BRIEFING

Economic Dialogue with the President of the Eurogroup

ECON on 24 February 2015

The Eurogroup President Jeroen Dijsselbloem has been invited for an Economic Dialogue in line with the EU economic governance framework, in particular Article 2ab of Council Regulation (EC) 1466/97 as amended by Council Regulation (EC) 1175/2011. He was appointed by the Eurogroup as its president on 21 January 2013 for a term of two and a half years. As the President of the Eurogroup, he is also chairing the Board of Governors of the European Stability Mechanism (ESM). List of all Economic Dialogues is available on ECON homepage.

1. Economic situation in the euro area

Euro area recovery has gathered momentum at the end of 2014[1]. According to Eurostat's flash estimate, euro area GDP expanded by 0.3% (q-o-q) in the last quarter of 2014, after 0.2% (q-o-q) a quarter earlier, reflecting stronger-than-expected data from Germany[2] and the broader euro area (including a modest output growth in France, while Italy's economy technically came out of recession - generally defined as two consecutive quarters of negative growth - as its GDP remained flat). This data took the annual growth rate for the euro area's economy to 0.9% in 2014. Moreover, in its Winter 2015 forecast, published at the beginning of February, the Commission upgraded its growth projections for the euro area to 1.3% in 2015 and 1.9% in 2016 (+0.2 p.p. in both years compared to the Autumn 2014 forecast) on the back of a sharp fall in oil prices, the euro's depreciation, additional monetary policy stimulus (see below) and the expected stimulus, mostly from 2016 onwards, from the Commission's Investment plan. However, these projections remain subject to considerable uncertainty, reflecting risks stemming from economic, geo-political and financial developments.

Eurogroup work programme: 1st half of 2015

On 8 December 2014, the Eurogroup issued its indicative work programme for the first half of 2015.

A large part of the agenda is devoted to coordinating policy responses to bolster economic growth and job creation in the euro area. The Eurogroup will also:

- Continue to review macro-financial assistance programmes and exert the related post-programme surveillance;
- Monitor implementation of the SGP, in particular as many Member States have 2015 as a deadline for EDP correction;
- Implement 2014 euro area recommendations and preparations for euro area guidance;
- Prepare Euro Summit meetings, including the report of four Presidents on economic governance. In this regard, an analytical note was presented on 12 February 2015;
- Participate in preparing the bridge financing arrangements for the Single Resolution Fund.

Euro area HICP inflation further declined into negative territory, matching the lowest level on record. According to Eurostat's flash estimate, euro area inflation dropped to -0.6% in January 2015, down from -0.2% a month earlier, against the backdrop of falling energy prices. This is the lowest level on record seen last time in July 2009. As such, HICP inflation rate has been remaining below the ECB's inflation target (of below but close to 2%) for nearly 2 years. On 22 January 2015,

[1] See Annex 1 for an overview table of the main euro area economic indicators.
[2] German GDP expanded by 0.7% q-o-q in the last quarter of 2014, well above 0.3% q-o-q awaited by market participants, as domestic demand surprised on the upside.

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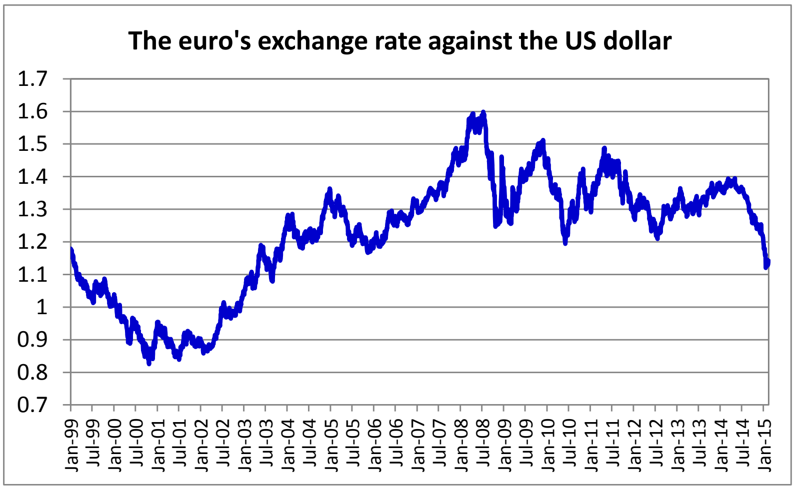
the ECB announced an expanded asset purchase programme[3]. The next monetary policy meeting of the ECB Governing Council[4] will take place on 5 March 2015 (in Cyprus).

German long-term interest rates have dropped to record lows on the back of low inflation, the ECB's asset purchase programme and safe-haven status as uncertainty surrounding Greek talks stoke some risk aversion among investors**.** The benchmark 10-year German government bond yield dropped to close to 0.3% at the beginning of February 2015, falling below the equivalent Japanese bond yields for the first time on record[5].

Euro area unemployment slightly declined at the end of 2014, though remains at historically high levels. After peaking at 12.0% during the first nine months of 2013, the euro area unemployment rate continued on its downward trend, decreasing marginally from 11.5% in November 2014 to 11.4% in December 2014. However, this figure masks large differences across Member States: at the low end of the spectrum, the unemployment rate stood at 4.8% in Germany and 4.9% in Austria, while on the other side, 23.7% and 25.8% of the workforce was unemployed in Spain and Greece[6] respectively. The euro area's youth unemployment came in at 23.0% during the last month of 2014, as compared to a record high of 24.3% at the beginning of 2013.

The euro area's current account surplus further widened. According to Eurostat's estimate, the euro area's current account surplus rose to EUR 66.1 billion (2.6% of GDP) in the third quarter of 2014, up from EUR 57.8 billion (2.3% of GDP) a quarter earlier, as an increase in the trade balance of goods more than compensated a decrease in the trade balance of services. The highest current account surpluses were observed in Germany and the Netherlands (EUR 54.0 and 14.7 billion respectively), while Belgium recorded the largest current account deficit (EUR 2.9 billion).

The Euro has extended its downward trend and dropped to an 11-year low of USD 1.12 on 23 January 2015 before edging marginally up to USD 1.14 by mid-February 2015 (see figure below). This downward trend reflects rising deflationary pressures (as evidenced by the latest HICP developments) as well as differences in both growth and interest rate outlook between the two sides of the Atlantic.



Source: ECB (daily data).
Note: Increase (decrease) in the EUR/USD rate corresponds to the euro's appreciation.

[3] This quantitative easing programme is targeting a monthly purchasing volume of EUR 60 billion until at least September 2016, declaredly in order to address the risks of a too prolonged period of low inflation. The programme encompasses the purchase in the secondary markets of asset-backed securities, covered bonds, as well as sovereign bonds (see ECB President Mario Draghi's introductory statement for more detail),

[4] Note that the accession of Lithuania to the euro area on 1 January 2015 triggered a change in the voting rights system within the ECB Governing Council, as according to European Union treaties, a rotation system was to be implemented as soon as the number of Governors exceeded 18. Under the new system National Central Bank Governors take turns in holding voting rights on a monthly basis, while the ECB's Executive Board Members hold permanent voting rights.

[5] The switch occurred on 3 February 2015, when the yield on German and Japanese 10-year bonds stood at 0.306% and 0.335% respectively.

[6] The latest available data for Greece are from October 2014.

2. Surveillance of fiscal policies

According to the Commission Winter 2015 forecast, the aggregate budgetary consolidation in the euro area is expected to come to a halt in both 2014 and 2015 as the annual changes in aggregate structural balances are projected to remain close to zero over this period (after having been positive between 2010 and 2013). Consequently, the fiscal policy stance has been broadly neutral in 2014 and is expected to remain so in the course of 2015.

As to the general government deficit in the euro area, it is expected to fall to 2.6% of GDP in 2014, down from 2.9% a year earlier, reflecting both implemented consolidation measures (predominantly expenditure based) and an increase in nominal GDP. The headline deficit-to-GDP ratio is projected to further decline to 2.2% in 2015. The public debt ratio is expected to increase to 93.1% of GDP in the euro area in 2014 before peaking at 94.4% in 2015.

As regards the procedural situation within the SGP, currently eight euro area Member States are in the corrective arm, i.e. under an EDP. These are (in brackets the current deadline for the deficit correction): IE (2015), EL (2016), ES (2016), FR (2015), CY (2016), MT (2014), PT (2015) and SI (2015). The remaining euro area countries are under the preventive arm of the SGP. For more information pertaining to the implementation of the SGP, see a separate EGOV overview table.

Assessment of 2015 Draft Budegtary Plans (DBPs) of euro area Member States

During the autumn assessment of 2015 DBPs (including the assessment of the updated Latvian DBP of December 2015), **no DBP was considered to be at risk of particularly severe non-compliance with the SGP provisions**. Nevertheless, some fiscal consolidation plans were found falling short (or at a risk of doing so) of the requirements specified under the SGP. In particular:

- 6 DBPs were found to be compliant with the SGP provisions (DE, IE, LU, LV, NL and SK);
- 3 DBPs were found to be broadly compliant with SGP provisions (EE, SI and FI);
- 7 DBPs presented a risk of non-compliance with SGP provisions (BE, ES, FR, IT, MT, AT and PT).

As such, the risk of non-compliance can have implications for possible steps under the EDP. In particular, the **Commission is expected to publish its assessment of FR, IT and BE by the end of February 2015** based on the finalised budget laws and the expected specification of the **structural reform programmes**.

On 13 January 2015, the Commission published a Communication on the best use of flexibility within the current provisions of the SGP. This new interpretation, which does not amend existing rules, mainly concerns elements in the preventive arm of the SGP and will be applied as from spring 2015 onwards.

The Council (ECOFIN) of 17 February 2015 underlined the need to maintain credibility and effectiveness in the implementation of the SGP. It also stressed that more attention should be paid to the quality and composition of fiscal adjustment as well as to the influence of fiscal policy on growth, by improving expenditure efficiency and prioritising productive investment in government spending, by shifting towards a taxation system that is more efficient and supportive of growth, and by addressing tax fraud and tax evasion to ensure fairness and allow Member States to collect tax revenues in a more effective manner.

The Council also welcomed the Commission's intention to provide a full assessment of the transposition of the Fiscal Compact into national law by mid-2015.

Further reading:

- Overview of the Stability and Growth Pact – January 2015 (on EP homepage)
- Involvement of independent fiscal bodies in SCP and NRP – January 2015 (on EP homepage)

3. Surveillance of macroeconomic imbalances

On the basis of the MIP scoreboard (see Annex 2) the Commission identified in its 2015 Alert Mechanism Report (AMR) **ten euro area Member States** at risk of imbalances that may hinder the smooth functioning of the economies or hamper the proper functioning of the EMU. For these Member States the Commission is undertaking so-called in-depth-reviews (IDRs) to assess whether the imbalances identified during the 2014 Semester Cycle still persist or pose a risk:

- **Excessive macroeconomic imbalances** experienced by Italy and Slovenia;
- **Macroeconomic imbalances requiring "specific monitoring"** experienced by Ireland, Spain and France;
- **Macroeconomic imbalances** identified in Belgium, Germany, the Netherlands and Finland. In addition Portugal is submitted to an IDR for the first time.

The results of the IDRs for these countries (together with the Staff Working Documents in a single analytical document for each Member State) are expected to be published by the Commission on 27 February 2015.

Out of the remaining Member States, **six** were **not considered at risk of macroeconomic imbalance**, while **two** (Greece and Cyprus) were not proposed for IDRs, as the surveillance of imbalances already takes place in the context of the **macroeconomic adjustment programmes**.

Nature of imbalances (based on 2015 AMR)
• High and unsustainable **current account deficits** have been **considerably reduced**, but the adjustment has been driven by a **contraction in demand**, including investment (e.g. PT, EL, ES, and IT), which could have negative implications for medium-term potential growth if not corrected; • **Current account surpluses** in some Member States (e.g. NL and DE) have not sufficiently declined; • The recovery in competitiveness is encouraging, as a result of adjustments and reforms, but **sustaining competitiveness remains a key concern** in many countries (e.g. FI, CY, EL, FR), in particular for Member States with large external imbalances; • **High levels of private debt** (e.g. IE, NL, PT and LU), **public debt** (e.g. EL, IT, BE, IE and PT) and the high level of external liabilities still constitute substantial vulnerabilities for growth, jobs and financial stability. The related problems are aggravated by low inflation; • **Unemployment** (e.g. ES, EL) and other social indicators remain very worrying, even more because the economic growth has been insufficient to improve the labour and social situation.

The Council (ECOFIN) of 17 February underlined the need to concentrate on addressing key challenges, in particular restoring competitiveness and addressing high public and private indebtedness as well as high external debt levels, while clearly distinguishing between Member States' challenges in terms of different types and degrees of risk and the respective urgency by which they should be addressed in order to avoid negative consequences. It also considered that the corrective arm of the MIP should be applied where appropriate.

Further reading:

- Implementation of Macroeconomic Imbalance Procedure - December 2014
- Overview of the Macroeconomic Imbalance Procedure - September 2014

4. Banking Union: recent developments

Financial Stability: In its November 2014 Financial Stability Review, the ECB sees three key short-term risks to euro area financial stability (see table below) on the back of an uncertain economic situation, with weak growth and low inflation, as well as the legacy issue of weak bank and non-bank balance sheets and public finances due to the crisis.

The first risk, the search for yield, can turn into a systemic risk if excessive leverage is allowed to build up. However, leverage in the banking sector seems to have remained at reasonable levels but increased in the shadow banking sector. Weak bank profitability is a risk since this limits banks' ability to improve their loss-absorbing capacity, although in some countries there are signs that non-performing loan formation is stabilising. Finally, as regards the risk of a re-emergence of sovereign debt sustainability concerns, the recent improvement in market participants' sentiment could turn on the back of setbacks relating to fiscal consolidation and structural reforms.

Key risks to euro area financial stability	
	Current level (colour) and recent change (arrow)[7]
1. Abrupt reversal of the global search for yield, amplified by pockets of illiquidity, with signs of a growing use of leverage in the non-bank financial sector	→
2. Persistent weak bank profitability in a weak, fragile and uneven macroeconomic recovery	→
3. Re-emergence of sovereign debt sustainability concerns, amid low nominal growth and wavering policy determination for fiscal and structural reforms	↑

Pronounced systemic risk   Medium-level systemic risk   Potential systemic risk

Source: ECB November 2014 Financial Stability Review.

Single Supervisory Mechanism (SSM): Following the ECB's Comprehensive Assessment, those banks for which capital shortfalls were identified now have time until April (baseline scenario) or July (adverse scenario) 2015 to cover them. In addition, Lithuania joined the Eurozone, meaning it also joined the SSM. Three Lithuanian banks (SEB bankas, Swedbank and DNB bankas) now fall under the direct supervision of the ECB. All three banks were part of the Comprehensive Assessment, with none of them presenting capital shortfalls under the envisaged scenarios.

Single Resolution Board (SRB): On 1 January 2015, the SRB took office. In case of need, the SRB's key mission is to ensure an orderly resolution of failing banks while minimising costs for taxpayers and to the real economy. One of the SRB's main tasks in that context is to take preparative actions and ensure that resolution plans are credible and workable.

Focus: Emergency Liquidity Assistance (ELA) and the Greek banking sector

On 4 February 2015, the ECB decided to lift the waiver for debt instruments issued or guaranteed by Greece, which allowed them to be used in monetary policy operations despite not fulfilling minimum credit rating requirements. Hence Greek sovereign bonds can no longer be used as collateral for refinancing operations with the ECB.

In the event that solvent euro area credit institutions facing temporary liquidity problems cannot access funding through normal monetary policy operations, they can get ELA instead from their national central bank up to a certain limit set by the ECB. Recently (12 and 18 February), the ECB decided to raise the maximum amount of ELA extended to the Greek banking sector by EUR 5.0 billion and EUR 3.3 billion respectively, for a total of EUR 68.3 billion.

One particular concern has been the high rate of non-performing loans in Greece. According to ECB statistics, 26.9% of outstanding loans and advances were classified as doubtful or non-performing in June 2014, compared with a euro area average of 11.8%.

[7] The colour indicates the current level of the risk which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next year and a half, based on the judgement of the ECB's staff. The arrows indicate whether this risk has intensified since the previous FSR.

5. Financial assistance to EU Member States: recent developments

At the current juncture, two euro area Member States are under financial assistance programme, namely Cyprus and Greece. Member States that have exited a financial assistance programme are subject to post-programme surveillance (PPS) by the Commission and the ECB (Ireland, Portugal, Spain), some in combination with post-programme monitoring (PPM) by the IMF. For more information, see the latest version of the EGOV financial assistance table on EP homepage.

The ESM approved on 8 December 2014 the disbursement of EUR 350 million **to Cyprus**, following the completion of the fifth review and approval of the supplemental Memorandum of Understanding. The review concluded that Cyprus should keep reform momentum and address the remaining challenges, in particular establishing a sound and effective restructuring framework to address the non-performing loan problem and enable banks to support the economy. Following the completion of the fifth review, EUR 3.268 billion of funds (out of a total of EUR 8.968 billion committed to Cyprus by the ESM) still remain to be paid upon meeting programme conditionality in quarterly disbursements until 2016. As regards the latest state of play of programme, Eurogroup President Jeroen Dijsselbloem said following the Eurogroup's meeting of 16 February that the foreclosure framework constitutes a "hurdle right now" and called upon Cypriot authorities to implement this framework as soon as possible.

The latest disbursement to **Greece** by the EFSF (EUR 1.0 billion) was carried out on 13 August 2014 after the implementation of the second set of milestones linked to the fifth review. This review started at the end of September 2014, without being concluded. EUR 1.8 billion of EFSF funds is the remaining amount to be disbursed. The current financial assistance programme to Greece ends on 28 February 2015.

State of play of the Greek negotiations (as of 23 February 2015, 12:00)

The Eurogroup and the Greek government engaged in intensive negotiations for weeks, as the Greek macro-economic adjustment programme expires at the end of February.

At the Eurogroup meeting of 20 February, an agreement in principle was reached to extend the current programme of Greece by four months under the existing conditions, using flexibility to the full extent. The purpose of the extension is to give time for the successful completion of the review and for talks on a possible future follow-up arrangement. Greek government is required to submit by the end of 23 February a list of measures it intends to take during the remainder of the programme period. If the list is approved by Eurogroup, the ratification process of the deal will begin.

Key elements of the agreement:

- Greece honours its financial obligations to all creditors.
- Only approval of the conclusion of the review of the extension allows for any disbursement of the outstanding tranche and the transfer of the 2014 SMP profits.
- Funds in the HFSF buffer continue to be available during the extension and can only be used for bank recapitalisation and resolution.
- Greece ensures to have appropriate primary fiscal surpluses. For the 2015 primary surplus target, the institutions will take the economic circumstances in 2015 into account.
- Greece refrains from unilateral actions and from the roll-back of measures already agreed.
- Close cooperation between Greece and European as well as international institutions continues.

Next steps:

- The list submitted by Greece will be assessed and if approved, the national parliaments of some Member States will start their ratification process.
- The list of reforms will be further specified and then agreed with the institutions by the end of April.
- During the extension period, discussions on a possible follow-up arrangement will be held.

Annex 1: Key economic indicators for the euro area

		2013	2014	2014(Q1)	2014(Q2)	2014(Q3)	2014(Q4)
Output							
Economic sentiment	indicator	93.6	101.3	101.5	102.2	100.8	100.7
Industrial confidence	balance	-9.3	-4.2	-3.5	-3.6	-4.8	-4.8
Gross domestic product	% ch. on prev. year	-0.5	--	1.1	0.8	0.8	0.9
	% ch. on prev. period	--	--	0.3	0.1	0.2	0.3
Private							
Consumer	balance	-18.6	-10.0	-11.2	-7.7	-9.9	-11.2
Private consumption	% ch. on prev. year	-0.6	--	0.6	0.7	1.0	--
	% ch. on prev. period	--	--	0.2	0.3	0.5	--
Investment							
Capacity utilisation	level, %	78.0	79.9	80.1	79.5	79.9	80.0
Gross fixed capital formation	% ch. on prev. year	-2.4	--	2.3	0.9	0.0	--
	% ch. on prev. period	--	--	0.3	-0.6	-0.3	--
Labour market							
Unemployment rate	% of labour force	12.0	11.6	11.8	11.6	11.5	11.4
Unemployment expectations	balance	34.4	21.3	23.6	16.4	21.4	23.7
International transactions							
World trade	% ch. on prev. year	2.6	--	3.1	2.9	3.6	--
	% ch. on prev. period	--	--	-0.4	0.8	2.0	--
Trade balance	merchandise, billion €	154.9	171.6	42.7	43.1	46.3	39.5
Current-account balance	billion €	214.2	220.5	59.0	57.8	66.1	37.6
Prices							
Consumer inflation expectations	Balance	16.9	8.2	13.1	8.6	6.5	4.7
Headline inflation (HICP)	% ch. on prev. year	1.3	0.4	0.6	0.6	0.4	0.2
Monetary and financial indicators							
Nominal interest rates (3 month)	(level)	0.22	0.21	0.30	0.30	0.16	0.08
Bilateral exchange rate EUR/USD	(level)	1.33	1.33	1.37	1.37	1.33	1.25
Nominal effective exchange rate	% ch. on prev. year	3.9	0.5	3.1	2.9	-0.3	-3.4
	% ch. on prev. period	--	--	0.8	-0.1	-2.1	-2.1

Source: DG ECFIN data as of 13 February 2015 (the next update is scheduled for 6 March 2015).

Annex 2: Scoreboard for the surveillance of macro-economic imbalances within the euro area

Values for year 2013	External imbalances and competitiveness					Internal imbalances					
	3 year average of **Current Account Balance** as % of GDP	**Net Interna-tional Invest-ment Position** as % of GDP	% Change (3 years) of **Real Effective Exchange Rate with HICP deflators**	% Change (5 years) in **Export Market Shares**	% Change (3 years) in **Nominal ULC**	% y-o-y Change in deflated **House Prices**	**Private Sector Credit Flow** as % of GDP	**Private Sector Debt** as % of GDP	**General Government Debt** as % of GDP	**Unemployment rate** - 3 year average	% y-o-y Change in **Total Financial Sector Liabilities,** non-consolidated
Thresholds	**-4/+6%**	**-35%**	**±5% (EA)**	**-6%**	**+9% (EA)**	**+6%**	**14%**	**133%**	**60%**	**10%**	**16.5%**
BE	-1.6	48.8	-0.3	-9.1	8.6	0.0	-2.0	162.2	97.9	8.2*	-3.5
DE	6.6	42.9	-1.9	-10.7	7.7*	1.8	1.3	103.5	76.4	5.2*	-6.3
EE	-0.7	-47.2	3.1	13.5	9.6	7.3	5.4	119.4	9.8	10.3	8.9
IE	4.0	102.1	-3.9	-4.9	1.3	0.3	-5.7	270.3	116.1	13.1*	0.7
EL	-3.9	-121.1	-4.4	-27.3	-10.3	-9.3	-1.1	135.6	174.7	23.3	-16.3
ES	-0.7	-92.6	-0.4	-9.1	-4.6	-9.9	-10.7	172.2	91.6	25.1*	-10.2
FR	-1.3	-15.6	-2.3	-13.0	3.9	-2.6	1.8	137.3	91.1	10.1*	-0.6
IT	-0.9	-30.7	0.0	-18.4	4.1	-6.9	-3.0	118.8	127.8	10.4	-0.7
CY	-4.0	-156.8	-0.8	-27.2	-5.9	-5.5	-11.2	344.8	101.8	14.6*	-19.5
LV	-2.8	-65.1	-1.7	8.4	10.5	6.6	0.8	90.9	38.2	14.4	5.2
LU	5.5	216.4	0.7	2.2	10.5	4.9	27.7	356.2	23.2	5.7*	8.8
MT	3.9	72.1	-1.3	-4.0	9.8	-2.1	2.3	143.1	69.5	6.2*	1.7
NL	9.7	31.2	0.4	-9.5	5.6*	-7.8	2.1	229.7	68.9	6.3*	-3.2
AT	1.4	-0.2	0.7	-17.0	6.4	2.9	0.2	125.5	81.2	4.5	-3.6
PT	-2.5	-116.2	-0.6	-5.3	-3.0	-2.5	-2.4	202.8	124.8	15.4*	-5.3
SI	2.8	-38.2	-0.7	-16.5	1.3	-5.8	-4.0	101.9	70.0	9.6*	-10.5
SK	-0.7	-63.8	2.1	-2.2	2.5	-0.5	5.4	74.8	54.3	13.8*	-0.3
FI	-1.6	6.3	0.1	-32.2	9.6	-1.3	0.7	146.2	54.7	8.2*	-11.8

Source: Eurostat MIP Scoreboard indicators, updated on 16 February 2015. The shaded cells indicate values above the threshold. * = 2014.

Annex 3: Key messages of briefing papers on "Debt sustainability and economic convergence of euro-area Member States: Challenges and Solutions"

The final versions of the external briefing papers will be made available on the ECON homepage.

The paper by **Paolo Mauro** *(Peterson Institute of International Economics)* provides policy recommendations to foster economic convergence and debt sustainability for the Member States, given the present macroeconomic situation and the public finances. The global economic and financial crisis that took place in 2008 has led to a deep risk of prolonged stagnation and to a more substantial divergence among the countries. Moreover, the public debts of advanced economies reached the highest levels since the Second World War. This scenario demonstrated the need of low debts to afford fiscal stimulus (with respecting the SGP and own domestic rules) and highlighted the vulnerability of several countries. The economic growth appears to be sluggish up to the next twenty years.

The author's recommendations are the following:

- The fiscal planes should be based on realistic projections. The cyclical economic history shows that crises were caused by slowdowns in economic growth because they were not recognized in time by policymakers;
- Improve monitoring, disclosure, and management of the materialization of fiscal risks;
- The rules of the SGP need to be simplified in order to avoid unclear understanding of the architecture and to better benefit from fiscal rules. Technically speaking, the escape clauses should be based on numerical criteria and the estimation method for potential output growth should be changed;
- Cut taxes on labour, consumption, property, and on social security contributions for youth. Moreover, increase the share of infrastructure and education;
- Improve official lending to increase the investors trust on indebted countries, plus the coordinated issuance of growth-indexed bonds, so that countries would pay higher interest during a strong economic growth and lower interest during weak times.

In his paper, **Clemens Fuest** *(Zentrum für Europäische Wirtschaftsforschung, ZEW)* looks at the sustainability of public finances and debt levels in the Euro area against the backdrop of the provisions of the Stability and Growth Pact (SGP). He shows that the budgetary surpluses required for many countries to bring down their debt levels to the reference value of 60 % debt-to-GDP would simply be unrealistic. Hence he turns his attention to enhancing economic growth instead, specifically focusing on public investment and growth oriented tax reforms.

Regarding the former, he shows that in many countries public investment has been sharply reduced to improve public finances, noting that the contribution to sustainability are smaller than the contribution of equivalent cuts to consumption expenditure would have yielded, although it also means that there should be many viable investment projects available in these countries. However, he rules out financing these through taking on more debt, referring to the 'golden rule' of public finances; only net public investment should be debt financed, whereas many member states already now are incurring more debt even though net public investment is negative. In light of this he also is sceptical of introducing any more flexibility into the SGP, since it may undermine its credibility, lessen the commitment to fiscal sustainability and thus raise risk premia in government bond markets, rendering fiscal sustainability even harder to achieve. Turning to tax reforms, he proposes shifting the tax burden from e.g. labour and corporate income tax to higher taxes on consumption and property, still taking into account revenue constraints and distributional implications. Such a tax structure would be better able to support growth. Also, if countries need to temporarily boost consumption or investment, he suggests using tax instruments to that end, such as a temporary cut in the standard rate of VAT or a temporary increase in tax allowance for investment in equipment.

The paper by **Paolo Manasse** *(Università di Bologna)* argues that there is a trade-off between debt sustainability - the main goal of fiscal discipline - on the one hand, and the real economic convergence on the other hand. Based on statistical and econometric evidence, the author moreover claims that the current fiscal framework does not improve this trade-off as convergence in debt-to-GDP ratios and structural balances across the euro area has been associated with real economic divergence along several dimensions, in particular in terms of unemployment, investment and, at least temporarily, output growth. In other words, the current fiscal framework has remained pro cyclical. If this aspect remains unaddressed, the author warns it could undermine the existence of the monetary union. In this regard, the recent flexibility guidelines are a step in the right direction but their overall impact is to be limited as 1) the structural reform clause (which exchanges fiscal flexibility for reforms) may have a negative impact on the economy in the short term - therefore further accentuating the pro cyclicality of the framework; 2) the investment clause is likely to be ineffective (it will concern only a limited number of projects); and 3) the cyclical clause is excessively complex and does note remover the pro-cyclical bias of the framework. Therefore, the author proposes:

- Creation of inter-European transfers, such as a European Unemployment Insurance Scheme with harmonised criteria across Member States and funded for example via shares of Member States' VAT receipts;
- Reform of the present SGP framework along three dimensions, namely simplification and focus on debt targets, more incentives for structural reforms and more discretion for individual Member States to allocate the agreed consolidation effort over time.

In the paper by **Xavier Ragot** *(Observatoire Français des Conjonctures Économiques)*, three main challenges are singled out that Europe faces today. The first one is nominal divergence, i.e. differing price levels across euro area countries. The main driver of this process is diverging wages, singling out in particular Germany for extraordinary wage moderation, which in his view is a result of different national wage setting institutions. The second is a lack of aggregate demand, the main evidence for which is low inflation and the large current account surplus of the euro area. In his analysis, this is due to fiscal consolidation and failed demand management on a European level, noting that country-specific recommendations (CSRs) are set for individual countries without regard to their aggregate impact when considered all together. The final challenge is high levels of public debt. Together these form a trilemma for European policymakers: lowering public debt through fiscal consolidation constitutes a drag on aggregate demand, which is the same problem if nominal divergence is addressed through wage cuts, while to increase aggregate demand means taking on more debt or raise wages.

Concisely, his proposed solution is for deficit countries to invest more to increase productivity while exercising wage moderation, with surplus countries simultaneously raising their wage levels. Specifically, all the flexibility in the SGP should be used to sustain aggregate demand in the southern countries, while aggregate demand in the euro area should in the future be managed in a more centralized fashion using for example the Annual Growth Survey as a tool, with CSRs then drawn up to support this aggregate stance. Nominal divergence would be tackled by creating national councils reporting on wage dynamics who would coordinate their work on a European level. Also, due to its extreme wage moderation, a credible path should be defined for Germany to raise its price level. Finally, he calls for a programme of investment in southern Europe, much larger than the Juncker Plan.