

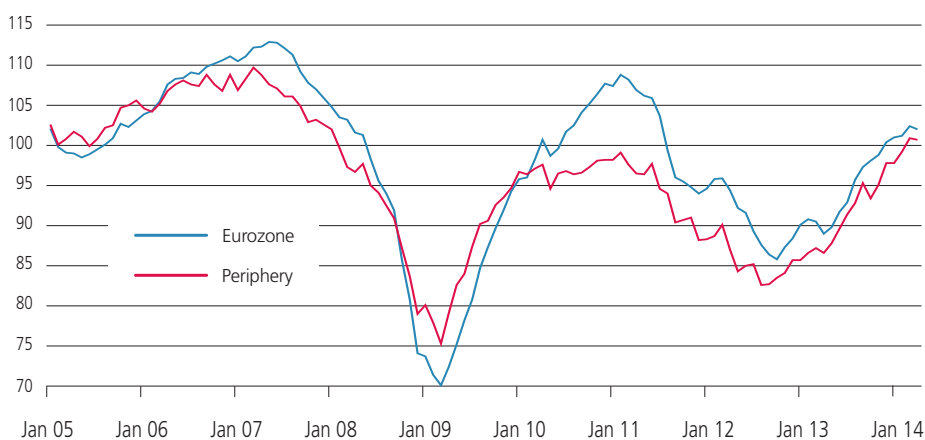
# EURO PLUS MONITOR

SPRING 2014 UPDATE

- **The euro crisis is over.** The European Central Bank has defused the systemic risks. More importantly, the four initial crisis countries (Greece, Ireland, Portugal and Spain) are starting to reap the rewards of their profound reforms. Cyprus is no more than one year behind.
- **Serious problems persist.** That is normal. Every major region in the developed world has them. But the systemic threats and contagion risks that were the hallmark of the euro crisis have gone. At the moment, the currency union between England and Scotland looks more at risk than the euro.
- **Back to balanced growth.** The eurozone economy is expanding at a rate close to its 1.8% trend. The data no longer show a clear gap between core and periphery or between exports and domestic demand. Instead, we find differences within the core (with Germany strong and France lagging behind) as well as the periphery (with Portugal, Ireland and Spain strong, and Greece still behind despite huge efforts).
- **Approaching normal.** Economic sentiment in the once struggling reform countries has edged above its long-term average. As Chart 1 below shows, it is now almost in line with the eurozone as a whole.
- **The worst of austerity is over except for reform laggard France.** While exports continue to rise, consumer confidence has advanced slightly above the long-term average in the eurozone, including above-average readings for Spain and Italy.
- **Serious adjustment progress continues.** Since November 2011, the Euro Plus Monitor has tracked adjustment progress within the eurozone and some of its neighbours. The Spring 2014 Update shows no major change in the scores and rankings. That is good news: almost all countries in need of adjustment have continued to improve their underlying fiscal balance and their external competitiveness at an impressive speed. France remains the exception.
- **Staying the course for a jobs rebound.** Unemployment remains far too high. But with the usual lag, it has started to come down. The recent labour market gains in Spain, Ireland, Portugal and Greece suggest that the reforms are starting to bear fruit.

Chart 1: Economic Sentiment: The Rebound

Economic sentiment in the overall eurozone and the periphery (weighted average for Greece, Italy, Portugal and Spain); 100 = long-term average



Source: European Commission

## Contents

The Euro Plus Monitor: Overall Results and Method	Page 3
Fiscal Adjustment: The Worst is Over	Page 4
External Adjustment: Major Progress	Page 5
Labour Cost Adjustment: The Great Convergence	Page 6
Reform Drive: Ongoing Progress	Page 7
Outlook: Starting to Reap the Rewards	Pages 8-10

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The Euro Plus Monitor is a joint research project between Berenberg, one of the leading privately owned banks in Europe, and the Lisbon Council, a Brussels-based think tank. First published in 2011, the Euro Plus Monitor has become a premier competitiveness ranking of eurozone countries, as well as Poland, Sweden and the United Kingdom.

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The views expressed in The Euro Plus Monitor are those of the principal authors alone and do not necessarily represent the views of Berenberg, the Lisbon Council or any of their associates.



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**'Adjustment in action: the rapid progress we had diagnosed in previous years has continued.'**

## The Euro Plus Monitor: Overall Results and Method

The euro confidence crisis has forced a brutal front-loaded adjustment on the peripheral economies of the eurozone. The Adjustment Progress Indicator (see Table 1 below) tracks the progress countries are making on four key measures of adjustment: 1) a reduction (or increase) in the fiscal deficit, adjusted for interest payments and cyclical factors, 2) the rise (or fall) in exports relative to imports in the external accounts, 3) changes in unit labour costs, and 4) the pace of pro-growth structural reforms.

The Spring 2014 Update uses additional data releases since The 2013 Euro Plus Monitor, which was published in December 2013. It also incorporates some revisions to previous official data and projections, for instance those for unit labour costs and fiscal deficits in 2013.

Not much has changed in the intervening period. The results in the Spring 2014 Update are very similar to those found in The 2013 Euro Plus Monitor. For the reform countries, that is mostly good news. The rapid progress we had diagnosed in previous years has continued.

The four reform countries which asked for and received external support before 2013 – **Greece** (No. 1), **Ireland** (No. 2), **Spain** (No. 3) and **Portugal** (No. 4) – retain the top four spots. All of them except frontrunner Greece raised their adjustment-progress scores slightly. **Italy**, at No. 11, remains above average. But it has fallen back slightly (down from No. 9 in 2013) because its reform drive stalled somewhat amid political uncertainty last year. Prime Minister Matteo Renzi needs to deliver the promised reforms to catch up with Spain. The score for **Cyprus** (No. 7 again) slipped a little, largely because labour cost data now show a less pronounced decline for 2013 than European Commission estimates had projected six months ago. While their economies are doing more or less well at the moment, the low scores for **Austria** (No. 15), **Germany** (No. 16), **Finland** (No. 17), **Belgium** (No. 18), **Luxembourg** (No. 19) and **Sweden** (again the worst performer as No. 20) suggest that these countries are becoming increasingly complacent. To some extent, this is part and parcel of a rebalancing within Europe. But over time, it could also make them vulnerable to future crises.

**Table 1: Adjustment Progress: Eurozone Periphery Tops the League**

Rank	Country	Total Score			External adj.		Fiscal adj.		Labour Cost Adj.		Reform drive		
		2014	Change	2013	2014	Change	2014	Change	2014	Change	2014	Change	
2014	2013												
1	1	Greece	8,7	0,0	8,7	6,7	-0,1	9,7	0,2	8,3	0,1	10,0	0,0
2	2	Ireland	8,1	0,4	7,7	8,7	0,0	7,1	1,6	8,2	-0,3	8,5	0,3
3	3	Spain	6,9	0,1	6,9	7,5	0,0	6,4	-0,1	5,8	0,1	7,9	0,2
4	4	Portugal	6,8	0,1	6,8	6,8	-0,4	7,6	0,9	5,0	-0,3	7,8	0,1
5	5	Slovakia	6,3	0,0	6,3	7,7	-0,1	6,8	-0,4	5,3	0,4	5,5	0,0
6	6	Estonia	6,2	0,0	6,2	7,3	0,1	2,5	0,4	6,5	-0,1	8,3	-0,5
7	7	Cyprus	5,2	-0,6	5,8	5,6	-0,5	4,6	0,5	5,4	-1,9	n.a.	n.a.
8	8	Poland	4,9	-0,1	4,9	5,2	0,0	6,5	0,3	2,4	0,0	5,4	-0,6
9	11	Slovenia	4,7	0,4	4,3	6,4	0,0	5,7	0,5	3,1	-0,2	3,6	1,4
10	10	United Kingdom	4,6	0,2	4,4	3,9	-0,2	5,5	0,5	2,7	0,0	6,1	0,3
11	9	Italy	4,5	-0,1	4,6	4,3	0,0	6,1	-0,3	2,7	0,2	5,0	-0,3
		<b>Euro-17</b>	<b>4,3</b>	<b>0,1</b>	<b>4,2</b>	<b>4,3</b>	<b>-0,1</b>	<b>5,0</b>	<b>0,0</b>	<b>2,6</b>	<b>0,1</b>	<b>5,2</b>	<b>0,2</b>
12	12	France	3,5	0,1	3,3	3,0	-0,3	5,2	0,6	2,0	0,0	3,7	0,2
13	13	Netherlands	3,4	0,0	3,3	4,6	-0,4	3,5	0,4	2,9	0,1	2,4	0,0
14	14	Malta	3,3	0,0	3,3	4,6	-0,7	2,5	0,5	2,8	0,2	n.a.	n.a.
15	15	Austria	2,9	-0,2	3,2	3,1	0,2	2,4	-0,1	1,1	-0,1	5,1	-0,9
16	16	Germany	2,7	0,2	2,5	3,6	0,3	3,9	-0,1	0,9	-0,1	2,4	0,9
17	17	Finland	2,4	0,0	2,4	1,6	-0,3	0,2	0,0	2,6	-0,2	5,1	0,4
18	18	Belgium	2,3	0,1	2,2	3,7	0,0	2,3	0,2	1,4	0,0	1,8	0,2
19	19	Luxembourg	1,9	0,0	1,9	1,8	-0,6	0,6	0,1	4,1	-0,1	1,2	0,6
20	20	Sweden	1,7	-0,2	1,9	2,4	-0,1	0,0	0,0	0,5	-0,4	4,0	-0,2

*Notes: The total score is the average of the four subscores for external adjustment, fiscal adjustment, labour cost adjustment and reform drive, all on a scale of 10 (best) to zero (worst possible). The change gives the change in score relative to The 2013 Euro Plus Monitor of 03 December 2013. For details on the method, see that 03 December 2013 report. If revisions to back data have affected the 2013 results, the precise scores presented here for 2013 can differ slightly from those published in December 2013 as we have recalculated the 2013 scores on the basis of the new data. Sources: Eurostat, European Central Bank, European Commission, OECD and Berenberg calculations.*

'The end of harsh austerity is allowing domestic demand to rebound modestly.'

## Fiscal Adjustment: The Worst is Over

It has been tough. Under the pressure of crisis, those eurozone members most in need of reining in their excessive deficits have corrected their fiscal stance aggressively and in a frontloaded manner. Markets and the troika left them no choice. But the worst is over. While they cannot afford to relax, they need only comparatively modest expenditure cuts or tax hikes from 2014 onwards to keep their public finances in order. The end of the harsh austerity is already allowing domestic demand to rebound modestly across the euro periphery.

Chart 2 below shows the cumulative fiscal adjustment after 2009 until 2014 corrected for the effects of the short-term business cycle, interest rates and some one-off factors.

**Greece** (No. 1) stands out as the country with the most severe fiscal squeeze and thus the most serious recession. But the fiscal correction has also been very significant in **Portugal** (No. 2), **Ireland** (No. 3), **Spain** (No. 4) and **Italy** (No. 8). Outside the eurozone, **Poland** (No. 6) and the **United Kingdom** (No. 7) have also raised taxes and reined in spending to a significant degree. Part of the progress has been the mere unwinding of the post-Lehman fiscal stimulus.

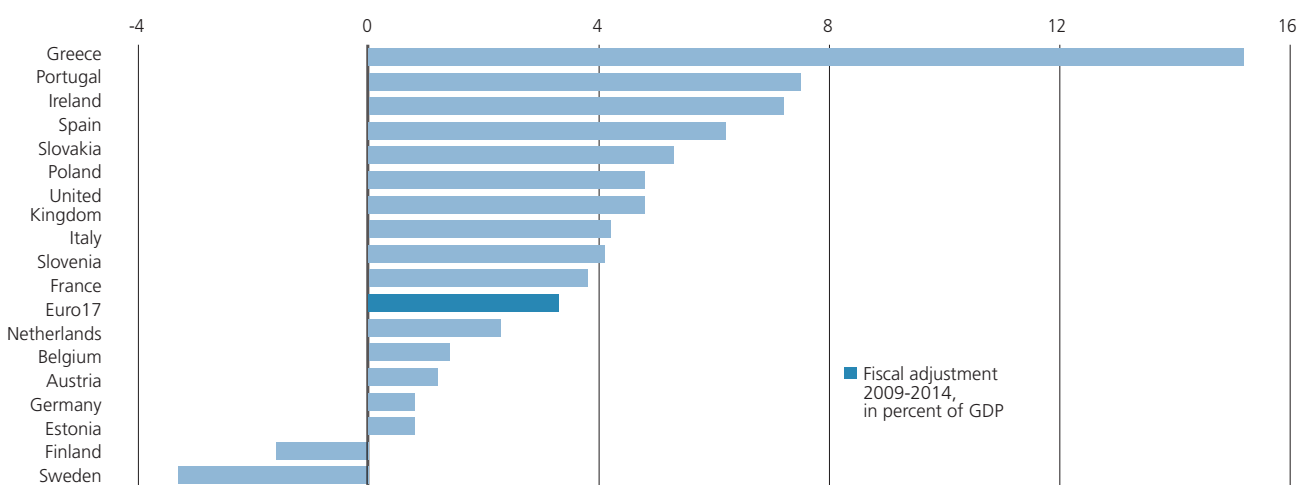
To bring out the underlying trend and the change in the fiscal stance, our fiscal analysis focusses on the structural primary balance.

- For the eurozone, this balance rose to 1.5% of gross domestic product in 2013, up from -1.6% in 2009.
- Italy also raised its underlying surplus to 4.5% in 2013, up from 0.5% of GDP in 2009.
- Germany moved to an even larger surplus of 2.9%, up from 1.9%.
- And even Greece delivered a surplus of 6% in 2013, reversing the exceptional deficit of -9.6% in the 2009 election year.

The headline deficits including interest expenditures and the fiscal shortfalls caused by recession still look much worse than these underlying numbers. But the peripheral economies have now emerged from recession. As a result, the headline deficits can fall substantially in coming years. After the harsh austerity of recent years, only modest extra tightening worth less than 1% of GDP per year is now required to put public finances on a sustainable path in most of these countries, with Greece needing much less than that. The worst is over.

Chart 2: Wrenching Fiscal Adjustment

Cumulative change in the underlying primary fiscal balance 2014 over 2009 in percent of GDP



Sources: European Commission, Berenberg calculations

# 'Economies with excessive external deficits have turned their external balance around convincingly.'

## External Adjustment: Major Progress

If a country has lived beyond its means, the adjustment after the party should show up most visibly in its external accounts. To track the progress, we examine two different aspects, namely 1) the shift in the balance of exports and imports (net exports) and 2) the rise of the share of exports in a country's GDP. For both components, we look at the overall shift as well as the shift relative to the 2H 2007 starting situation. We then aggregate the results into a single score for each country.

The results reveal a clear pattern. All economies that were running excessive external deficits until 2007 (or 2009) have turned their external balance around convincingly. **Ireland** (No. 1), **Spain** (No. 3), **Portugal** (No. 5) and **Greece** (No. 6) are among the top six economies in the sample for their overall external adjustment progress (see Table 1 on page 3).

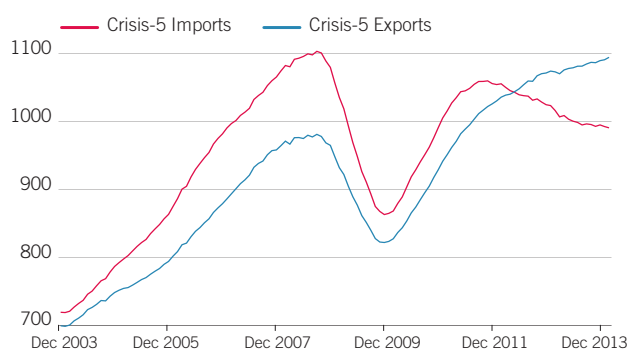
Upon tightening their belts, the reform countries also managed to raise their exports. Chart 3 below shows overall exports and imports for the five major euro crisis countries (Italy, Spain, Greece, Portugal and Ireland). While exports are now 12% above their pre-Lehman peak, imports are 10% below that level.

With an easing of domestic austerity, the decline in imports looks set to come to an end soon while exports will likely rise further, helped by underlying gains in competitiveness as well as stronger domestic demand in core Europe, the United States and the United Kingdom.

During the pre-Lehman boom, the euro crisis countries had all lived beyond their means with significant current account deficits ranging from catastrophic (Greece, Spain) to just worrying (Italy). All of them are now running external surpluses. Chart 4 below shows the combined current account position for Italy, Spain, Greece, Ireland and Portugal.

**Chart 3: More Exports, Less Imports – the Periphery Adjusts**

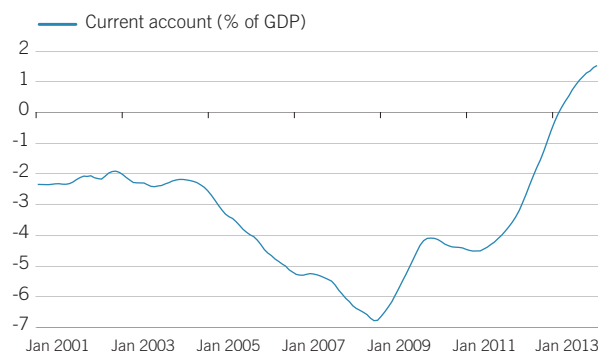
Nominal exports and imports of goods and services, 12-month rolling sum, in billions of euros



Sources: Eurostat

**Chart 4: Serious Surplus: Current Account Balance at the Periphery**

Current account balance in percent of GDP, 12-month rolling sum; Greece, Ireland, Italy, Portugal and Spain combined



Source: Eurostat, national statistics

**'Under the pressure of crisis, wage moderation has taken hold with a vengeance across the periphery.'**

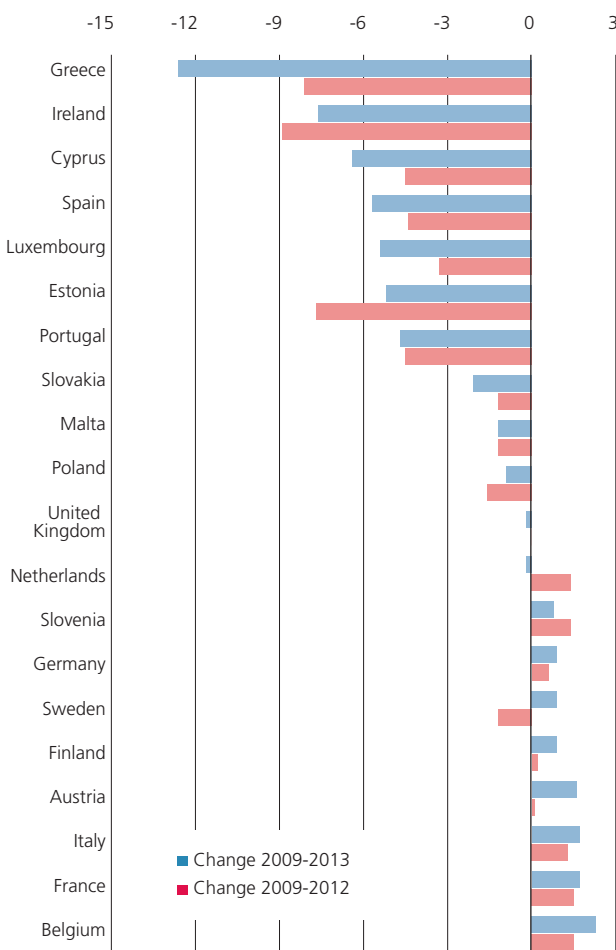
## Labour Cost Adjustment: The Great Convergence

Competitiveness is an ill-defined buzzword. The ultimate proof of whether a country can compete is whether its producers can find customers for their wares and whether the country can attract enough investment to provide jobs for its people. Labour costs are one of many aspects that determine this.

Under the pressure of crisis, wage moderation has taken hold with a vengeance across the euro periphery. In some countries, nominal wages have fallen amid high rates of unemployment and cuts in public spending. At the same time, wage moderation has ended in Germany. The result is a rapid convergence of unit labour costs across much of the eurozone.

**Chart 5: Real Unit Labour Costs – Converging Fast**

Cumulative change in real unit labour costs, deviation from the eurozone average in percentage points, 2012 over 2009 and 2013 over 2009



Sources: Eurostat, Berenberg calculations

Chart 5 below shows how much the cumulative changes in real unit labour costs over- or undershot the eurozone average since 2009. As nominal wages have declined or stagnated and companies shed less productive workers in the severe adjustment recession, real unit labour costs have tumbled in the eurozone periphery. At the same time, costs are rising in Germany, which can afford it, and in France, which cannot.

For comparison, Chart 5 presents two values for each country, the changes until 2012 and those until 2013. The difference is what happened in 2013. In **Greece, Spain, Portugal and Cyprus**, real unit labour costs fell further relative to the eurozone average in 2013. In Ireland, however, which had seen a massive correction in labour costs before, the economic recovery led to a small rebound in labour costs.

Among the crisis countries, **Italy** stands out as the one with a rise rather than a correction in real unit labour costs. However, Italy has managed to increase its exports to non-EU countries by 40% over the four years to Q1 2014. This shows that Italy is less uncompetitive than the labour cost data suggest.

The rapid improvement in the quality of Italian export goods, moving from mass market wares to top-of-the-market brands, apparently allows Italy to sell its exports at prices which cover the recorded increase in unit labour costs.

Beyond the data in Chart 5, the score for labour cost adjustment as presented in the Overall Results (Table 1) also incorporates how much countries have corrected any labour cost overshoot 2000-2009. It also adds the same analysis for nominal unit labour costs which we have presented here for real unit labour costs.

‘Governments at the euro periphery have taken many steps to make their economies leaner and fitter.’

## Reform Drive: Ongoing Progress

Countries that have lived beyond their means need to tighten their belts. But squeezing domestic demand, slashing labour costs and raising exports are only part of the solution. To make their fiscal positions sustainable in the long run without excessive pain, countries have to raise their long-term growth potential. In short: they need pro-growth structural reforms.

**Crises are handmaidens of change.** Under the pressure of crisis and under the vigilance of the troika, governments at the euro periphery have taken many steps to make their economies leaner and fitter for growth. They have reformed their labour markets, cut pension and other welfare entitlements, streamlined administrative procedures and deregulated product markets. While the benefits of such reforms only show up with a lag, typically only when the initial adjustment recession has given way to a new upswing, such reforms ultimately matter more than the initial readiness to rein in excesses in public or private spending.

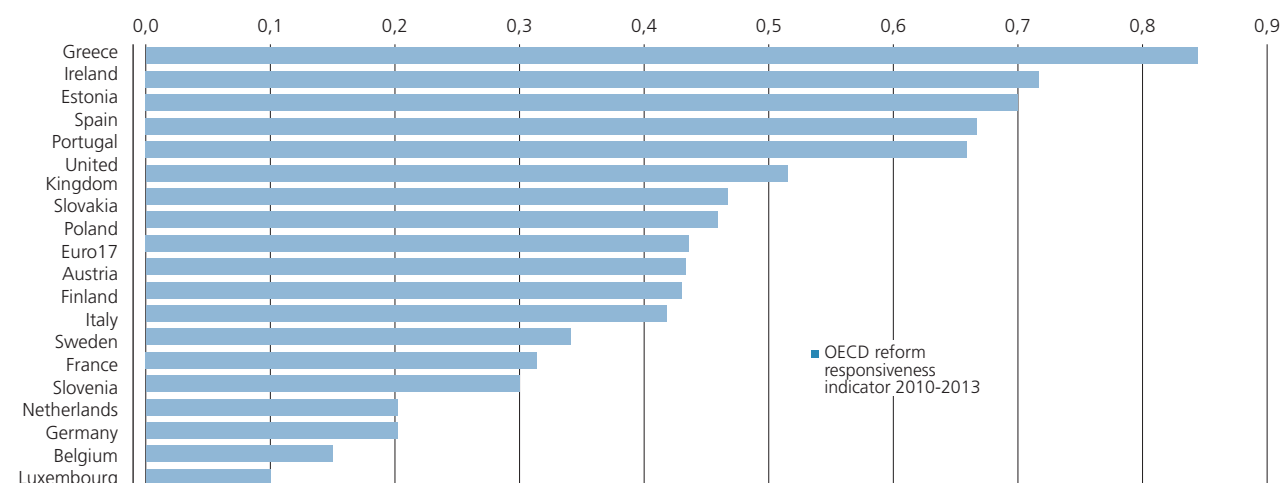
To measure how much countries have done, we employ the expertise of the Organisation for Economic Co-operation and Development (OECD): the OECD identifies five prioritised areas for reform for each member country every year. In each of these areas it makes a number of concrete recommendations and subsequently measures

whether these have been followed up (Score 1) or not (Score 0). For The Euro Plus Monitor 2014 Spring Update, we incorporate the underlying country data behind the OECD’s Going for Growth 2014 report into the data we had used for The 2013 Euro Plus Monitor.

As Chart 6 below shows, **Greece** (No. 1) tops the reform drive ranking by a significant margin, followed by **Ireland** (No. 2), **Estonia** (No. 3), **Spain** (No. 4) and **Portugal** (No. 5). **Italy**’s reform effort remains slightly below average. Indeed, the score for Italy (No. 11) is slightly worse than it was in The 2013 Euro Plus Monitor (see Table 1 on page 3) as Italian reforms stalled amid political uncertainty in late 2013. **France** (No. 13) remains our bigger concern, although it has advanced marginally.

Chart 6: Reform Drive, Ongoing Progress

OECD reform responsiveness indicator, average 2010/2011 – 2012/2013



Source: OECD

'The reforms are working. The gains have started to show up in the labour market.'

## Outlook: Starting to Reap the Rewards

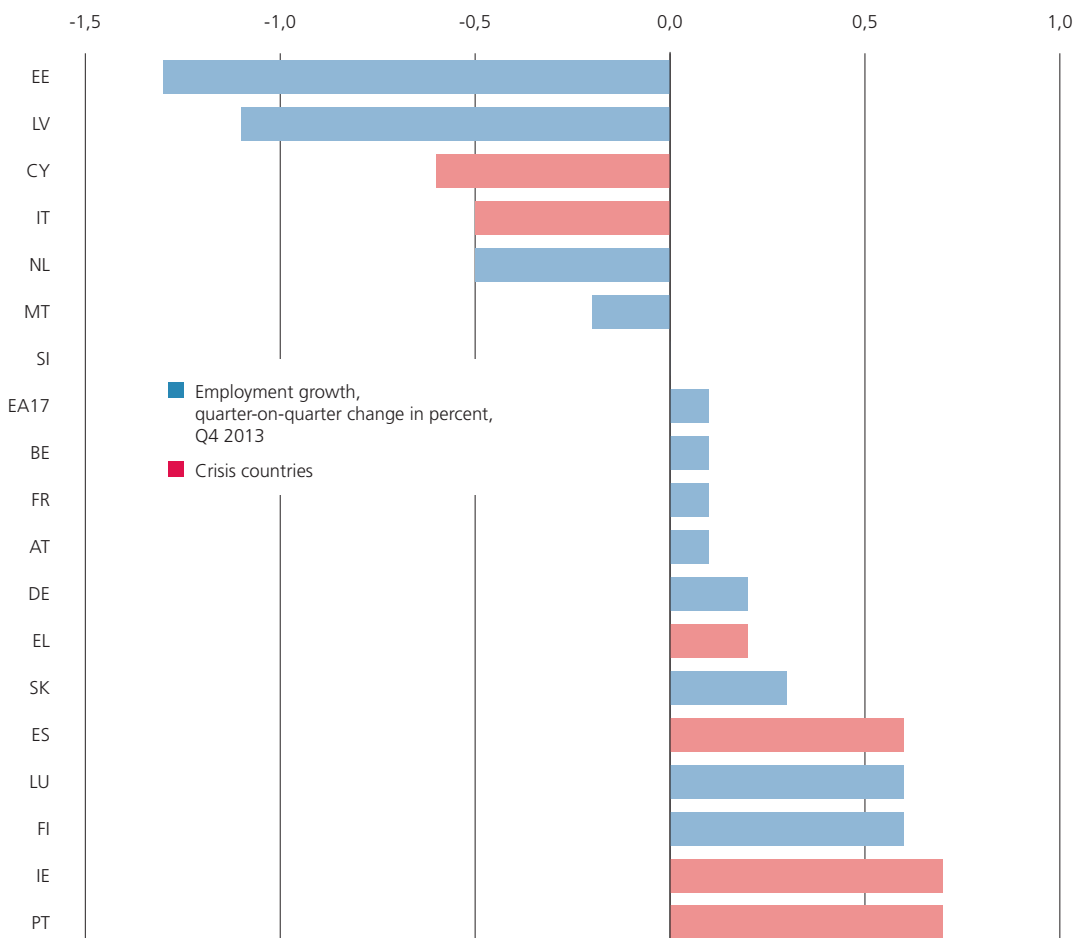
One year ago, The Euro Plus Monitor **Spring 2013 Update** came to a simple conclusion: if policymakers stay the course, the euro crisis could be largely over by the end of 2013. If so, they would be rewarded by a jobs rebound.

This seems to be happening. The Spring 2014 Update shows that the adjustment progress has continued at the euro periphery at an impressive pace. As a result, the eurozone is gradually becoming a more coherent and dynamic economy. With the worst of austerity over, the major reform countries have returned to at least modest growth. More importantly, the gains have started to show up in the labour market. Chart 7 below gives the quarterly change in employment in the last quarter of 2013 for the eurozone and its member countries. Employment rose in Portugal, Ireland, Spain and even Greece in late 2013.

**The euro crisis was tough.** Amid an irrational market panic, the vulnerable countries at the euro periphery had to reform their labour markets while crushing domestic demand through severe austerity at the same time. The first results of their reforms had been record unemployment throughout the region and some unrest on the streets. Seen in an historic context, this should not have been a major surprise. Decades ago, Britain's Margaret Thatcher and, more recently, Germany's Gerhard Schröder learned that labour market reforms amid an economic crisis first lead to record unemployment and unrest on the streets. But their reforms did work. Britain today has one of the most robust labour markets in the EU while Germany enjoys virtual full employment and a balanced budget. History has proven the reformers right.

**Chart 7: The Rebound in Employment has Started**

Quarter-on-quarter change on employment in Q4 2013



Source: Eurostat



# 'If Prime Minister Valls prevails, France's very lacklustre cyclical upturn could gradually strengthen in coming years.'

**On the right track.** All in all, the eurozone periphery is very much on the right track. We are confident that, if the reformers stay the course, they will also be proven right by history.

The Spanish example brings out the progress. Spain has suffered a triple blow. The bursting of a domestic real estate bubble, the post-Lehman recession and frontloaded austerity amid the euro crisis had pushed Spanish unemployment to a record of 26.4% by February 2013. But since then, the tide has turned. In the twelve months to April 2014, the number of unemployed in Spain fell by 305,000 on the national measure (see Chart 8 below). Eurostat, which uses a slightly different method, even gives a 350,000 decline for the last 12 months, with the rate now at 25.3%. The trend looks solid.

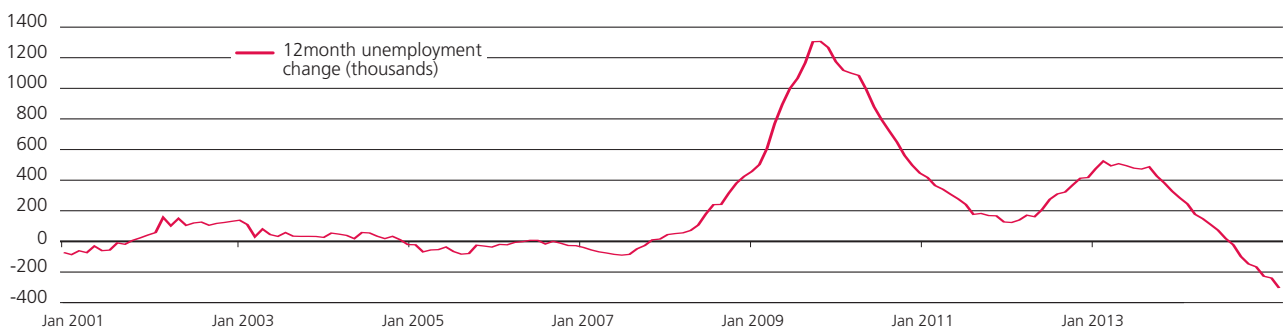
The first gains in employment at the euro periphery have come a little earlier and look a little stronger than the still modest pace of GDP growth would normally warrant. This suggests that the reforms are working. In more flexible labour markets, the hiring starts earlier.

Of course, the eurozone still faces serious problems.

1. The gains are still tentative. At the periphery, policymakers need to stay the course to reap the rewards of their efforts. Structural reforms need to be fully implemented, fiscal rigour must continue.
2. Italy and France still have a lot to do. Both face major structural issues. Because they never had to meet the troika, the reforms have so far been a little haphazard in Italy and far too timid in France.

**Chart 8: Spanish Unemployment Falling Fast**

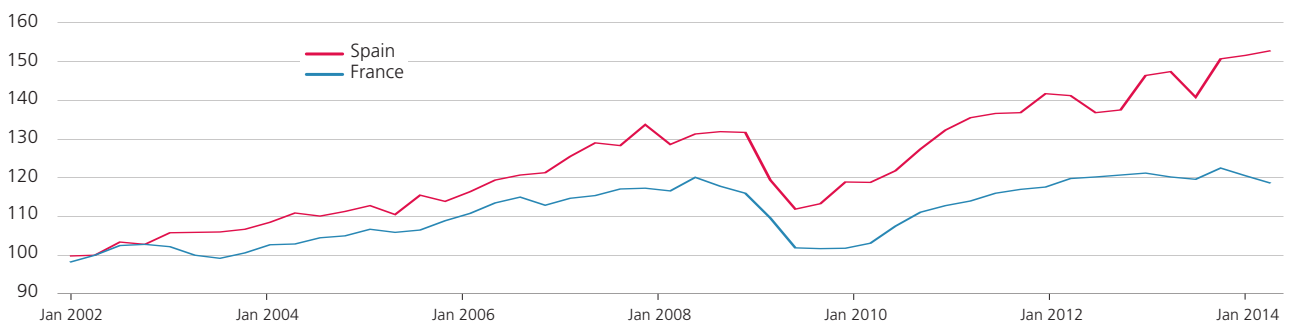
Year-on-year change in the total number of unemployed in thousands



Source: Instituto Nacional de Empleo (INEM)

**Chart 9: Export Growth: Spain is Competitive – France is Not**

Real exports of goods and services, national accounts definition, rebased to Q1 2002 = 100



Source: Eurostat

## 'An Italian turnaround could be one of the bigger stories for 2014.'

An Italian turnaround could be one of the bigger stories for 2014. Having achieved a structural primary surplus of 4.5% of GDP in 2013 after years of harsh austerity, Italy can now afford to cut some taxes as long as it restrains public spending. Italian trend growth remains weak, a tad below 1%. Fortunately, Italy is now fiscally stable at such tepid trend growth. If Prime Minister Renzi delivers on some of his reform promises (labour market as well as political reforms), trend growth could improve.

**France remains a problem.** In The 2011 Euro Plus Monitor, published in November 2011, we warned that alarm bells should be ringing in France. As the only major country in the EU with deep-seated structural problems that has not done much about these problems yet, France has become the sick man of Europe. But with low household and public debt along with fiscal deficits that are roughly average for the OECD (ex-Japan), it is not a candidate for a financial crisis. France now seems to have its most reform-minded prime minister in more than a decade. Manuel Valls' proposals do not go far enough to let France catch up to Germany or Spain. But freezing much of social spending and cutting some other government expenditure to reduce the corporate tax burden makes sense. If Mr Valls prevails, France's very lacklustre cyclical upturn could gradually strengthen in coming years.

**Crisis exit.** Spain and Ireland have left their support programmes, Portugal is having a clean exit now. Greece will likely be granted lower interest rates and longer maturities on its European support loans from the first package in late 2014. Beyond that, Greece will not need further debt relief or a third support package. A big debt burden (175% of GDP) that is largely financed for 30 to 50 years at favourable rates (thank you, Europe) is manageable. As pro-growth reforms bear fruit over time, the reform countries will be able to reduce their debt ratios significantly later this decade.

**Serious risks remain.** A Russian invasion of Ukraine could be a bad confidence shock for much of the EU. But an external threat would likely strengthen the internal cohesion of the eurozone and elicit a big European Central Bank response, probably in the form of quantitative easing. It would not lead to a return of the euro crisis. As long as policymakers at home do not backtrack, the systemic euro crisis should be over for good.



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## About the Lisbon Council

The Lisbon Council for Economic Competitiveness and Social Renewal asbl is a Brussels-based think tank and policy network. Established in Belgium as a non-profit, non-partisan association, the group is dedicated to making a positive contribution through cutting-edge research and by engaging politicians and the public at large in a constructive exchange about the economic and social challenges of the 21<sup>st</sup> century.

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