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Dear Michael, Dear Ministers,

I would like to thank you for the important supportive conclusions on the Annual Growth Survey and Fiscal Sustainability Report in Tuesday's Ecofin. Referring to our debate on Tuesday, I want to share with you also in a written form some reflections on the matters we discussed. The Commission will continue to work on these issues in view of our March meeting and for communication purposes, as agreed.

On 22 February the European Commission will publish its winter forecast. Without prejudging our detailed findings, we can already make three key observations. First, growth in the eurozone is likely to turn positive only gradually in the second half of 2013, and there will inevitably be a lag before a strengthening of economic activity has an impact on job creation. Second, survey indicators point to growing confidence. And third, the confidence effects in financial markets are becoming clearly visible, although lending to the real economy remains subdued, which also reflects current economic conditions.

Against this background, I would like to make a few points about a debate that has not been helpful and has risked to erode the confidence that we have painstakingly built up over the past years in numerous late-night meetings. I am referring to the debate about the fiscal multiplier, i.e. the marginal impact that a change in fiscal policy has on economic growth.

The debate in general has not brought us much new insight. Multipliers are larger when households are highly indebted and when interest rates are low. On this, there was already consensus among economists. Beyond that, the recent studies' robustness is limited by their rather short time horizon, and the fact that it cannot be excluded that other factors impacted on growth compared with what was expected in forecasts around 2010 and 2011.

To: ECOFIN Ministers

Cc: Mr Draghi, ECB
Mr Wieser, EFC
Mr Vijlbrief, EPC
Mr Hoyer, EIB
Mr Regling, ESM
Mrs Lagarde, IMF

One reason to question the analysis present in these studies is that such growth forecast errors may arise either because the *impact* of fiscal change (the multiplier) was estimated with error or because the *size* of the eventually implemented fiscal change was different from the forecast, or both. In our view, the analysis is not robust enough to distinguish this.

In fact, the actual consolidation turned out much larger than what was included in the forecasts under the usual no-policy-change scenario. In the case of the forecast in the IMF WEO Spring 2010 (as referred to in the IMF's recent working paper on this issue), the actual consolidation was 2½ times larger.

If one takes into account that most of this was announced already in the 2010 stability programmes, coupled with the impact of deteriorating confidence in the sustainability of government debt in some countries, then the growth experience across euro area countries would be consistent with the multiplier that is also used in the common macroeconomic models (for example in that used by the Commission services, which is on average 0.8, depending on circumstances, e.g. composition of adjustment, household indebtedness).

A second reason is that the period under analysis, namely the early years of the crisis, included both the growth effect of fiscal consolidation and that of fiscal stimulus. Both the Commission and the IMF have found that the biggest growth forecast errors occurred in 2010, when most countries were implementing temporary fiscal stimulus measures after the huge fall in activity in 2009, rather than consolidation measures. Likewise, the 2009-10 stimulus measures could have a larger impact only because it was expected they would be phased out again. Consolidation that is announced as permanent and perceived as credible tends to be associated with a smaller multiplier than temporary measures.

Recent studies on fiscal multipliers are of particularly limited use when it comes to the specific case of Greece. Indeed, in a recent opinion piece published in the Greek press, IMF Chief Economist Olivier Blanchard stated that to associate Greece's underperformance with programme design "represents a fundamental misreading of the historical record and of the IMF's research on fiscal multipliers."

In 2009, the fiscal deficit had reached 15.6% of GDP and markets were no longer willing to finance Greece's high debt levels. It was this situation that led to the launch of the financial assistance programme in the spring of 2010. However, persistent uncertainty and problems with implementation in the first years of the programme meant that the Greek economy could not benefit from confidence effects that should have mitigated the short-term impact of fiscal consolidation. Since last summer, the Greek programme has been brought decisively back on track. A great amount has now been achieved in Greece in terms of fiscal consolidation and the implementation of growth-enhancing reforms. The agreement in the Eurogroup last December has removed the damaging uncertainty that had been hanging over Greece for too long, and paved the way for a return of confidence.

It is now up to the Greek authorities to ensure through determined implementation of the reform programme that this confidence continues to grow.

Finally, in the January IMF staff paper, Olivier Blanchard and his co-author themselves stressed that they are not calling for a reversal of the fiscal policy course followed during the crisis and that other factors should also be taken into account when determining the appropriate pace of fiscal consolidation for any single country. Such other factors include, in particular, the confidence effects that are materialising now due to our policies and from which the vulnerable countries are benefiting.

Indeed, if one takes into account the deterioration of investor confidence expressed by rising government bond yields, the results of the multiplier analysis change and the estimated error on the multiplier becomes insignificant, as shown in Box I.5 on page 41 of the Commission's autumn 2012 forecast.

Two recent examples illustrate the impact of credible fiscal consolidation policies on investor confidence. In Belgium, yields on ten-year government bonds were close to 6% in late 2011, as investors fretted at implications for public finances of the lack of a government almost a year and a half after the June 2010 elections. But following the formation of a new government in December 2011 and the subsequent adoption of the 2012 budget, yields fell to around 3%.

Likewise, yields on ten-year Italian government bonds were above 7.3% in November 2011, but dropped below 5% by March 2012 as markets were convinced by Italy's budgetary decisions. A 100 basis-point fall in sovereign yields saves Italy around €3 billion in the first year alone.

The easing of market tensions has certainly been helped by the ECB's decision on Outright Monetary Transactions. However, OMTs come with clear conditions, including a credible fiscal strategy and growth-enhancing reforms. Reform policies stand at the beginning of the causality chain, and rightly so as we know by experience.

The continued economic weakness is largely related to the inevitable deleveraging underway following the build-up of private and public debt during the credit boom of the last decade. This boom also led to a structural misallocation of economic resources, and it will take further time and effort to bring this back into balance.

Public finances in the EU are gradually improving, and so is markets' confidence in governments' action in this area. In 2009 and 2010, fiscal deficits in the euro area were above 6% of GDP. For 2012 they are expected to be somewhat above 3% of GDP, which is a welcome improvement. We expect a further decline this year.

Here again the situation across countries varies considerably. This is why the Commission applies a differentiated approach to consolidation, taking into account the respective challenges of each and every Member State when determining the required fiscal adjustment effort.

Each country's consolidation effort is specified in so-called structural terms, which means removing the effects of the business cycle and one-off measures on the budget. If growth deteriorates unexpectedly, a country may receive extra time to correct its excessive deficit, provided it has delivered the agreed structural fiscal effort. Such decisions were taken last year for Spain, Portugal and Greece.

Yet, we have to recall that public debt in the EU has risen from around 60% of GDP before the crisis to around 90% of GDP. And it is widely acknowledged, based on serious academic research, that when public debt levels rise above 90% they tend to have a negative impact on economic dynamism, which translates into low growth for many years.

That is why consistent and carefully calibrated fiscal consolidation remains necessary in Europe. And that is why it is important that the debt criterion was upgraded in the six-pack. Accordingly, we will have to decide on the Member States' medium-term objectives during the spring.

There is a convincing economic and political case for maintaining a steady consolidation pace throughout the ups and downs of the cycle. The EU's reinforced Stability and Growth Pact ensures the balance sheet adjustment necessary to support confidence in country-specific circumstances, while providing a safeguard in case of unforeseen growth shortfalls.

The stability culture embodied in Europe's reinforced economic governance does not stand in the way of sound, long-term growth. To the contrary: Carefully calibrated fiscal consolidation in a credible medium term horizon creates the conditions for sustainable growth for years to come.

Yours sincerely,