BRIEFING

# Economic Dialogue and Exchange of Views with Vice-President Dombrovskis and Commissioner Moscovici

ECON on 14 April 2015

*Vice-President Dombrovskis and Commissioner Moscovici have been invited to an Economic Dialogue on the implementation of the 2015 European Semester in accordance with Article 2ab of Council Regulation 1466/97. This note focuses on the latest developments in the context of the ongoing European Semester cycle, including the implementation of Country Specific Recommendations, Stability and Growth Pact, Macroeconomic Imbalances Procedure and briefly presents the state of play in Member States under Macroeconomic adjustment programme.*

## 1. Implementation of the 2015 European Semester Cycle

The 2015 European Semester started with the publication of the first Annual Growth Survey (AGS) and Alert Mechanism Report (AMR) presented by the Commission on November 2014. The AGS outlined the new jobs and growth agenda based on three mutually reinforcing pillars (investment, structural reforms and growth-friendly fiscal consolidation) as well as the Commission's proposal to streamline and reinforce the multilateral surveillance process. The AMR identified 16 Member States as experiencing macroeconomic imbalances, such as declining competitiveness or asset bubbles.

On 26 February 2015, in line with the new streamlined design of the European Semester, the Commission presented its economic surveillance package which included a single comprehensive assessment - so called Country Report - for each EU Member State[1] and the euro area as a whole. These reports analyse Member States' economic policies and present the in-depth reviews of macroeconomic imbalances in the 16 countries identified in the AMR. They also provide an assessment of the 2014 Country Specific Recommendations[2] (see Box 1).

**Box 1: Implementation of the 2014 Country Specific Recommendations**

According to the qualitative assessment provided in the Country Reports, EU-28 Member States fully/substantially implemented about 7.5% of Country Specific Recommendations (CSRs) received in 2014. Some progress has been registered on approximately 43% of the CSRs, while almost half of the recommendations have not been implemented at all or only in a limited manner. As regards the euro area as a whole, which has been assessed for the first time using the grid applied at a country level, it has made substantial or some progress on all the 2014 recommendations.

See a separate EGOV note for more information on the implementation record by Member State.

On 2 March 2015, the Commission published its proposals for Broad Economic Policy Guidelines (BEPGs) and Guidelines for Employment Policies[3]. The 2015 draft BEPGs and the employment guidelines are as follows: 1) boosting investment; 2) enhancing growth by the implementation of structural reforms;

[1] Except for Greece (so as to take into account the late February 2015 Eurogroup's decisions).

[2] Prior to the streamlined Semester, only the in-depth reviews were published in March, while the Country Reports (previously called Staff Working Documents) were issued in May/June. The publication of a single comprehensive report at an earlier stage is expected to help increase the transparency of the European Semester as well as its ownership by stakeholders.

[3] These guidelines, based on Article 121 and 148 of the Treaty on the Functioning of the European Union (TFEU), lay down the scope and the direction of policy coordination among EU Member States.



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3) removing key barriers to growth and jobs at EU level; 4) improving the sustainability and growth-friendliness of public finances; 5) boosting demand for labour; 6) enhancing labour supply and skills; 7) enhancing the functioning of labour markets; 8) ensuring fairness, combating poverty and promoting equal opportunities (see a separate EGOV note for more information). While these guidelines are non-binding, their implementation is monitored in the context of the European Semester as, *inter alia*, they serve as a reference for the CSRs.

Finally, the Commission also published on 2 March 2015 the main findings of the public consultation on the Europe 2020 Strategy[4] accompanied by an updated report on the state of play regarding the EU 2020 targets[5]. According to the results of this consultation, the strategy as a whole, including its objectives, priorities and targets, still remains valid, relevant and meaningful. Though most flagship initiatives served their purpose, their visibility has remained weak. Therefore, the strategy could be improved by stronger ownership and involvement at all levels (see Box 2). The Commission will present proposals for the review of the Europe 2020 Strategy before the end of the year.

**Box 2: Main results of the Europe 2020 public consultation**

| **STRENGTHS** | **WEAKNESSES** |
|---|---|
| • Overwhelming support for an EU-wide jobs and growth strategy<br>• Consistency of the areas covered by Europe 2020 with the challenges to be tackled<br>• Relevant and mutually reinforcing targets<br>• Some already tangible progress: the EU is on course to meet or closely approach the targets on education, climate and energy | • Lack of visibility of the flagship initiatives<br>• Need to improve the delivery and implementation of the strategy<br>• Insufficient involvement of the relevant stakeholders<br>• Far from reaching the targets on employment, research and development and poverty reduction |
| **OPPORTUNITIES** | **THREATS** |
| • Actors willing to play an active role in the strategy<br>• Close monitoring of the strategy through the European Semester<br>• Alignment of Europe 2020 with the Commission's priorities (jobs, growth and investment) | • The crisis has amplified divergences across and within Member States<br>• Political nature of the targets and Member States' lack of ambition |

Source: European Commission (2015).

**Next steps:**

- 12 May 2015: Council conclusions on in-depth reviews under Macroeconomic Imbalance Procedure;
- Mid-May 2015: Commission is to present its proposals for the Country opinions and 2015 CSRs;
- 19 June 2015: Council's approval of 2015 CSRs and Council's opinions on the updated Stability/Convergence Programmes;
- 25-26 June 2015: European Council is to endorse integrated CSRs;
- 14 July 2015: Adoption of integrated CSRs by the Council.
- During the implementation of the Semester Cycle, Economic Dialogues will be held in the competent committee of the EP, in particular with the Council in order to implement the "*comply or explain*" principle included in EU law.

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[4] This public consultation was held between May and October 2014.

[5] See EGOV table on Member States progress in implementation of EU2020 targets.

## 2. Implementation of the Stability and Growth Pact

### State of play:

Currently, eight euro area countries (IE, EL, ES, FR, CY, MT, PT, SI) and three non-euro area countries (HR, PL, UK) are under the Excessive Deficit Procedure (EDP), while eleven euro area countries (BE, DE, EE, IT, LV, LT, LU, NL, AT, SK, FI) and six non-euro area countries (BG, CZ, DK, HU, RO, SE) are under the preventive arm of the Stability and Growth Pact (SGP). A detailed overview is provided in a separate EGOV briefing.

**Box 3: Commission communication of January 2015 on flexibility within the SGP**

Main new features of the Communication are specifications by the Commission on how it will take into account within the Stability and Growth Pact (SGP) the following elements:

(1) Structural reforms ("structural reform clause") under the preventive and corrective arms of the SGP;
(2) Capital contribution to the European Fund for Strategic Investments (EFSI) under both arms;
(3) Public investments co-financed with EU funds ("investment clause") under the preventive arm of the SGP;
(4) New definitions of "economic good and bad times ("fiscal adjustment matrix") that specify (based on country-specific "output gap"- and growth-levels) the required fiscal effort under the preventive arm of the SGP.

Compared to earlier practise and interpretations, the new elements included in the Communication concern notably the preventive arm of the Pact. For Member States under the corrective arm of the SGP, i.e. which are subject to an on-going Excessive Deficit Procedure (EDP), the above mentioned features would not imply a major change to the current practise.

The main new flexibility interpretation features in the preventive and corrective arms are visualised in synthetic overviews provided in Annexes 1 and 2.

### Latest developments:

(1) On 25 February 2015, the Commission recommended that no EDP is opened for **BE**, **IT** and **FI**: though these countries' fiscal efforts are not in line with the debt reference value, the Commission was of the opinion that the debt criterion should be considered as currently complied with after taking into account all relevant factors under Article 126(3) of the TFEU[6]. On that basis, these countries remain in the preventive arm of the SGP and their CSRs of July 2014 remain applicable;

(2) On 10 March 2015 a revised recommendation to correct the excessive deficit was adopted by the **Council for FR**. It follows a Commission proposal of 25 February 2015 to extend the deadline for FR to correct its excessive deficit by two extra years to 2017. The revised recommendation also sets the deadline of 10 June 2015 for FR to take effective action and to report in detail on the consolidation strategy that is envisaged to achieve the targets. The extension of the dead-line for correction was based on the assessment by the Commission that

[6] According to Article 126(3) of the TFEU, the Commission shall take into account in its assessment of compliance with debt and deficit criteria whether the government deficit exceeds government investment expenditure and *all other relevant factors*, including the medium-term economic and budgetary position of the Member State. Article 2(3) of the Regulation 1467/97 as amended by the Regulation 1177/2011 further specifies that these *all other relevant factors* are to include, among others, developments in the medium-term economic, budgetary and government debt positions. The Commission must also take into account any other factors put forward by the Member State concerned (in particular financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances).

"*the available evidence does not allow to conclude on no effective action*"[7]. Assessment of effective action is based on the methodology[8] agreed by the Commission and the Member States in the Terms of Reference endorsed by the Council in June 2014. With respect to multi-annual EDPs, these guidelines stipulate that "*in forthcoming assessments of effective action, the Commission will examine whether the overall fiscal effort over the EDP correction period is delivered in order to balance – at least partially – the asymmetry in the assessment*"[9]. While the Commission re-iterated this approach in its Report on Public Finances in the EMU 2014[10], the Commission assessment of effective action under the EDP in the case of FR only covered the years 2013 and 2014 instead of the entire correction period (2013-2015) as specified in the Council recommendation of 21 June 2013. For 2015, the Commission draft recommendation and the Council recommendation do not include an assessment of effective action[11].

## 3. Implementation of the Macroeconomic Imbalance Procedure

The 2015 Alert Mechanism Report, published by the Commission in November 2014, identified 16 Member States at risk of macroeconomic imbalances.

On 26 February 2015, the Commission published a Communication on the results of the in-depth-reviews for the 16 Member States previously identified and an assessment of the implementation of the 2014 CSRs, as well as Country Reports for each MS[12]. The Commission concluded[13] that:

(1) Six MSs (BE, NL, RO, FI, SE and UK) are in a situation of "**macroeconomic imbalances requiring policy action and monitoring**";
(2) Two MSs (DE and HU) are in a situation of "**macroeconomic imbalances requiring decisive policy action and monitoring**";
(3) Three MSs (IE, ES and SI) are in a situation of "**macroeconomic imbalances requiring decisive policy action and specific monitoring**";
(4) Five MSs (BG, HR, FR, IT and PT) are experiencing "**excessive macroeconomic imbalances**".

The Commission specified that:

- Risks of imbalances have significantly increased for HR and FR;
- Specific monitoring of ongoing and planned reforms will be carried out for IT, BG and PT;
- The monitoring will be part of the post-programme surveillance for IE and ES;
- There is no tangible improvement in imbalances identified last year in DE (i.e. persistently high current account surplus) and the policy response has been insufficient so far;
- There is no tangible improvement in the trend of imbalances identified last year for HU.

The Commission is currently holding bilateral meetings with Member States to discuss the Country Reports before mid-April, by which the Member States present the National Reform Programmes

[7] This implies that the Commission de facto interprets that "effective action" has taken place as it proposed an extension of the dead-line for correction (see Annex 2).This is for the first time the Commission based its recommendation on such premises, establishing thus a precedent for future assessments of effective action under the provisions of the SGP.
[8] This methodology encompasses inter alia the so-called "top-down" and "bottom-up" approaches (for more information see a separate EGOV note, page 4).
[9] See page 18 of the Council document ST 10945 2014 REV 1 ADD 1 REV 1 belonging to the terms of reference.
[10] See page 39.
[11] For more information on the EDP on FR, see a separate EGOV note.
[12] Except Greece.
[13] See EGOV note "Implementation of MIP - State of play March 2015",the "At a glance: the Macroeconomic Imbalance Procedure" and the "At a glance: Implementation of MIP Country Specific Recommendations" for further details.

(NRPs) outlining their plans to boost jobs and growth. In May, on the basis of the outcomes of dialogues and NRPs, the Commission will:

- Evaluate whether to recommend to the Council the opening of **Excessive Imbalance Procedures (EIP) for FR and HR;**
- Propose a new set of the 2015 **CSRs**, including specific MIP recommendations issued to 16 Member States that present macroeconomic imbalances.

On 17 February, the ECOFIN Council considered that "*the **corrective arm of the MIP should be applied** where appropriate*" and that "*there is a need to improve the predictability and stability of the process, including in the subsequent monitoring and the implementation of the relevant policy recommendations at the national level*".

The **ECB** mentioned in its Economic Bulletin of March 2015 (pp. 48-50) that "*The outcome of the 2015 in-depth-review shows that the imbalances are becoming increasingly severe in a number of countries. ... However, every year the number of countries with excessive imbalances is growing ... whereas the EIP has never been invoked by the Commission. This raises questions about the application of the procedure and the effectiveness of its preventive arm"*. The ECB concluded that "*It is important to make full and effective use of the instruments of the MIP, including its **corrective arm**, in order to reduce the potential risks to the smooth functioning of the EMU*."

## 4. Latest developments in countries under Economic adjustment programme

### Greece

***Financial assistance: State of play***

In March 2014, teams of the Commission, the ECB and the IMF (formerly the so-called "Troika") completed the fourth review mission and agreed with Greek authorities that the economy has begun to stabilize, and is poised for a gradual resumption of growth. It also reported that: (1) fiscal performance is on track to meet programme targets; (2) the authorities are making progress on structural reforms to improve the growth potential and flexibility of the Greek economy; (3) the authorities are continuing their efforts to strengthen the social safety net.

In April 2014, the Eurogroup noted that Greece's financial sector has stabilised, as also shown by the success of all four core banks having raised the required capital solely from private investors. "Troika" staff concluded in August 2014 that the milestones to be completed by end June 2014 can be considered broadly met; therefore, Greece received in August 2014 the final tranche (of EUR 1.0 billion) under the fourth review.

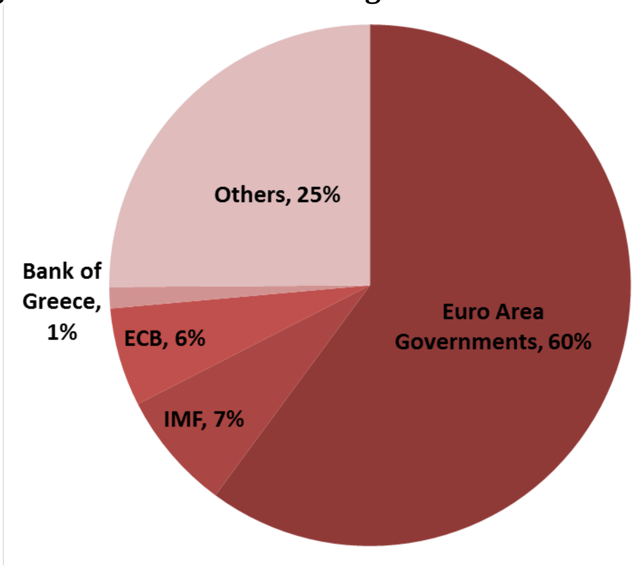
The fifth review started in September 2014 and is still on-going. EUR 1.8 billion of EFSF funds have not been disbursed (out of EUR 144.7 billion of EFSF funds for Greece). After the January 2015 elections, the Eurogroup and the new Greek government have been engaged in intensive negotiations. As far as the financial assistance of the Eurogroup is concerned, the programme has been extended on 27 February 2015 by four additional months until 30 June 2015. As to the IMF, the programme continues until 2016 (EUR 11.6 billion out of EUR 28 billion have been disbursed so far). However, Greece faces a series of debt loan repayments this year, including to the IMF, with around EUR 450 million repaid on Thursday 9 April 2015.

As Greece's cash reserves are drying up, the Greek government submitted a new list of reform proposals on 1 April 2015 in order to fulfil the conditions attached to the disbursement of the next tranche of financial assistance totalling EUR 7.2 billion (out of which EUR 1.8 billion from the

EFSF, EUR 3.5 billion from the IMF and a transfer of EUR 1.9 billion in profits the ECB made on the Greek bond purchases under the Securities Market Programme).

Finally, note that Greece' gross government debt stood at EUR 324.1 billion at the end of 2014 (or about 177.7% of GDP). The distribution of this outstanding debt across different categories of bondholders is depicted in Figure 1 below.

**Figure 1: Greece's outstanding debt as of 31 December 2014**




Source: EC, IMF, ECB, Greece's Public Debt Management Agency and EGOV calculations.
Note: The shares do not add up to 100% due to rounding.

### *The Greek banking sector: State of play*

According to the statistics published by the Bank of Greece, the Greek banking sector has recently seen a very sizeable loss of deposits. Over a period of just two months the aggregated amount of overnight deposits in the Greek credit institutions declined by more than 12% from EUR 166 billion in December 2014 to EUR 146 billion in February 2015 (the March 2015 data is not yet available).

In order to shield the Greek banks from the effects of the withdrawals, the ECB has apparently raised the ceiling for Emergency Liquidity Assistance to Greek banks to more than EUR 71 billion according to statements in the financial press; however, at present there is no official ECB statement available that would make the actual situation transparent.

On 4 February 2015, the ECB lifted the waiver for debt instruments issued or fully guaranteed by Greece, which allowed those instruments to be used in Eurosystem monetary policy operations despite the fact that they did not fulfil minimum credit rating requirements. As the situation stands, in the wake of that decision Greek banks can no longer use Greek sovereign bonds which they hold as collateral for their refinancing operations with the ECB.

However, according to data published by the Greek Central Bank, the Greek banking system is not particularly reliant on Greek sovereign debt as collateral.

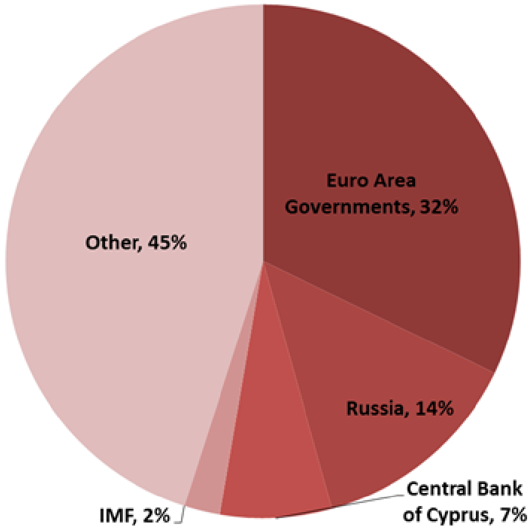
The overall economic situation may hence affect Greek banks much more: Greek banks are already exposed to one of the highest levels of non-performing loans in Europe. If increased economic uncertainty or a political standoff were to lead to a further fall of the country's GDP, it would further weaken the Greek banks' solvability via increasing non-performing loans and losses on the existing non-performing exposures.

## Cyprus

Following the completion of the fifth quarterly review and approval of the supplemental Memorandum of Understanding, the ESM disbursed EUR 0.35 billion on 8 December 2014, bringing the total amount of the disbursed EU's financial assistance to EUR 5.7 billion out from a maximum available of EUR 8.968 billion (availability period ends on 31 March 2016). 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. As to the IMF, about €86 million is subject to approval by the IMF's Executive Board as the completion of the fifth review has been postponed following delays in program implementation and ensuing legal uncertainties (see also the IMF Article IV Consultation Staff Report on Cyprus, of 22 October 2014, page 15). The IMF financial assistance amounts to SDR 891 million (about EUR 1 billion) under the Extended Fund Facility (out of which about EUR 420 million were disbursed to date). The latest review mission took place from 27 January to 6 February 2015. Given the suspension of the effective application of the foreclosure framework and delays in adoption of the legislation on insolvencies, reaching staff-level agreement on this review was not possible.

Finally, note that Cyprus' gross government debt stood at EUR 18.5 billion at the end of 2014 (or about 107.0% of GDP). The distribution of this outstanding debt across different categories of bondholders is depicted in Figure 2 below.

**Figure 2: Cyprus' outstanding debt as of 31 December 2014**




Source: EC, IMF, ECB, Cyprus' Public Debt Management Office and EGOV calculations.

On 6 April 2015, after an incremental relaxation over the past 18 months, Cyprus lifted its last remaining capital controls imposed in March 2013 (i.e. monthly cap of EUR 20 000 on transfers by individuals to foreign banks and of EUR 10 000 for travelers moving money out of the country). To date, Cyprus is the only euro area Member State that put into place such type of measures.

# Annex 1: Preventive arm of the SGP - New/updated "flexibility" elements

**<u>"Financial contribution to EFSI"</u>**: National contributions to the capital of EFSI are regarded as "one-off measures"; they can therefore not lead to a deviation from MTO.

**1**. Country-specific **MTO** as endorsed/adopted by the Council

**2**. Commission assessment

**3a** MTO attained

**3b** Deviation from MTO

**4a** Warning

**4b** Temporary deviations to MTO accepted based on "<u>structural reform clause</u>" and "<u>investment clause</u>"

**5** Council recommendation for adjustment path, based on Commission recommendation (within 1 month)

**5a** Member State complies

**5b** Member State does not comply

**6** Council may adopt lack of effective action decision based on Commission recommendation

**7** Sanction: interest-bearing deposit of 0.2% of GDP (only for euro area Member States)

**Three new/updated clauses**
**(which might be cumulative)**
**Note: New elements are in bold below**

**<u>(1) New definition of "economic good and bad times"</u>** in view of the adjustment of the structural effort according to the situation in the cycle: A novelty is a **matrix with 5 categories defining the economic situation, mainly based on the so-called "output gap", and the required fiscal effort under these categories.**

**<u>(2) New/updated "structural reform clause"</u>**: The **scope of eligible reforms is widened; structural reforms with an impact on the potential growth** can also be taken into account (**until now COM used to insist on the structural reforms with a direct impact on the debt sustainability and explicitly favoured reforms of pension schemes**). These reforms must be (1) adopted and (2) implemented or sufficiently documented. Additional time to reach the middle-term objective (MTO) can be granted provided that the deviation does not exceed 0.5% of the GDP, that the MTO is reached within the 4 years programme period and that an appropriate safety margin is continuously preserved so that the deviation from the MTO or the agreed adjustment path does not lead to an excess over the 3 % of GDP reference value for the deficit.

**<u>(3) New/updated "investment clause"</u>:** Temporary deviations from the MTO or the adjustment path towards it are allowed to **accommodate investment, provided** that (**new elements compared to the previous "investment clause" as set out in the letter of Commission Vice-President of 3 July 2013 are in bold)**:

(i) GDP growth is negative or GDP remains well below its potential (**with an output gap greater than minus 1.5%**);

(ii) deficit is not higher than 3% deficit and an appropriate safety margin is preserved (**does not include anymore an explicit reference to the "debt reduction benchmark"**);

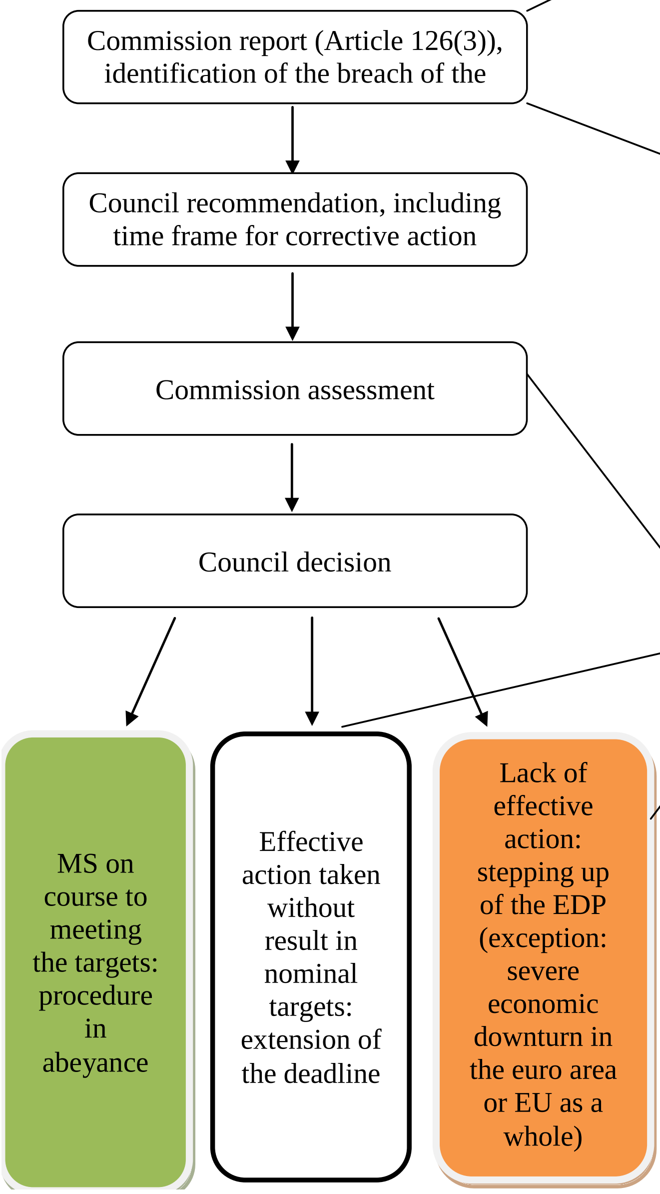
(iii) **investment levels are effectively increased a result.**

(iv) eligible investments are national expenditures on projects co-funded by the EU under the Structural and Cohesion policy, Trans-European Networks and the Connecting Europe Facility, **and the co-financing of projects also co-financed by the EFSI**;

v) **the Member State must also compensate for any temporary deviations and the MTO must be reached within the four-year horizon of its current Stability or Convergence Programme.**

**COM will apply the clause without the previous condition of a large negative output gap in the euro area or EU as a whole.**

## Annex 2: Corrective arm of the SGP - New/updated "flexibility" elements




**National Contributions to EFSI**: In case of a non-respect of the deficit or debt reference values, the Commission will consider the contributions to the capital of EFSI to be a "relevant factor" in line with Article 2(3) of Regulation (EC) No 1467/97 -→ An EDP will not be launched if a non-respect is due to the contribution and if the excess over the reference value is small and is expected to be temporary.

The Commission will take into account **structural reforms** or well documented plans for such reforms as relevant factors when opening or not an EDP and when setting the timeline for the correction. The **scope of eligible reforms is widened, given that structural reforms with an impact on the potential growth** can also be taken into account (until now COM used to insist on the structural reforms with a direct long-term positive budgetary effects and explicitly favoured reforms such as on pension schemes). If agreed reforms are not implemented, the Commission will consider it **an aggravating relevant factor**.

The Commission will take into account **structural reforms** or well documented plans for such reforms as relevant factors when extending the deadline of an on-going EDP, if effective action has been taken by the concerned Member State.

If agreed reforms are not implemented, the Commission will consider it **an aggravating relevant factor** when assessing effective action in response to the EDP recommendation and when setting a deadline for the correction of the excessive deficit.