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COVER NOTE

From:	EFC
To:	Delegations
Subject:	Main areas for coordination of economic policies and reforms - EFC report

Delegations will find attached EFC report on the "Main areas for coordination of economic policies and reforms.

Main areas for coordination of economic policies and reforms

– EFC report –

The European Council on 24-25 October held a discussion on completing and ensuring the smooth functioning of EMU. It focused in particular on enhanced economic policy coordination, contractual arrangements and associated solidarity mechanisms, strengthening the social dimension and completing the Banking Union. To this end, it underlined that closer coordination of economic policy areas should focus on policy areas where positive effects on competitiveness, employment and the functioning of the EMU are most prominent. As a first step, it agreed to make a shared analysis of the economic situation in Member States and the euro area. To this end it would hold a discussion in December, following the publication of the Commission Annual Growth Survey (AGS) and the Alert Mechanism Report (AMR), with the aim to agree, on the basis of the relevant indicators, on the main areas for coordination of economic policies and reforms.

The two Commission reports were discussed by the Economic Policy Committee on 20 November and by the Economic and Financial Committee on 29 November. The following points summarise the outcome of the discussions:

- Members broadly share the Commission's analysis of the economic situation in the EU for the coming year. Economic recovery is still modest and fragile, but the economic outlook seems to gradually become more positive, with growth becoming more robust going forward. Fiscal consolidation is progressing with a reduction of fiscal deficits and debt ratios forecast to peak in 2014 and decrease as from 2015. EU economies continue to progress with correcting internal and external imbalances. This rebalancing is underpinned by substantial competitiveness gains over the past years in Member States that previously had large deficits. Unemployment has stabilised, although at high levels, and employment expectations are showing moderate signs of improvement. While there is also room for positive feedback loops between confidence, investment and credit, downside risks to economic recovery still are present, underlining the need for determined and ambitious implementation of agreed policies at EU level and of country-specific recommendations in Member-States.

- Members agree with the economic challenges identified by the Commission and the broad policy priorities[1] identified in the AGS. In line with the Commission assessment, Members however point to progress in a number of these policy areas over the last years. Notably, progress has been made on fiscal consolidation, including stronger fiscal frameworks, which has contributed to stabilise and reduce the high debt ratios, and improved market sentiment. Steps have also been taken to restore the banking sector, through restructuring, rising capital and new standards, and to restore lending to the economy, in particular targeted towards SMEs. The recent agreement on a single supervisory mechanism for banks also provides a first step towards a Banking Union, but more needs to be done in this context. Measures have also been taken to reform labour markets by combating segmentation and promote participation and special efforts are targeting young people. Wage moderation and real wage dynamics are contributing to reduce unemployment divergences and unit labour developments are supporting the needed rebalancing in the euro area.
- The legacy of the crisis, deleveraging needs in the public and private sector, fragmentation of financial systems and credit markets, sectoral restructuring and adjustment and high levels of unemployment will nevertheless continue to weigh on growth. There are also substantial differences in the outlook for growth and labour markets across Member States. In some Member States economic recovery is still held back by high private indebtedness, which – together with financial fragmentation – reduces the room for productive investment and consumption, and improvements in the net international investment position of the most indebted economies have been slow. The lending conditions for businesses are still constrained. Moreover, high surpluses persist in some Member States, which could point to an insufficient level of investment. The social impact of the crisis is still being felt with unemployment at high levels, in particular for the young, though positive effects of growth and labour market reforms on labour market performance will gradually materialise over time. Long-term unemployment levels have been rising and risks of higher structural unemployment would have negative effects on the EU growth potential. While fiscal consolidation has progressed, the mix of expenditure and revenue measures has not always been growth friendly, with some Member States increasing revenue by rising tax rates and overall tax burden, and by reducing public investment.

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1 The five broad priorities are: 1) Pursuing differentiated, growth-friendly fiscal consolidation; 2) Restoring lending to the economy; 3) Promoting growth and competitiveness for today and tomorrow; 4) Tackling unemployment and the social consequences of the crisis; and 5) Modernising public administration.

- Looking forward, Members concur with the Commission on the need to focus priorities on strengthening efforts in areas where important challenges prevail and where progress has been less pronounced, or has been more disparate among Member States. Against this background and taking into account the Commission's overview of progress in implementation of country-specific recommendations over the past three years, the most important areas for enhanced coordination of economic policies and reforms in Europe are to promote growth and competitiveness to build a lasting recovery and tackling unemployment in a sustainable manner. These two priorities are closely interlinked, with sustainable growth translating into new job opportunities and lower unemployment, and employment supporting growth. In particular, further progress is needed in the implementation of structural reforms to assist in creating the much needed investment opportunities that will help shift resources towards the production of tradable goods and services, increasing external competitiveness and boosting productivity. In this context Members support the Commission's "2014 Single Market Report"[2], pointing to key areas of the Single Market where growth potential is the strongest and simplify the overall business environment. Members underline that sustainable public finances are a prerequisite for economic growth. Notwithstanding progress with fiscal consolidation, debt ratios remain high in most Member States. Members therefore emphasise the need to continue pursuing differentiated growth-friendly fiscal consolidation and reducing debt ratios in line with the Stability and Growth Pact. In this context, more attention should be paid to the quality of fiscal adjustment by ensuring an appropriate mix of revenue and expenditure measures, including shifting taxes away from labour; more efficient public spending and modernisation of public administrations; and giving priority to public spending aimed at increasing the growth potential. Meanwhile, EU financial instruments should continue to be mobilized in support of growth and employment, in line with the conclusions of the European Council. Finally, restoring lending to the economy and ensuring a healthy banking sector is key for providing finance for productive activity and sustain the economic recovery.

[2] A single market for growth and jobs: an analysis of progress made and remaining obstacles in Members States - Contribution to the Annual Growth Survey 2014.

- **To support sustainable growth and jobs, ensure a smooth function of EMU and a lasting rebalancing, specific attention should be given to**:

➢ <u>Improving the functioning and flexibility of product and services markets</u>, including by increasing competition in network industries as well as a more ambitious implementation of the Services Directive and opening up services sectors.

➢ <u>Implementation and follow-up on reforms regarding the functioning of labour markets,</u> to increase labour participation and facilitate labour mobility. Important measures also include increase the flexibility of wage formation, reducing the tax-wedge on labour and improving education and skills performance.

➢ <u>Pursue the on-going restructuring of the banking sector in order to ensure financial stability, restore</u> lending to the economy, the functioning of the single market and overcoming fragmentation of financial markets. The Banking Union, including a single supervisory and resolution mechanisms, provides one key element of the EU level response and should be adopted and implemented as swiftly as possible.

In view of the conclusions and intentions of the European Council to return to **the social dimension of EMU** in December, the following points summarise the outcome of discussions so far:

- Work has progressed on the integration of social aspects in the European semester, including the use of an employment and social scoreboard in the Joint Employment Report and enhanced dialogue with social partners while acknowledging that further measures to enhance the social dimension in the euro area are voluntary for those outside the single currency.
- As regards the Macroeconomic Imbalances Procedure (MIP) first discussions have taken place on the overall appropriateness of introducing auxiliary social indicators in the scoreboard of the Alert Mechanism Report. Members have raised concerns about the implications of including social indictors into the MIP and emphasised that the analysis of social indicators should not dilute the aim of the MIP as a detection, prevention and correction tool for macroeconomic imbalances, which is significant for the functioning of the EMU. On the basis of the Commission proposals, the Economic Policy Committee intends to discuss the suggested indicators.