

# The EEAG Report

## on the European Economy

### 2014

---

## RECOMMENDATIONS FOR EUROPE

### Chapter 2 SWITZERLAND: RELIC OF THE PAST, MODEL FOR THE FUTURE?

- **Learn from the Swiss approach to diversity management.** The European Union faces difficult choices and disagreement within and across its member countries. The Swiss approach to diversity management can be seen as a useful model for Europe. Europeans have always tried to homogenise their countries' national cultures, and cultural heterogeneity across European Union member countries is increasingly problematic. The Swiss, by contrast, are both very much aware of their internal cultural diversity, and very proud of their country, conscious of the advantages of belonging to it.
- **Embrace pragmatic compromises as a way of laying firm foundations for common institutions and policies.** The Swiss Confederation's institutional structure is increasingly similar to that which the European Union is currently struggling to develop. Swiss history suggests that European citizens and policy-makers may more clearly see the advantages of togetherness, and perhaps find it easier to proceed towards political union, as changes in the world's geopolitical situation make it increasingly necessary for the European Union to deploy a common foreign policy.
- **Adopt both a common legal and regulatory infrastructure, and a comprehensive and rigorous fiscal system.** European nation states have long implemented single-market frameworks and redistribution schemes that have only recently been introduced by the Swiss Confederation. Switzerland, by contrast, has pioneered public debt brakes and relies on the threat of bankruptcy to ensure responsible and prudent lending and borrowing at lower levels of government. All of these institutional features are only slowly and problematically being extended to the euro area and the European Union.

### Chapter 3 AUSTERITY: HURTING BUT HELPING

- **Euro area policy-makers should deal with the periphery's debt overhang.** Debt levels still appear to be far from sustainable levels for several periphery countries. High debt levels are likely to act as a drag on growth, as servicing debt requires the transfer of resources from debtors to creditors. Slow growth, however, will exacerbate the debt overhang problem. Debt rescheduling should be seen as a way of dealing with the problem, provided that the further reforms required do take place in periphery countries.

- **Countries in which the crisis has permanently changed the growth outlook need to accept some degree of fiscal austerity and embrace downward wage flexibility.** Weak domestic demand moderates price and wage inflation, supporting the real devaluation path that is needed to restore the competitiveness lost during the boom years. That path can be followed in less costly manner and at a faster pace if wages adjust flexibly.
- **Periphery countries should make their labour markets more flexible.** Productive resources need to be reallocated across industries and firms. While austerity deepens the crisis, high unemployment largely reflects the slow and painful character of labour reallocation processes in situations where uncertainty and institutions make firms keen to fire, but reluctant to hire. Labour market reforms could considerably accelerate the structural reallocation of labour and shorten the recession.
- **The fiscal policy framework in the periphery countries should be strengthened** to lend more credibility to the fiscal programs. In the absence of such a framework, credibility can only be gained through frontloading the fiscal programme, which is typically more costly in terms of output and employment than a more back-loaded programme. As debt levels are still high in some periphery countries, and austerity will be with them for some time, such a framework is all the more important to reduce the short-term cost of austerity.

#### Chapter 4 BANKING UNION: WHO SHOULD TAKE CHARGE?

- **The ECB's Comprehensive Assessment of Financial Institutions needs to be as rigorous and transparent in reality as claims suggest it will be.** Only a full revelation of legacy problems can ensure that the concept of a banking union does not appear to be a scheme for channelling resources to those euro area member states with weak banking industries. This perception would undermine political support for the necessary centralisation of bank supervision, regulation and resolution.
- **Clarification of who will pay for the legacy problems revealed by the Comprehensive Assessment is essential.** The costs should logically be borne by the member states responsible for past supervision. Since this weakens the link between weak sovereigns and banks in the short run, member states should be eligible for ESM support under appropriate conditions.
- **The list of creditors exempt from bailing-in should be kept short.** The principle of bailing-in some creditors of failing banks is sound. But a long list of exemptions may make it difficult to ensure that banks have enough contingent liabilities to meet reasonable recapitalisation needs.