Association d'Instituts Européens de Conjoncture Economique

# AIECE General Report

## For the AIECE Autumn 2015 General Meeting

## Part 1

Coe-Rexecode

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# 1. Euro area economic outlook

## Recent developments

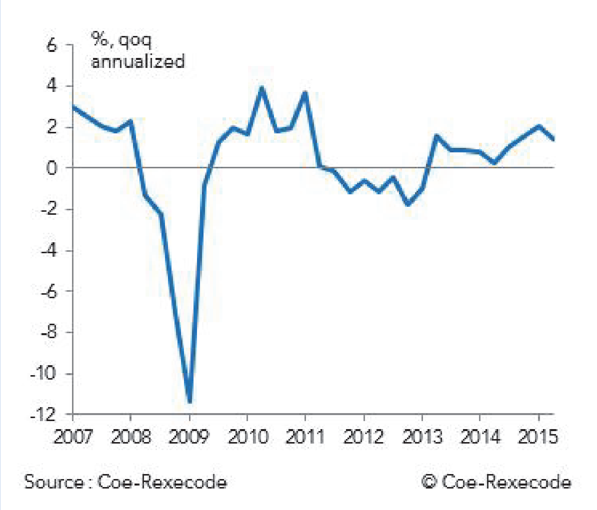
The euro area is going through an **economic recovery** that proves lasting and shared, though only moderate. In the second quarter of 2015, euro area GDP grew by 0.4% q.o.q. in volume terms, after growing by 0.5% in the first quarter of 2015, by 0.4% in the last quarter of 2014, and by 0.3% in the third quarter of 2014. The second quarter of 2015 was the ninth consecutive quarter with positive GDP growth for the euro area, the longest such period since 2003-2008. Nevertheless, the average quarterly growth rate over these 9 quarters has been 0.3%, below the 0.5% quarterly average of the 2000-2007 years.

Indicators suggest that this **moderate growth trend is continuing**. The euro area composite PMI has averaged 53.9 in the third quarter, exactly as it did in the second quarter. The European Commission Economic Sentiment Indicator amounts to 105.9 for October, its highest level since 2011.

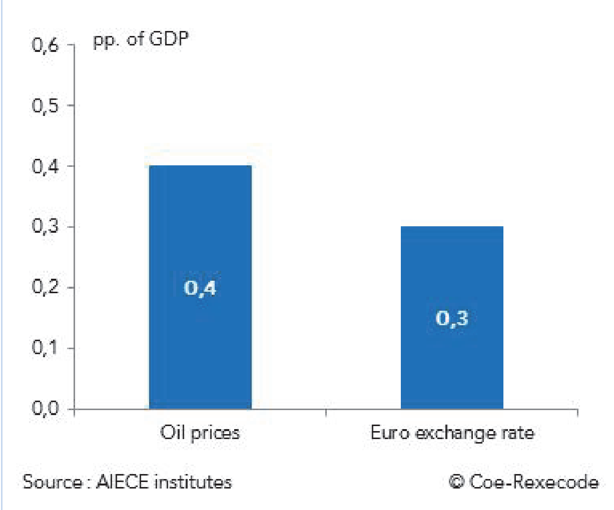
Of course, exogenous factors are playing an important role in that growth upswing. First of all, **oil prices** have gone through a steep fall since July 2014. The Brent price of 49.5$ as at October 30 was 57% below its 2014 peak. Low oil prices have strongly contributed to boosting consumers' purchasing power and corporate margins. Responding AIECE institutes deem on average that low oil prices will account for 0.4 percentage point of the 2015 euro area GDP growth.

The **euro exchange rate** is the second key exogenous factor contributing to euro area growth. Its fall has boosted exporters' margins and enhanced net external trade. In October, the euro's nominal effective exchange stood 10% below its 2014 peak, and more significantly enough, the euro's real effective exchange rate stood 20% below its 2014 peak (Coe-Rexecode calculations). Nevertheless, the euro's real effective exchange rate has been almost stable in real terms since March. Responding AIECE institutes deem on average that the weak euro will account for 0.3 percentage point of the 2015 euro area GDP growth. Put together, these oil and euro impact estimates would imply that 0.7 point of 2015 euro area growth (about half of the projected growth for 2015) is of a very cyclical nature, which raises the question of the euro area's capacity to grow once their benefits have vanished.

*Graph 1.1: Euro area GDP growth*

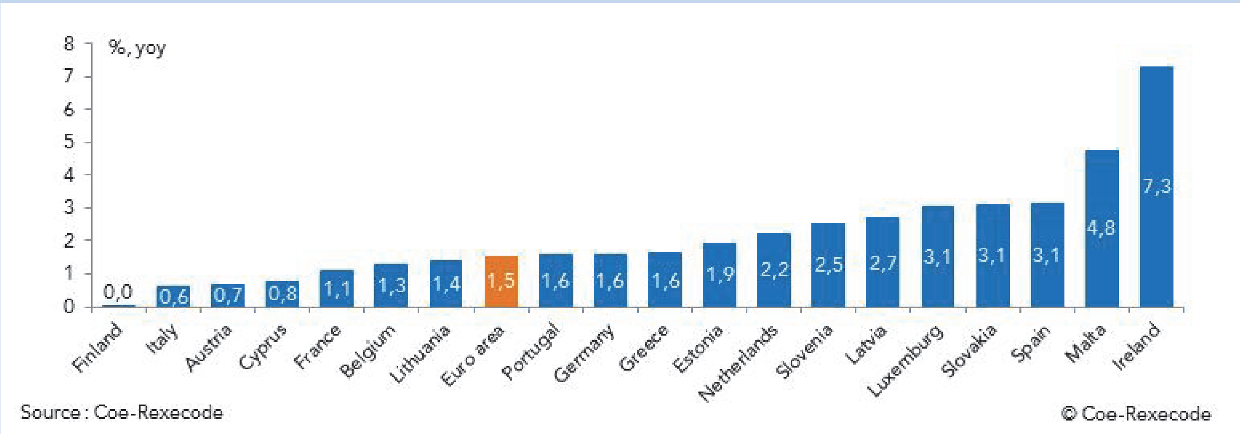



*Graph 1.2: Estimated 2015 GDP impact of external factors*



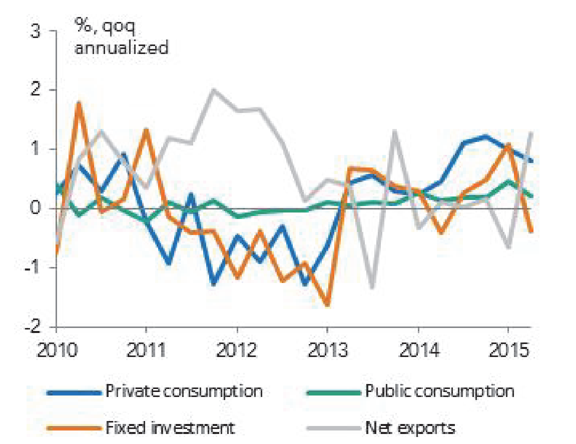

On a **country-by-country** basis, each of the 19 countries in the euro area except Luxemburg have experienced positive (or null) q.o.q. GDP growth in the second quarter. Ireland, Latvia, Malta and Spain even posted quarterly growth figures above the 1% mark. On a y.o.y. basis, Ireland was growing by an impressive 7.3%, Malta by 4.8%, and Spain, Slovakia and Luxemburg all by 3.1%. On the downside, Finland's GDP stagnated, Italy grew by 0.6% and Austria by 0.7%.

*Graph 1.3: Euro area Q2 2015 GDP growth by country (yoy.)*



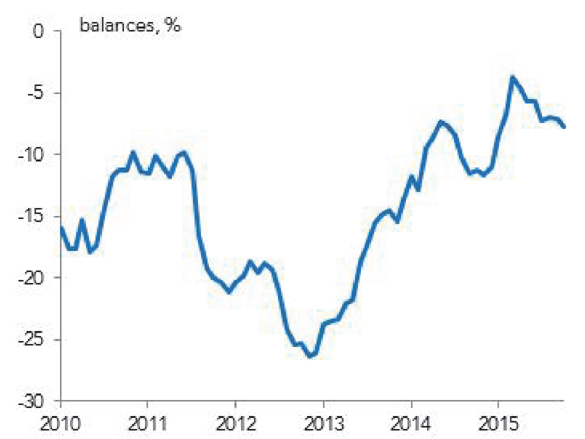

From a **growth components** standpoint, private consumption is clearly the driving force behind the euro area economic improvement. Over the latest four quarters, it has contributed to 68% of euro area growth (while it represents 56% of GDP), ie. on average 1.0 pp. of annualized GDP growth. Over that time period, public consumption has contributed to 0.3 pp. of growth, investment to 0.4 pp., net exports to 0.2 pp., while variations of inventories have dampened growth by about -0.3 pp. Beyond the positive (but gradually waning) impact of low oil prices, two drivers should keep supporting private consumption: i) the ongoing improvement in the labour market (since mid-2013, 2 million net jobs have been created in the euro area) and ii) the low interest rates environment implying a sharp reduction in the interest burden for households and companies. Nevertheless, consumer confidence as measured by the European Commission has been slowly yet steadily declining since its March 2015 peak, potentially indicating that the private consumption engine may slightly slow down. On the opposite, it is worth noting that the European Commission's business survey in the retail trade sector has reached a peak in October, suggesting ongoing high growth of consumption. Net exports may represent a secondary growth engine, owing to the weakness of the euro. Net exports alone contributed to 1.3 pp. of annualized GDP growth in the second quarter of 2015. The euro area trade balance should post a record level in 2015, close to €250Bn vs. €194Bn in 2014. But the health of emerging economies represents a significant unknown for the euro area's future export potential.

*Graph 1.4: Euro area GDP components' contributions to growth*




Source : Coe-Rexecode © Coe-Rexecode

*Graph 1.5: Euro area consumer confidence indicator*




Source : European Commission © Coe-Rexecode

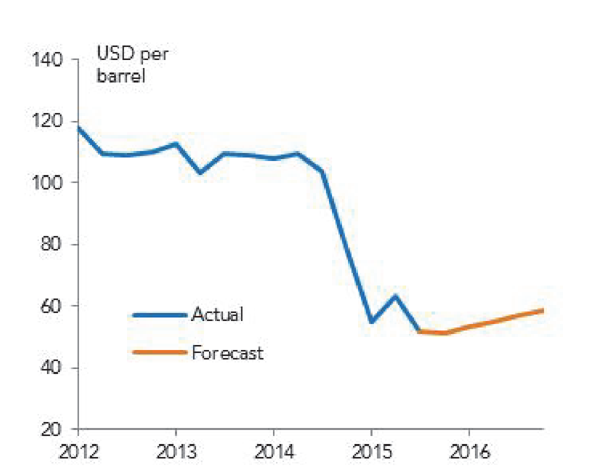
The **key condition for a lasting recovery** in the euro area would be a clear improvement in fixed investment, more specifically corporate fixed investment. So far, it has failed to materialize. It even dropped by -0.5% in the second quarter (yet after a strong first quarter). Capacity utilization in manufacturing industry has been improving (to 81.5% for the ongoing quarter according to the European Commission), but it remains slightly below its long term average (of 82.1%). The spectacular improvement in the gross disposable income of non-financial companies (+20% yoy. in the second quarter) has failed to translate into a fixed investment surge up to now. This situation may reflect the fact that subdued investment stems from low investment demand rather than financial constraints. Drags on fixed investment mentioned by the AIECE institutes include i) remaining overcapacities, ii) weakness of euro area expected demand, iii) macroeconomic, fiscal and regulatory uncertainty, iv) weak export demand, v) spillovers from weak public investment and vi) remaining credit constraints in selected countries such as Italy and Greece. Nevertheless, huge discrepancies are appearing between countries regarding the evolution of investment in transportation and machinery equipment, the assets that are the most sensitive to the development of the business cycle. Its rebound turns impressive in Spain while no recovery at all can be seen in Italy. Investment  in these assets is stagnating in France while its growth remains subdued in Germany. Household investment and more generally the construction sector also remain depressed in several euro area countries.

The **Juncker plan** is meant to induce an acceleration of euro area fixed investment. Responding AIECE institutes deem on average that it will only have a modest +0.1% impact on productive investment in 2015 and +0.5% in 2016 (ie. +0.0% and +0.1% impact on GDP in 2015 and 2016 respectively).

## Forecasts

AIECE institutes expect that **the oil price and the euro exchange rate** will continue to display growth-friendly levels in the forthcoming quarters. The Brent is expected to amount to 51.6$ in the fourth quarter of 2015, and would only appreciate to an average of 56.0$ across 2016. The USD/EUR exchange rate is expected to be 1.11 in the fourth quarter of 2015, and would slightly depreciate to an average of 1.09 in 2016. AIECE institutes believe that oil prices and the exchange rate will continue to explain respectively 0.4 point and 0.3 point of euro area GDP growth in 2016.

*Graph 1.6: Oil price (Brent) forecast*



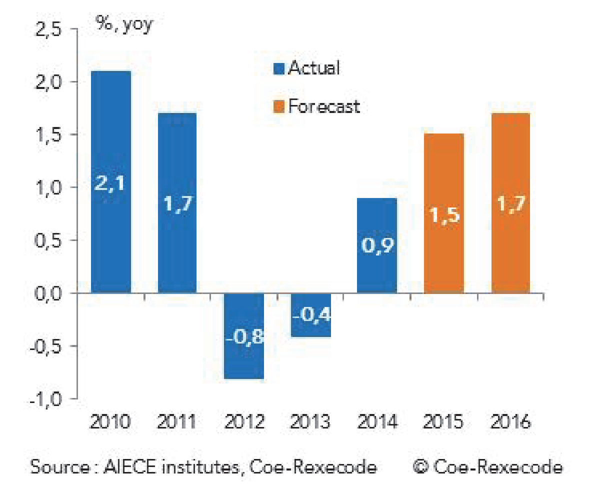

Source : AIECE institutes, Coe-Rexecode © Coe-Rexecode

*Graph 1.7: EUR/USD exchange rate forecast*

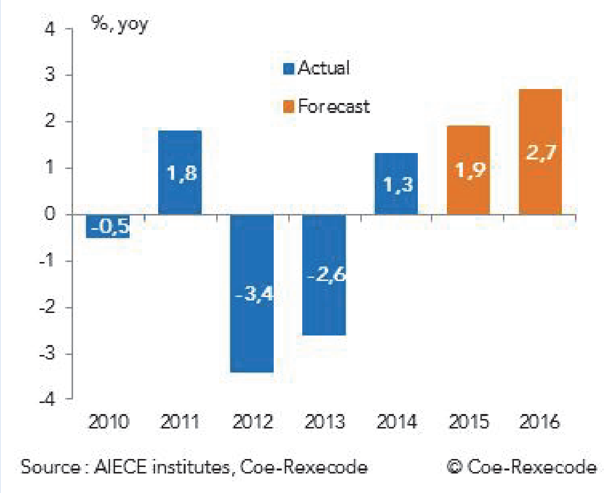

Source : AIECE institutes, Coe-Rexecode © Coe-Rexecode

Against this favorable backdrop, AIECE institutes believe that the **ongoing recovery will continue** and even slightly strengthen in 2016. GDP growth is on average expected to be 1.5% in 2015 and 1.7% in 2016. The individual institute forecasts range between 1.3% and 1.8% for 2015, between 1.2% and 2.4% for 2016. On a quarterly basis, GDP growth is expected to reach its peak level in the third quarter of 2016.

*Graph 1.8: Euro area GDP growth forecast*




*Graph 1.9: Euro area fixed investment growth forecast*




At first glance, this growth acceleration may seem all the more surprising as the positive cyclical growth drivers will start to wane gradually in the coming quarters. Looking at the estimated **growth components**, the expected growth pickup is mostly explained by a strong anticipated acceleration of fixed investment. AIECE institutes deem that fixed investment will grow by 2.7% in 2016 vs. 1.9% in 2015, though all institutes do not share that view. The 2016 estimate would represent the highest yearly growth of fixed investment since 2007. Private consumption is estimated to grow by 1.7% in 2015 and 1.6% in 2016, public consumption by 1.1% in both 2015 and 2016.

The euro area **labour market** is going through a continuing improvement. 2 million net jobs have been created since mid-2013. The September unemployment rate amounted to 10.8% vs. 11.5% a year before. The unemployment rate is expected to continue decreasing. AIECE institutes forecast that the average unemployment rate will be 11.0% in 2015 and 10.5% in 2016, with a level of 10.3% in the fourth quarter of 2016.

Euro area consumer prices have gone through two periods of negative **inflation** in 2015: in January-March and in September. The October flash estimate indicates that inflation has gone back to 0.0%. Core inflation (excluding unprocessed food and energy) seems to have stabilized around 0.9% since the beginning of 2015. AIECE institutes anticipate an acceleration of inflation at the turn of 2016. Its annual level would amount to 0.2% in 2015 and 1.1% in 2016.

## Risk factors

AIECE institutes have been asked about their perception of 5 key upside and 5 key downside risks for their scenarios (to be rated from 1 – very low to 5 – very strong). A first takeaway is that **risks seem to be tilted to the downside**, with downside risks being given an average 2.6 magnitude rating vs. 2.1 for upside risks.

Among **downside risks**, emerging turmoil due to the expected Fed rate hike and external balances (rated 3.3 on average) and a China hard landing (rated 3.0) are viewed as the strongest risks. The drop of activity in oil-exporting countries (rated 2.7), full-blown deflation in Europe (rated 2.2) and a US growth accident (rated 1.7) are viewed as less serious threats. Selected institutes have also highlighted the following downside risks: a further escalation of tensions in the Middle East and/or Ukraine, the threats of "Brexit" and "Grexit", and a quick acceleration of price level dynamics (were oil prices to rise again) which would force the ECB to suddenly tighten its monetary policy.

Among **upside risks**, a corporate investment surge in Europe (rated 2.5 on average) and a new real estate cycle driven by the end of banks' deleveraging (rated 2.2) are considered the most significant, though with low absolute scores. A reacceleration of China growth (rated 2.0), an easing of geopolitical tensions in EMEA (rated 1.9) and a further drop in oil prices (rated 1.8) are not viewed as very significant. Selected institutes have also insisted that further easing by the ECB could enhance their scenario.

## Impact of the European refugee crisis

The euro area (and the EU at large) is undergoing an unprecedented **inflow of refugees**. According to Frontex statistics, 710 000 illegal migrants have crossed the EU's external borders in the first nine months of 2015, vs. 282 000 for the whole of 2014. These official statistics probably underestimate the magnitude of the phenomenon, which has clearly acceleterated in the past few months. This demographic shock should have a very assymetric effect on European countries, with final destination countries such as Germany and Sweden and, to a lesser extent, transit countries such as Greece, Italy and the Balkans the most concerned. Germany alone accounted for 1/3 of EU asylum applications in July, and received six times more applications than France. The 3 responding German AIECE institutes (DIW IFW and IW) on average estimate that the refugee wave will cause Germany to welcome 1.1 million more refugees than it normally would in 2015, and 0.8 million more in 2016. Together, these inflows represent 2.3 % of Germany's current population.

For the countries most concerned, the **macroeconomic effects should be of three types**: i) uptick in public and private consumption in the short term (effect similar to that of a fiscal stimulus), ii) increase in the labor supply that may relieve tense labor markets but also generate issues for selected categories of workers, and iii) longer term modifications of demographic trajectories. The few AIECE institutes that communicated economic impact estimates at this early stage deem that the refugee inflow may have a +0.1 % impact on euro area GDP in 2015 and +0.2 % in 2016.

## Questions for discussion

1. What is the underlying strength of the structural recovery in Europe beyond the cyclical factors at play?
2. What drives the acceleration in fixed investment embedded in 2016 forecasts?
3. Can Europe withstand the negative externalities induced by a strong slowdown of emerging economies?
4. Are any structural reforms having a significant impact on the growth path in Europe?
5. Will the refugee inflow affect Europe's growth potential beyond the induced fiscal stimulus?

# 2. Non-euro area economic outlook

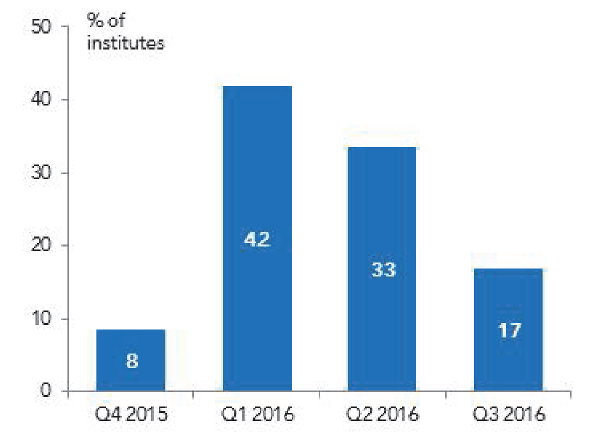
## EU-level outlook

Growth has been consistently **stronger at EU-level than at euro area level** in recent years, while difference were small before the sovereign debt crisis. AIECE institutes believe that this trend will continue. On average, they foresee that EU growth will amount to 1.8% in 2015 and 1.9% in 2016. With the exception of the BoE that is about to start tightening, monetary policy is a key topic for many of these countries in a context where low energy prices and the ECB's QE put their exchange rate and inflation under pressure and force them to undertake very loose monetary policies. Of course, there is a huge heterogeneity across the 7 non-euro area countries which partcipated to the AIECE survey.

*Graph 2.1: EU GDP growth forecast*


Source : AIECE institutes, Coe-Rexecode © Coe-Rexecode

*Graph 2.2: Expected timing of BoE monetary tightening*




Source : AIECE institutes © Coe-Rexecode

## United Kingdom

**UK** GDP increased by 0.5% qoq in the third quarter of 2015, slightly slower than in the previous quarter (0.7 % qoq). Output in manufacturing and construction is estimated to have fallen. Conversely, output growth was strongest in the services industries, the most important driver of the UK's economic recovery. The unemployment rate has decreased sharply over the past two years, from 7.7% in the three months to August 2013, to 5.4% in August 2015. Growth is likely to remain driven by total investment and consumer spending. The Gfk index is strongly above its pre-crisis level. It is consistent with the upturn in household real income growth, explained by the low level of inflation, the increase in employment and the rise in nominal wage growth. The CPI fell back to -0.1% in the year to September 2015. External factors (weak commodity prices and appreciation of the GBP) are pushing prices down. It will likely allow the BoE to wait a little before raising rates. On average, AIECE institutes believe that the BoE will start raising its key rate in the second quarter of 2016. Nevertheless, in light of the rise in wage growth and unit-labor-cost growth, domestic inflation should increase gradually in the coming months.

## Switzerland

Economic activity is slightly improving in **Switzerland**. GDP increased by 0.2 % qoq in Q2 2015. The Swiss franc is still significantly overvalued. This situation continues to have an impact on economic development, and notably on the labour market. Employment growth declined and unemployment increased slightly. Annual consumer price inflation remains clearly in a negative territory. Growth in Switzerland is likely to pick up during the second half of 2015, sustained by domestic demand. Nevertheless, the impact of the Swiss franc appreciation remains important, maintaining corporate profits under pressure.

## Sweden, Norway and Denmark

Economic activity in **Sweden** is strengthening. GDP increased by 1.1% qoq in the second quarter of 2015. The unemployment rate has been decreasing and inflation has been rising since last year. This trend is expected to continue. Nevertheless, external factors are pushing prices down. To maintain the robustness of the upturn in inflation, the Riksbank has decided to extend the government bond purchasing programme by an additional SEK 65 billion (SEK 200 billion in total by the end of June 2016). The repo rate is left unchanged at -0.35 %.

**Norway**'s economy has been slowing down due to the low oil prices environment. The government budget will tap in to the world's largest sovereign wealth fund, so as to finance a set of tax cuts. An economic transition to reduce Norway's dependence on oil now has to be achieved.

**Denmark**'s economic outlook has been improving over the past two quarters and it is expected to continue doing so, with private consumption the main driving force. Despite being under tension at the start of 2015 due to the launch of the ECB's QE, the Danish krone's peg to the euro has been fully maintained.

## Poland and Hungary

**Central European economies** as a whole are far from suffering from the Ukraine crisis and have been experiencing a significant growth acceleration. Private consumption and investment are the main drivers of that growth upswing. Poland experienced 0.9% GDP growth qoq and Hungary 0.5% GDP growth qoq in the second quarter of 2015. Most Central European economies are experiencing negative inflation rates and their central banks have to maintain very accommodative monetary policies. A strengthening of the ECB's QE could be a destabilizing force.

## Questions for discussion

1. When and at what pace will the Bank of England start tightening its monetary policy?
2. Can the ECB's monetary policy pose financial risks for non-euro area neighbouring countries?
3. Can Norway be threatened by persistently low oil prices?
4. Can Central and Eastern European countries maintain their current expansion pace?

# 3. Monetary policy

## Monetary policy stance

The ECB continues implementing a **very loose monetary policy**. After lowering its key rate to the “zero lower bound” of 0.05% in September 2014, it has embarked on an expanded asset purchase programme (of €60Bn monthly asset purchases for a duration of 19 months at least) since March 2015, so as to bring back inflation to its objective of a level close to but below 2%. With the September HICP flash inflation estimate standing at +0.0%, it still has a long way to go to reach that objective. Core inflation, for its part, is rather resilient and has retrieved the 1% growth line (yoy.) according to the October flash estimate.

Overall, 77% of the AIECE institutes believe that the ECB’s monetary policy stance is **appropriate for the euro area** as a whole, while 12% see this monetary policy as inappropriate and 12% are unsure. In addition, 76% of AIECE institutes believe that the ECB’s monetary policy stance is also appropriate for their country specifically, while 24% believe it is not. Interestingly, all 3 responding German AIECE institutes do not see the ECB’s stance as appropriate for Germany.

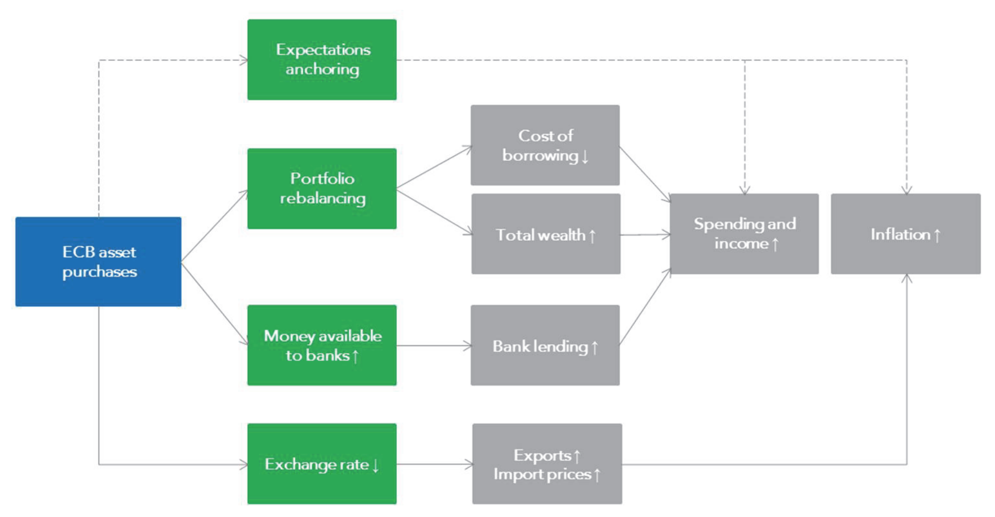
## QE effectiveness

Eight months after its launch on 9 March 2015, the ECB’s **QE has been implemented as planned**. At October end, a total of €539Bn have been purchased by the ECB, ie. roughly €67Bn per month, more than the €60bn announced at the launch of the QE. Of these, €394Bn have been public bonds, €131Bn covered bonds and €15Bn asset-backed securities. With at least 12 more months to go until the end of the monthly purchases, the Eurosystem’s balance sheet has already increased by €519Bn. Mario Draghi had announced in 2014 that the ECB wished to inflate its balance sheet by roughly €1000Bn.

Is the ECB’s QE program working? It is certainly too early to answer this question definitely, one needs to bear in mind that the counterfactual cannot be known. But 71% of **AIECE institutes believe that the QE is working** in its current form, though many insist that its effects have only been moderate. One out of the 29 responding institutes believes that it is not working and 25% are unsure. Furthermore, responding AIECE institutes consider on average that euro area 2015 inflation would have been 0.3 pp. lower without the QE and that euro area 2015 GDP growth would also have been 0.3 pp. lower. Those skeptical regarding the ECB’s QE highlight that the QE doctrine was designed in the US where financial markets play a much larger role in the economy’s financing than in the euro area.

Theoretically, QE programs are intended to affect price levels through a set of 5 **transmission channels**: i) inflation expectations, ii) portfolio rebalancing towards corporate bonds, iii) portfolio rebalancing towards equity, iv) bank lending and v) the exchange rate. For a clear majority of institutes, the exchange rate is the most effective channel. 70% of institutes believe that this channel has proved strong or very strong so far. Expectations and portfolio rebalancing towards equity are also believed to have worked moderately so far. Bank lending and portfolio rebalancing towards corporate bonds are not believed to have reacted strongly by a majority of institutes. These results may seem surprising when compared to empirical evidence suggesting that bank lending has been strongly improving since the launch of the QE. Also, owing to the financing structure of the euro area's economy, the bank lending channel could be expected to be more crucial than market financing channels.

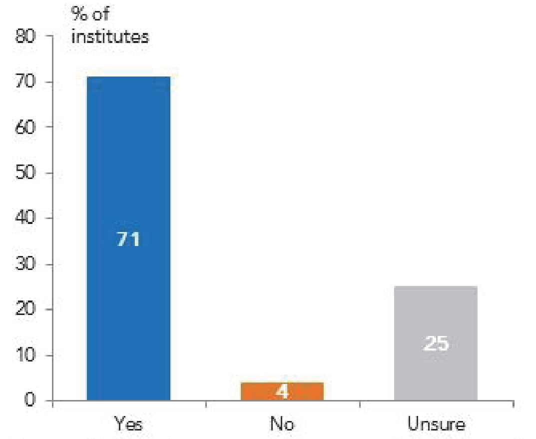
*Graph 3.1: Theoretical QE transmission channels*




## QE risks

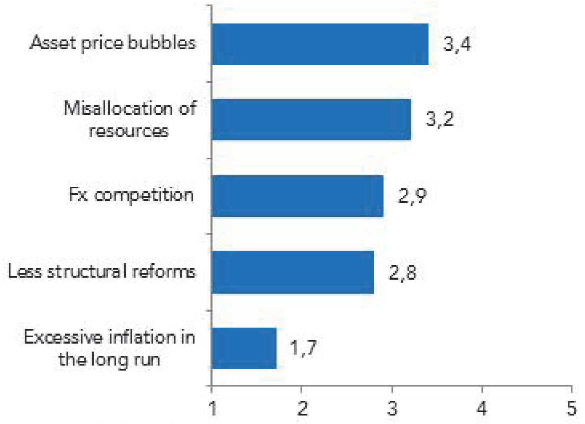
As an unconventional monetary policy, the ECB's QE is associated with potential risks, though these do not seem to have materialized so far. The two strongest such risks according to AIECE institutes are the formation of asset price bubbles and misallocation of resources/capital. Worldwide exchange rate competition and reduced willingness for structural reforms are also deemed significant risks. On the other hand, excessive inflation in the medium to long term is less of a concern.

*Graph 3.2: Is the ECB's QE working?*




Source : AIECE institutes © Coe-Rexecode

*Graph 3.3: Average rating of QE-related risks (from 1- very low to 5- very strong)*




Source : AIECE institutes © Coe-Rexecode

## Towards a QE2?

In the latest ECB press conference which took place in Malta on October 22, Mario Draghi hinted at potential further monetary easing by the ECB. Given the persistence of downside risks for growth and inflation, he indicated that the ECB was moving from a "wait and see" to a "work and assess" stance. The degree of monetary accommodation provided by the ECB is to be reassessed at the **Governing Council of December 3** in Frankfurt. Because some of the QE's initial effects have washed out and the QE stimulus in its current form may not be enough to bring back inflation to the 2% objective, there will be significant pressure on the ECB to announce new measures.

Mario Draghi repeatedly indicated that the QE program **could be extended in terms of its duration, size and composition**. 54% of AIECE institutes believe that the QE will be extended timewise (beyond September 2016), while 12% believe it will not and 35% are unsure. Those who believe it will be prolonged guess on average that it will be until May 2017, ie. 8 months beyond the September 2016 final date announced so far. It would bring its total length to 27 months, still way less than the previous Fed and BoE QE programs. Extensions in terms of size and composition seem much less certain to AIECE institutes. Only 27% believe the size of monthly purchases will be increased, while 42% believe they won't and 31% are unsure. Only 21% believe the composition of assets purchased will be extended, while 33% believe it won't and 42% are unsure.

When asked whether a **full-fledged QE2** would be desirable, only 20% of AIECE institutes answered yes, while 48% answered no and 32% were unsure. Many institutes believe it is too early to do so, and that enough time should be spent analyzing the ongoing QE's impact. Many also argue that too much may be expected of monetary policy, and that the other fields of macroeconomic policy also need to contribute to the euro area's recovery. Some institutes highlight that QE programmes tend to be most effective when interest rates are high, a condition that is not met in the euro area. Others recall that the current QE programme contains significant flexibility, thereby reducing the need to announce a second QE programme.

## Questions for discussion

1. Should the ECB resist the mounting pressure of financial markets in favour of a QE expansion?
2. What more/else can be done to improve the ECB QE's effectiveness?
3. Is the ECB's QE programme responsible for the increased volatility on financial markets?
4. What will be the impact of the upcoming Fed and BoE monetary tightenings on the ECB's monetary policy?

# 4. Fiscal policy

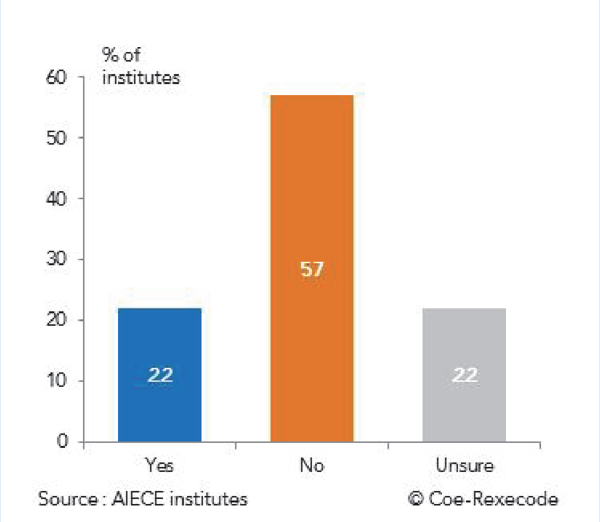
## Fiscal position

The euro area's **fiscal position has significantly improved** since its trough in 2009. The euro area's aggregate budget balance should amount to -2.0% of GDP in 2015, vs. -2.4% in 2014 and -2.9% in 2013. That would be the euro area's lowest budget deficit since 2007. Only five countries should have a 2015 budget deficit higher than the -3% threshold: Spain, France, Finland, Portugal and Greece. Needless to say that the decrease in the debt interest burden has greatly contributed to this improvement. As an example, with the current apparent interest rate on the French public debt represents an annual saving of 1.9% of GDP when compared to the 2007 apparent interest rate.

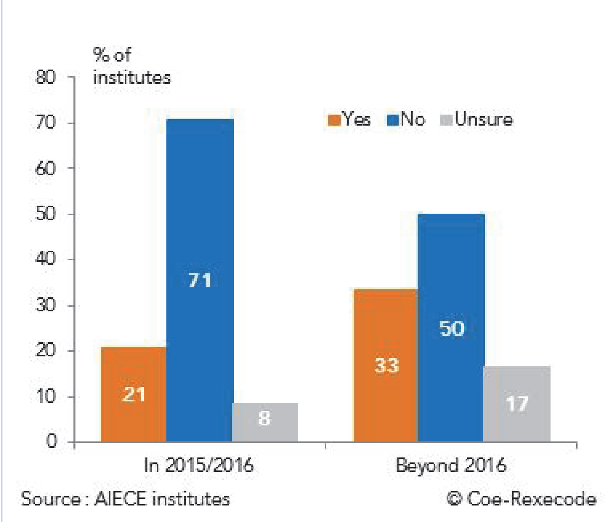
The **fiscal impulse** as measured by the change in the cyclically adjusted budget balance has improved markedly: it moved from -1.2% of GDP in 2013 to -0.3% of GDP in 2014. According to European Commission forecasts, it should amount to 0.0% of GDP in 2015 and 0.2% of GDP in 2016. This being said, only 22% of AIECE institutes believe the fiscal consolidation effort in the euro area has come to an end, while 57% believe it has not and 22% are unsure.

The evolution of **public debt** levels presents a less "rosy" picture. The gap between the situations of individual countries continues to widen. The standard deviation of debt-to-GDP ratios across euro area countries reached 40.3 in 2014 and could rise to 41.3 in 2016 (Coe-Rexecode forecast). It only amounted to 29.7 in 2007. Germany's public debt could cross below the 70% of GDP threshold in 2016, when that of France could reach the 100% of GDP bar. Only five years ago in 2010, their debt-to-GDP levels were about the same. Greece's public debt could near 200% of GDP by the end of 2015.

*Graph 4.1: Is fiscal consolidation in the euro area over?*




*Graph 4.2: Does Greece pose a threat for European growth?*



## The case of Greece

Even though, the agreement upon a 3rd bailout programme for Greece and the re-election of Syriza have removed Greece from the worry list of international investors, Greece's **fiscal situation remains problematic**. First of all, there is a high degree of uncertainty over the implementation of reforms pledged by Greece: only 28% of AIECE institutes believe that these reforms will be duly implemented, while 24% believe they will not and 48% are unsure. Greece's public debt as it stands is not sustainable and will not be repaid without a nominal haircut according to 88% of AIECE institutes.

Nevertheless, the **spillover risk** from Greece's fiscal situation is deemed to be contained. AIECE institutes only evaluate the probability of Greece leaving the euro area before 2020 at 25%. Only 21% of AIECE institutes think that Greece may pose a threat for the euro area's growth prospects in 2015/2016. Only 33% think that it may pose such a threat beyond 2016.

## Questions for discussion

1. Should the fiscal impulse of certain euro area countries be increased, as hinted by the ECB?
2. Could the sustainability of euro area countries' public finances be considerably overestimated due to the low interest rate environment?
3. Will the public debt-to-GDP ratios re-converge?
4. When should Greece's public debt be renegotiated?

# 5. Institutional environment

## Towards more institutional tensions

68% of AIECE institutes believe that the EU is heading **towards more institutional tensions** in the upcoming two years, while only 9% believe it is heading towards less tensions and 23% are unsure. European institutional tensions therefore represent another non negligible downside risk to the macroeconomic scenario.

The **list of institutional risk factors** that have been mentioned by AIECE institutes is long:

- The "Brexit" risk;
- The refugee crisis;
- Differing economic doctrines and consequently preferences on matters of fiscal policy (in particular obedience to fiscal rules) and structural reforms;
- Persistence of large disparities and lack of convergence between European economies;
- The remaining Greek risk;
- The burgeonning of anti-EU sentiment in several member states;
- The need for a common foreign policy towards Russia/Ukraine.

## The "Brexit" risk

The most immediate risk is perhaps the referendum to be organized in the UK as to whether the country should remain a member of or leave the EU. 61% of AIECE institutes judge that the **"Brexit" referendum poses a major threat** for the EU project, while 22% judge that it doesn't and 17% are unsure.

**On the one hand**, the UK is not a member of the euro area and one could therefore consider that a Brexit would not be so disruptive for EU institutions. It could hold a status close to that of Norway or Switzerland, non members of the EU but still participating to several European frameworks such as the common market and the Schengen Area.

**On the other hand**, no country has ever left the EU and a "Brexit" would be a dangerous precedent and would send a negative signal for the fuure of the European construction. It would probably encourage Euroskeptic and separatist political forces. It would also alter the traditional balance of powers within the EU, with unknown consequences.

## Solving the institutional challenge

The EU project has always rested on the **idea of continuing consolidation**. It would seem that the EU is now faced with the following alternative: deepen European integration towards more federalism or enter a slow decay period. The June 2015 Five Presidents' Report on "Completing Europe's Economic and Monetary Union" was meant to draw a vision and path for the EU's future. It proposes rather general guiding principles to deepen the EMU and to extend it to a genuine financial and fiscal union. But the underlying rules and mechanisms need further specification and are likely to lead to strong disagreements between member states. Yet only one AIECE institute is convinced that it provides the basis to solve the EU's institutional challenges.

It would seem to several AIECE institutes that **completing the banking and financial union** is the first and priority step to consolidate the EU. Several institutes also insist on the need for a fiscal union, but they diverge as to whether such a fiscal union should rest upon simple binding rules (as opposed to structural balances that leave leeway for interpretation) or upon a coordination framework. The question of fiscal transfers also needs to be answered. Other priorities are mentioned: enhancing democratic accountability and legitimacy, integrating labour markets and streamlining EU procedures.

If more federalism is the objective from a fiscal point of view, **three key questions** will need to be answered. What should be the target size of the EU budget with respect to GDP, for it to be meaningful? Should permanent or temporary transfers occur between member states, and if so under what mechanisms? What types of expenditures/investments should an enhanced EU budget focus on?

## Questions for discussion

1. Which upon the risks listed hereabove represent the greatest threats for the EU project?
2. Which countries may follow suit, were the UK to leave the EU?
3. What concrete steps can the Commission undertake to solidify the EU?
4. Are fiscal transfers across member states an option? To what extent ? What can be their main purpose ?