important to consider in reshaping the economic and budgetary surveillance. Reviewing the system of economic and budgetary surveillance, including the interaction between various surveillance instruments and the effectiveness of their application, naturally complement

the process of deepening EMU. The 6/2-Pack review to be delivered by December 2019 is a first opportunity to forge a way ahead in terms of the future surveillance architecture.

Figure 15: Completing the banking union

COMPLETING THE BANKING UNION

MEASURE	DESCRIPTION	European Commission	European Parliament	Council of the European Union
European Deposit Insurance Scheme (EDIS)	The proposal would further strengthen the protection of bank depositors across the Banking Union	●	●	●
November 2016 Banking Package	Reinforcing the banking Single Rulebook with further risk-reducing measures and rules to foster banks' infrastructure investment	●	●	●
A backstop for the Banking Union	Making the agreed backstop for the Single Resolution Fund part of the future European Monetary Fund	●	●	●
Further **reduction of non-performing loans** on EU banks' balance sheets	Package of initiatives to further reduce non-performing loans, complementing previous actions	●	●	●

● PRESENTED/AGREED
● AGREEMENT POSSIBLE BY MAY 2019 IF THERE IS STRONG POLITICAL COMMITMENT FROM ALL EU INSTITUTIONS

III. Conclusions

The EU by 2025 has the potential to be a more dynamic and resilient economy. As depicted, big challenges will have to be navigated over the coming years and during a period of an uncertain economic outlook. Failure to address the issues face on and in a co-operative manner at multilateral, regional or bilateral level could give rise to zero-sum policies and nourish a dystopian vision of a fragmented and stagnating Europe. Such a Europe would be plagued by external and internal conflict, featuring walls at its external borders and tightly secured internal borders, and with stratified populations living back-to-back and vulnerable to prejudice and populism. But a better Europe is feasible. Its people and its institutions have what it takes to pick the high road into the future, staying united in diversity, and charging the transformation towards a more inclusive, resilient and environment-friendly economic system. But such a success will have to be earned, not least by putting in place the right policies with the main axes being those illustrated in figure 9, pointing to the key policy areas that the EU should prioritise. They closely tie in with one another. It is by facing up the challenges in all areas – for some actions at the EU level and for others at the national level - that the pay-off in terms of stronger resilience and convergence is reaped.

Setting clear political aims is a precondition: restoring citizens' trust in the EU's ability to deliver opportunities, empowerment and protection for its citizens is a leitmotif for the years to come. As set out above, this will require a coherent EU economic policy that deliver opportunity and empower people, succeeds in charting a way forward for a deeper EMU without it happening "ultima ratio", and supports growth and productivity. Many actions rely on Member States' willingness to implement complex reforms, but new directions for policies with shared or EU executive competence are required as well. Shifting the perception that the EU is a partisan agent of the market and of the elites is no easy task and will require a focus at the EU-level on better delivering on common public goods in a new balance of competence-sharing with Member States, bringing the citizens back in.

The latest Eurobarometer survey shows that over two-thirds of respondents are convinced that their country benefits from being a member of the EU. This is the highest support measured for the EU in 35 years. The survey also indicates that unemployment, health & social security and immigration are the main concerns. Thus, when EU-level action is demonstrably effective, it should be taken and complement national policies. Both are in most cases needed to strengthen citizens' perception that they are being heard, and to increase their trust in the EU's delivery. It is not the institutions, who create the European project, but every EU citizen is part of it. Rebuilding legitimacy calls for moving away from dead-end discussions centred on the two poles of "subsidiarity vs European sovereignty", and framing the discourse not in terms of more or less Europe, but in terms of a better Europe.