EUROPEAN
COMMISSION

Brussels, XXX
SWD(2013) 379

COMMISSION STAFF WORKING DOCUMENT

Assessment of the 2013 national reform programmes and stability programmes for the EURO AREA

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on the implementation of the broad guidelines for the economic policies of the Member States whose currency is the euro

{COM(2013) 379}

Provisional Version

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EXECUTIVE SUMMARY

ECONOMIC OUTLOOK

The euro area is going through a protracted downturn and though market tensions have eased, the outlook for growth and employment remains subdued and is marked by persistent cross-country differences. Overall, GDP contracted by 0.6% in 2012. According to the Commission's spring 2013 economic forecast, GDP would fall by 0.4% in 2013, though by the end of this year, most of the Member States that are currently in recession are forecast to register positive quarterly growth again. Assuming that continued policy efforts prevent a renewed intensification of the sovereign debt crisis, the economy is expected to grow by 1.2% in 2014. External demand is set to remain the predominant growth driver in 2013, while bank, corporate and household deleveraging continues to weigh on domestic demand. Unemployment would peak at 12.3 % in the euro area in 2013.

Significant progress has been made on fiscal consolidation in the euro area. The headline deficit is expected to fall from 3.7% of GDP in 2012 to below 3% of GDP in 2013 for the first time since 2008. However the debt-to-GDP ratio continued to rise in 2012, exceeding 90% of GDP and is expected to reach 95.5% in 2013 and stabilise at 96% in 2014.

KEY ISSUES

A fragile banking system and weak economic activity are a legacy of the crisis and, combined with pre-existing structural and institutional challenges, have created periods of considerable upheaval in financial markets and individual Member States. With a number of vulnerable countries having to make sizeable adjustments and requiring external financing, the fabric of the Economic and Monetary Union (EMU) has been severely tested.

Faced with these deep challenges, both euro area Member States and the EU institutions have acted in a decisive way to combat the crisis, and progress has been made to implement the 2012 euro area recommendations. Member States, especially those under stress, have continued with fiscal consolidation and structural reforms, while at EU level, economic and budgetary governance has been strengthened. A permanent European Stability Mechanism (ESM) is now in place to address financial crises in the euro area, the Single Supervisory Mechanism for banks has been approved, and the ECB has taken non-standard measures, such as the announcement of the Outright Monetary Transactions policy.

However, the implementation of specific recommendations for individual euro area Member States and the euro area as a whole is incomplete and the most important challenge still remains to create the conditions for higher growth and lower unemployment. To do this, public, banking and private sector debt must be reduced in a growth-friendly way, while reforms that contribute to the rebalancing must be accelerated – by both surplus and deficit countries.

- **Rebalancing**: There is evidence that rebalancing in the euro area is underway. The improvement in the net export performance of vulnerable countries is driven not only by a fall in domestic demand but also by an increase in their competitiveness. However, the correction of large imbalances, such as high public and private debt or a loss of competitiveness, takes time and requires sustained reforms that may have negative consequences for growth in the short term. The challenge for euro area Member States; including the surplus countries, will be to make sure these fundamental economic reforms create investment and employment opportunities for the future.

- **Structural reform**: Boosting the euro area's growth potential calls for an ambitious programme of reforms. This should concentrate on opening up certain sectors to more competition, allowing in innovative firms while lowering prices for consumers. Business-friendly regulation – for example, swift and fair bankruptcy procedures – would clear the market of less efficient firms. Reforming labour law – for example, changing contract law to make it easier for young people to enter the jobs market – has benefits for employers and employees.

- **Fiscal policy**: Member States have delivered significant consolidation in 2012 and the overall budget deficit in the euro area is expected to fall below 3% of GDP in 2013. Thanks to the large efforts in the past two years fiscal consolidation can proceed on a more graduallpace. Making the adjustment as growth-friendly as possible will be essential. To that end, a more growth-friendly mix of spending and taxation in the budget, better fiscal governance and structural measures to increase the growth potential will help. Consistent implementation of well-designed fiscal reforms does not only improve public finances, it also helps rebuild governments' creditworthiness and reduce overall market uncertainty.

- **Financial sector**: Bank lending to the real economy – particularly SMEs – has not picked up and fragmentation of financial markets along national lines did not disappear, despite the easing of tensions on financial markets. The ratio of non-performing loans that banks are holding is increasing and the aggregate loan-to-deposit ratio of euro area systemic banks remains high. The challenge is to identify and eliminate any remaining pockets of vulnerability on bank balance sheets, to restore the internal market and to further break the link between banks and sovereigns.

- **Economic governance**: Since the eruption of the crisis the framework for economic, budgetary and structural surveillance and coordination has been significantly reinforced. The challenge is now that the EU institutions, including the Eurogroup, use this improved framework to encourage Member States to implement country specific recommendations and take account of the strong spillovers between countries.

INTRODUCTION

The repercussions of the global economic and financial crisis of 2008/9 are still being felt in the euro area. A fragile banking system and weak economic activity constitute the legacy from the crisis, and this has combined with longer-standing structural and institutional challenges unique to the euro area to create periods of considerable upheaval in financial markets and Member State economies. With a number of vulnerable countries facing very large adjustment needs, but also sizeable external financing requirements, the fabric of Economic and Monetary Union (EMU) has been severely tested. Faced with these deep challenges, both Member States and EU institutions have acted in a decisive way to combat the economic and financial difficulties facing the euro area and to reform and strengthen the EMU governance arrangements. Shortcomings have been identified in the original design of EMU in the light of the crisis and these are being addressed through appropriate measures in the areas of financial supervision and economic surveillance. Furthermore, the institutional architecture of EMU is reinforced, as temporary financial firewalls such as the EFSF and EFSM have been replaced by a permanent European Stability Mechanism. At the same time, the monetary policy framework of the ECB has adapted to the specific challenges of the crisis and become more supportive of financial stability, notably through emergency liquidity provision and the possibility of targeted asset purchases. This has resulted in a significant reduction of tail risks and has stabilised financial markets.

Despite evident progress, the euro area still faces significant obstacles on its path towards economic and financial recovery. Achieving a stable and complete EMU requires further broad-based integration in the financial, fiscal, economic and political domain, as discussed in the Commission's blueprint for a deep and genuine EMU[1]. The 2012 country-specific recommendations for the euro area already identified the need to achieve fiscal sustainability and foster growth as central challenges, as well as the need to restore the financial sector to good health and facilitate the adjustment of macroeconomic imbalances. While much has been achieved in the way of cementing the cohesiveness of the euro area since these recommendations were addressed to euro area Member States in 2012, further action to address these policy issues is still needed. The 2013 Annual Growth Survey set out the five most pressing challenges for the EU as a whole: these are also priorities for the euro area.

1. ECONOMIC DEVELOPMENTS AND CHALLENGES

1.1. Recent economic developments and outlook

The euro area is going through a protracted downturn. The clear easing of tail risks still contrasts with a relatively subdued outlook for growth and employment across the euro area. Given the need for balance-sheet adjustment in the public and private sector in several Member States, economic activity is expected to remain subdued throughout the forecast horizon and marked by persistent cross-country differences.

GDP contracted by 0.6% in 2012. Assuming that continued policy effort will prevent a renewed intensification of the sovereign-debt crisis in the euro area and improvements on financial markets are sustained, the economy is expected to move slowly out of

[1] COM(2012) 777 final.

recession. Recent readings of survey indicators point to a gradual stabilisation in the first half of this year and the beginning of the recovery only in the second half of 2013. On the back of a strong negative carry-over effect from 2012 and an expected weak first half of this year, real GDP is predicted to decline by 0.4% in the euro area in 2013. Looking ahead to 2014, real GDP is projected to expand by 1.2%, still affected by the need for balance-sheet adjustment in the public and private sector.

On the back of a global economic recovery, external demand is set to remain the predominant growth driver in 2013, while multiple headwinds continue to weigh on domestic demand. Deleveraging of banks, non-financial firms and households has made some progress, but is expected to continue weighing on domestic demand over the forecast horizon. Elevated uncertainty, which is affecting spending and investment decisions, is expected to fade gradually. Against this backdrop, a gradual increase in domestic demand is expected in the second half of this year.

While the euro area as a whole has been affected by the economic downturn, macroeconomic conditions differ considerably between Member States. Given the differences in labour and financial market situations in some Member States and the different needs for fiscal consolidation and private sector deleveraging, economic growth differentials in the euro area are expected to narrow only gradually. However, by the end of this year, most of the Member States that are currently in recession are forecast to register positive quarterly GDP growth again.

1.2. Challenges

Supporting growth to improve sustainability

The necessary adjustment of internal and external imbalances accumulated by euro area countries in the pre-crisis period is ongoing and will take time to run its course. The correction of large imbalances generally requires a sustained adjustment process with negative consequences for short-term growth, as it implies not only a demand restraining balance sheet adjustment of the different sectors of the economy, but also a change in the output structure towards a more sustainable pattern of specialisation. On the internal side, private sector balance sheet adjustment processes currently taking place in several Member States represent necessary corrections of strong prior credit growth. Non-financial private sector deleveraging involves a reduction in investment and an increase in saving rates, driven by the desire of households and corporations to improve their net asset position by paying down existing debts and/or increasing asset holdings. The current situation is particularly challenging to the extent that high levels of debt are held not only to the financial and non-financial private sector but also the public sector in some euro area Member States, which necessitates an encompassing assessment of deleveraging challenges in all the different sectors of the economy. On the external side, a rebalancing of euro area Member States' current account positions is on-going. This is driven in part by domestic demand compression in vulnerable countries, but also by competitiveness improvements. Although these developments include both a cyclical and a non-cyclical component, the latter appears to dominate in most countries. The challenge for euro area Member States; including the surplus countries, will be to continue facilitating external rebalancing processes by boosting the adjustment capacity of their economies and enhancing the growth potential so as to support the reallocation of factors of production by creating investment and employment opportunities.

The challenge of boosting the euro area’s growth potential calls for an ambitious programme of reforms, which increase flexibility, productivity and competitiveness.

Given the currently sizeable negative output gap in the euro area and the major increase in the number of unemployed during the crisis, such a programme plays a key role in making better use of Member States’ productive resources and alleviating the economic and social hardship caused by the rise in unemployment. Economic efficiency is increased, as this will facilitate a reallocation of workers and capital towards more productive and sustainable parts of the economy will increase national income and growth potential. Furthermore as unemployment progressively affects the present and future growth potential, removing obstacles to labour markets operating efficiently should therefore be seen as a central challenge at the current juncture. In addition, labour productivity will need to be supported to enhance longer-term growth prospects and enhance competitiveness through capital investment and measures boosting total factor productivity.

Improving fiscal positions in a growth-friendly manner

Member States have delivered significant consolidation in 2012. Some Member States have already corrected their excessive deficits, while others are forecast to do so in the near future. However, the debt ratio rose to 90% in the euro area as a whole in 2012. Therefore, the challenge is to put the debt-to-GDP ratio on a steadily declining path over time. In this context, it is important to continue on the path of differentiated and growth-friendly fiscal consolidation, as advocated in the Commission's Annual Growth Survey[2], taking due account of the starting position of each country. The focus should be on an overall efficient and growth-friendly mix of expenditure and revenue taking into account the country-specific characteristics. Consistent implementation of well-designed fiscal reforms does not only improve the position of a country's public finances but it also helps rebuild government's creditworthiness and reduce overall market uncertainty. This is especially true if fiscal plans are demonstrably growth-friendly, are clearly anchored in a multi-annual budgetary framework and address the long-term sustainability of public finances.

Safeguarding financial stability and improving credit flow to the real economy

Improved funding conditions for banks are yet to feed through to a pick-up of credit for the real economy. Significant differences persist across Member States as regards bank lending activity and the cost of funding to the private sector. Credit growth is currently held back by weak credit demand and supply. On the demand side, the challenge is to restore confidence and repair the strained balance sheets in the non-financial private sector. On the supply side, high lending rates are linked to the health of the banking sector with banks with a high ratio of non-performing loans, low profitability and/or a weak capital position charging high lending rates. Moreover, the current low-cost funding environment and the persistent high loan-to-deposit ratios indicate that there is a risk that banks start engaging in loan forbearance which would freeze the credit supply further and could undermine confidence in the sector as a whole. This is exacerbated by financial market fragmentation along national borders due to feedback loops between banks and sovereigns. Therefore, the challenge on the supply side lies in further breaking the feedback loops between banks and sovereigns and restoring the internal market in the financial sector. One important element in this regard is to promote the repair of bank balance sheets so as to facilitate an orderly deleveraging of both the banking sector and the non-financial private sector while sustaining the flow of new credit for productive uses in the real economy and particularly SMEs. To this end, the transparency of bank balance sheets should be enhanced and any remaining pockets of vulnerability should be identified and repaired.

[2] COM(2012) 750 final.

Making progress towards effective governance arrangements in the euro area

A new governance framework has come into force. Since the eruption of the crisis the framework for economic, budgetary and structural surveillance and coordination has been significantly reinforced. The challenge is now to use this improved governance framework to reinforce the commitment of Member States to implement country specific recommendations and to assure a coherent aggregate policy stance which reflects the strong spillovers between countries whose currency is the euro.

2. ASSESSMENT OF THE POLICY AGENDA

2.1. Fiscal policy and taxation

Budgetary developments and debt dynamics

Significant progress has been made on fiscal consolidation in the euro area. The structural deficit for the euro area improved by 1.4 percentage points (pps) in 2012. This testifies to the significant fiscal effort undertaken by euro area Member States over the year. Also, the headline deficit continued to improve by 0.4 pps and fell to 3.7% of GDP. According to the spring forecast, the overall structural balance of the euro area should improve by 0.75 pps in 2013. This should lead to a further reduction in the nominal deficit, which should fall below 3% of GDP for the first time since 2008 and by more than half from its peak in 2009-10 when it exceeded 6% of GDP on the back of fiscal stimulus and support for the financial sector.

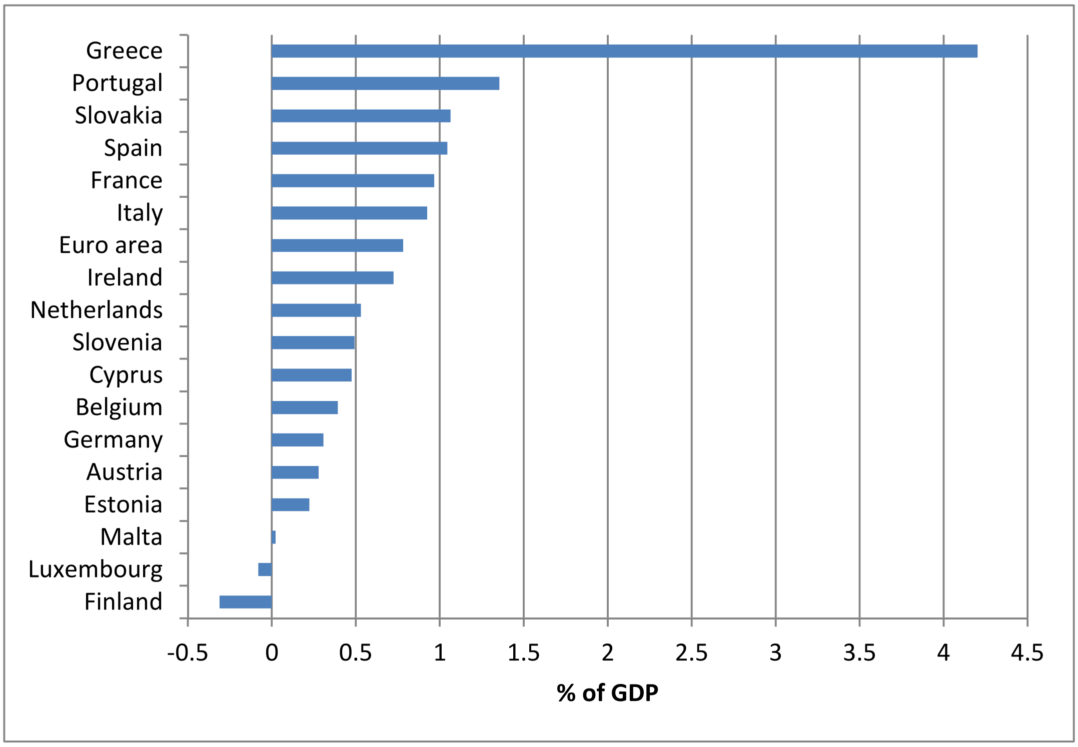
However the debt-to-GDP ratio continued to rise in 2012, as the effects of the consolidation programmes on debt will become visible only with time. The debt ratio of the euro area as a whole exceeded 90% of GDP in 2012. According to the Commission spring forecast the pace of debt accumulation will slow down markedly this year, but the debt ratio will continue rising and will reach 95.5% of GDP in 2013. Assuming no changes in fiscal policies, the debt ratio is forecast to stabilise at 96% in 2014. Member States fiscal plans as presented in Stability Programmes imply a similar debt pattern as forecast by the Commission with a slightly lower debt level in 2014. Provided that SCP plans are rigorously implemented, the debt ratio should decline further to just below 90% of GDP in 2016. Higher debt ratios can weigh on growth via the higher taxes needed to pay for interest charges and via higher sovereign risk affecting private risk and borrowing costs for private agents. These factors are more relevant when debt is larger. Therefore, consolidation efforts should be complemented by structural reforms to enhance the growth potential which would allow bringing down the debt ratio more rapidly. The recent amendments to the SGP have created a debt benchmark, which operationalized the debt criterion of the Treaty. It requires the Member States to reduce their debt ratios at a pace that would ensure reaching the 60% of GDP threshold at most over a 20-years horizon. However, Member States that were in EDP in November 2011 were granted a 3-year transition period during which they need to show sufficient compliance towards meeting the benchmark at the end of the transition[3].

The speed of consolidation over the period 2010 and 2013 for the euro area as a whole as well as the differentiation according to fiscal space was broadly appropriate. Over the period 2010 and 2013, the annual average improvement of structural balances in the euro area

[3] i.e. at the time the revised Regulation (EC) No 1467/97 entered into force.

is forecast to be 0.8% (see Figure 1). The largest adjustment was implemented in programme countries and countries facing market pressures such as Greece, Portugal, Italy and Spain or countries with high deficits in 2009 such as Slovakia and France. In Member States with a larger fiscal space such as Finland and Luxembourg structural balances have not improved or only moderately. However, for a number of countries, but especially for those experiencing a marked fiscal tightening, the underlying degree of policy retrenchment needed to deliver a given improvement in the structural balance is currently higher than in normal circumstances. This is attributable to the ongoing rebalancing towards tradable sectors that translate into temporary tax-poor growth and downward changes in potential growth. By contrast, but in a less significant manner, the discretionary fiscal effort is currently suggestive of a looser policy than the change in the structural balance in Germany, Luxembourg, Malta and Sweden. For the euro area as a whole, the degree of policy retrenchment is currently higher than what would appear from the structural effort[4]. Looking at the structural balances in a dynamic perspective, the European Commission recommended an EU consolidation strategy based on the principle of gradual and differentiated adjustment. Countries with high debt or under market stress were recommended to start consolidation in 2010 and others only in 2011. As a result, fiscal policies played a key role to support the economy and to avoid financial meltdown in 2009. For the euro area as a whole the fiscal stance was neutral in 2010. In 2011, the consolidation pace picked up to 0.9%, to peak at 1.4% in 2012. For 2013, the Commission forecasts a decline to an aggregate consolidation effort of 0.75%.

Figure 1: annual average structural effort over 2009-2013



Source: Commission 2013 spring forecast

The Stability and Growth Pact (SGP) is a flexible framework to guide the differentiated speed of fiscal adjustment and the recent improvements in the SGP will further enhance this role. While the nominal deficit and debt thresholds - respectively 3% and 60% of GDP -

4 See Box I.4 of the Spring Forecast of the European Commission.

are the main anchors of the SGP in the corrective arm, the consolidation paths towards these targets is defined in structural terms, i.e. assuming away the impact of the business cycle on the headline deficit. Therefore, if a significant deterioration of the economic outlook leads to missing the nominal target in spite of implementing the required structural effort, the deadline for correcting the excessive deficit could be postponed. In the preventive arm, countries should pursue steady adjustment towards their Medium Term Objectives (MTO) with the annual structural improvement of 0.5% as a benchmark, which can be modulated according to country-specific fiscal and economic situation, based on the criteria specified in the SGP. Also, the SGP rules allow a temporary deviation from the adjustment path towards the MTO due to the implementation of major structural reforms with direct long-term positive budgetary effects, including by raising potential sustainable growth, and which therefore have a verifiable impact on the long-term sustainability of public finances. The SGP provisions have served as a basis for the Commission's calendar of convergence towards the MTOs. In order to give a more tangible guidance to Member States on their path towards the MTO, an expenditure benchmark was introduced, which complements the assessment of the structural balance and requires Member States to keep the growth of expenditure, net of discretionary revenue measures, aligned with the medium-term rate of their potential growth[5]. A Member State that has overachieved the MTO could temporarily let annual expenditure growth exceed a reference medium-term rate of potential GDP growth as long as, taking into account the possibility of significant revenue windfalls, the MTO is respected throughout the programme period.

Based on the Stability Programmes, the structural effort in the euro area will decline further with a differentiation of consolidation based on fiscal space. This implies also that the headwinds from consolidation are expected to ease in the euro area as a whole. Thanks to the already implemented consolidation efforts and a robust economic performance, Estonia, Finland, Germany and Luxembourg have achieved their MTO, with Germany achieving it with a wide margin, or are expected to do so over the forecast period. Therefore, there is no more need for short-term consolidation measures and countries with structural balances above their MTO can let the net expenditure grow above the medium-term rate of potential growth as long as their MTO is preserved. The negative impact of consolidation on growth in these countries will fall away. Also Member States, which have corrected their excessive deficit, such as Italy or Austria, could assure a more gradual adjustment towards their Medium Term Objectives, in line with the calendar of convergence proposed by the Commission. As countries in the preventive arm represent more than 40% of the euro area GDP, the overall consolidation needs in the euro area, as well as the impact of consolidation on euro area growth, are diminishing.

Nonetheless, there remain substantial consolidation needs in some euro area countries as there are still a number of countries in excessive deficit procedure and countries in the preventive arm need to make progress of 0.5% as a benchmark towards the MTO. These consolidation efforts will weigh on economic growth with the size of the effects depending on many factors, such as the composition of consolidation, the state of the balance sheets of the private sector or the credibility of policies. Euro area Member States which are not under stress but are still in the excessive deficit procedure and fulfil the conditions for an extension of their deadline, should continue their fiscal efforts in line with the Council Recommendation addressed to them but with more attention to complementary measures to reinforce their growth potential and to correct their macro-economic imbalances. For a number of vulnerable countries that face both private and public deleveraging needs, consolidation can have a

5 Revised Regulation (EC) No 1466/97.

higher short term effect on economic growth in particular if rigidities exist in their financial-, labour- and product markets. Trading off public against private deleveraging is no option for these countries, as their overall external position is often negative, requiring a significant adjustment of the nation as whole. This is bound to be painful whatever the exact distribution between public and private deleveraging. These countries do not have an alternative as they have lost access to financial markets or are at risk of losing it.

Composition of public finance

While expenditure-led consolidations should be favoured, the focus should be on an overall efficient and growth-friendly mix of expenditure and revenue measures. Analysis of past episodes of consolidation suggests that expenditure-based consolidations are more likely to succeed. Also, given the relatively high tax burden in some of the euro area Member States, further tax increases could impact negatively on future growth and other more growth-friendly ways of revenue raising, such as broadening the tax base, should be considered instead.. Overall, in order to limit the short-term negative effects on growth, the composition of consolidations should find the right mix of growth-friendly measures on the expenditure side and the revenue side taking into account the country-specific economic and fiscal characteristics.

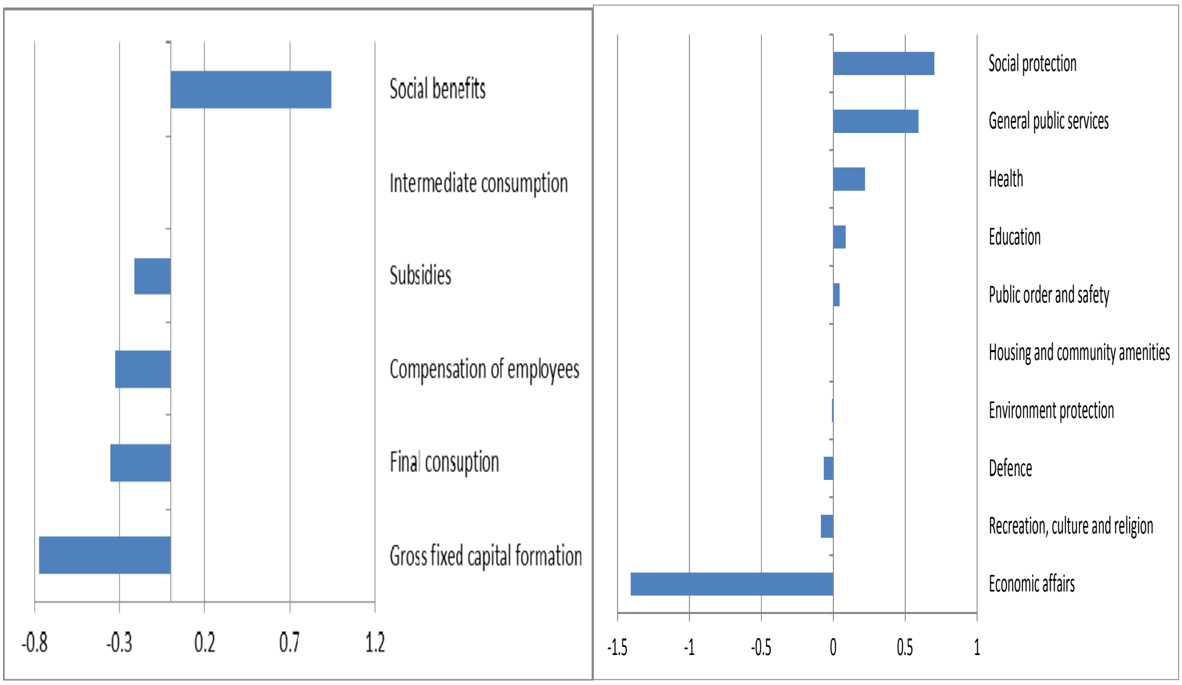
Consolidation efforts in the euro area have been broadly balanced between the revenue and expenditure side. Between 2009 and 2012 revenue ratio increased in the euro area by 1.3 percentage points to 46.2% of GDP, while expenditure ratio fell by the same amount to slightly below 50% of GDP, but still not reversed the large increase recorded in 2009 and remain above the level of 2008. In implementing their adjustment strategy countries such as Ireland[6], Greece, Portugal and Spain mostly relied on expenditure cuts. On the contrary, in countries such as France, Belgium, Italy and Luxembourg overall fiscal consolidation has been revenue-based although revenue ratios are already relatively high in these countries.

Expenditure cuts also affected growth friendly expenditure categories. Public investment was the most affected expenditure type (see Figure 2). Although investment projects are the easiest ones to target when making savings, it is unfortunate as investment is the most growth-friendly type of government expenditure. At the time when the private sector postpones investment, there is a case for the public sector to step in, while looking for budgetary savings in other parts of the budget. In order to alleviate this drawback, the Commission has announced in the Blueprint for a deep and genuine EMU that it would explore further ways to accommodate investment programmes within the preventive arm of the SGP. Also, the public wage bill and public consumption have been reduced since the start of the fiscal adjustment in 2010. Conversely, the relative share of social transfers increased. The large increase in social benefits has been related to the impact of the crisis on labour market and efforts by Member States to moderate its social consequences. These insights are confirmed by analysis of expenditure by functional type, which show significant increased government expenditure on social protection, which at least partly reflects the counter-cyclical nature of such spending - although conclusions here should be careful due to short time series of data available. Education expenditure has risen slightly, which is to some extent reassuring in view of the link to the long-term growth potential. Overall, however, this picture shows that there is still scope to improve the composition of fiscal adjustment on the expenditure side. In some cases the size and speed of adjustment was dictated by the developments on financial markets and

[6] Expenditure cuts are influenced by the public intervention in the financial sector.

deteriorating liquidity position of the government and did not leave much space for optimising policy measures. The improvements in financial markets should allow more considerate decisions on the composition of the budgets going forward. In other Member States, however, there is also the need to resist easy and temporary solutions for budgetary savings and aim at increasing efficiently and effectiveness of public spending in view of both current adjustment needs and the long-term challenges. Benchmarking of best practices and appropriate cost-benefit analysis could be useful techniques to enhance the efficiency in government spending.

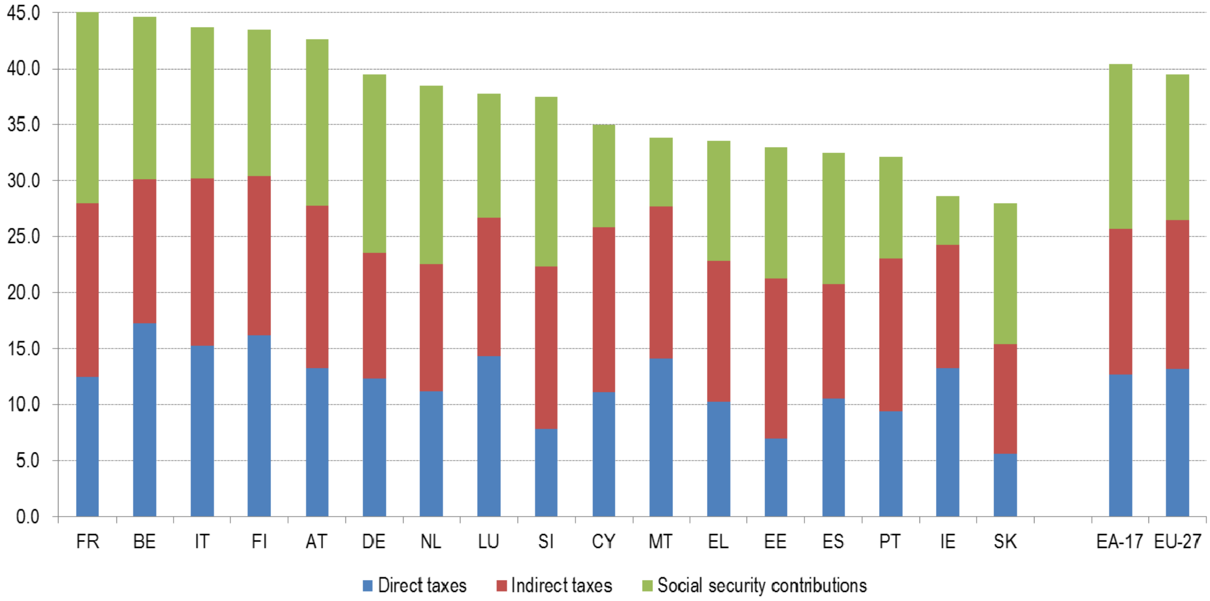
Figure 2 Change in total expenditure mix, by economic (2010-2012) and functional type (2010-2011), percentage points



Source: Commission Services

A majority of Euro Area Member States increased taxation across the board in 2011-2012 in the context of large fiscal consolidation needs. Broad based revenue measures were required in some Member States, which implies an increase of the tax burden also on labour and corporate income considered more detrimental for growth. They raised taxes on income and wealth, as well as indirect taxes on consumption. Personal income tax rates increased, in several cases in the form of general surcharges or solidarity contributions for high-income earners. There is also a tendency toward moderate increases in recurrent property taxation. Measures affecting the corporate income tax are more mixed, reflecting also very disparate starting conditions in the Euro Area: Several countries have reduced the corporate income tax rate while other Euro Area Member States have introduced special levies and surcharges on large companies in particular. In an effort to dampen negative effects of the crisis on private sector investments, several Member States introduced changes to the corporate tax base to further incentivise research and innovation investments and entrepreneurial activity. In the area of consumption taxes, both VAT rates and excise duties on energy, alcohol and tobacco have been increased in many Member States.

Figure 3: Tax-to-GDP ratio and tax structure in Euro area Member States, 2012 (per cent of GDP)



Source: Commission Services

The shares of direct and indirect taxes in GDP are expected to increase in parallel, leaving the overall tax structure relatively unchanged in the short term (see figure 3)**.** Some countries made an effort to improve their tax structure: measures have been taken there to shift from taxes on labour, including targeted reduction of taxes for particular labour market groups such as low income or second earners, to consumption, environmental or property taxes.

Going forward, there is still scope for many euro area Member States to improve the structure of the tax systems further. In particular France, Belgium and Italy have scope to further shift taxes away from labour. Such shifts would need to be properly sequenced to avoid revenue losses in the short term. In several countries, the possibility could be explored to accompany the increase in consumption taxes with a more pronounced use of recurrent property taxes and environmental taxation which are considered less detrimental to growth. Property taxes could usefully complement consumption taxes as a way to shift tax away from labour, given the possibly adverse effect of consumption tax increase on the poorest households and on tax fraud.

Many Member States have room to make the tax systems more growth friendly and raise additional revenue by broadening the tax bases. Hence, there is scope for reviewing tax expenditure in personal and corporate income taxation with a view increasing the overall efficiency of the taxation system. Belgium, France, Italy and Spain, in particular, would benefit from addressing the wide range of tax expenditures in their tax systems. Room also exists for improving VAT efficiency through a broader application of the standard rate and further rises in reduced rates in around half of the euro area Member States.

Finally, a majority of Member States could further improve the tax governance or/and further reduce their debt bias. Tax governance should continue to be improved in about half of the euro area Member States. This relates to sustained efforts in the mid to long term to enhance tax compliance and improve the efficiency of the tax administration. Italy, Malta and Spain could further intensify their efforts on tackling tax fraud and undeclared work, while Slovakia would benefit from to further improving VAT collection and strengthen the capacity of the tax administration. Finally, further reform efforts to reduce the debt bias in housing and corporate taxation may still be needed in some countries to address current imbalances and to prevent the recurrence of financial risks in these sectors. The Netherlands has room to further address the tax bias in the financing of housing investments, while Malta, Spain, Luxembourg and France have scope to continue to address the debt bias in corporate taxation.

Long-term fiscal sustainability

Coping with long-term expenditure trends influenced by population ageing is an important challenge. Significant progress has been made since 2009: Fiscal adjustment needs to assure long term sustainability declined from 5.8% in 2009 to 2.3% now for the euro area as a whole. To reach the 60% debt-to-GDP threshold by 2030 in the euro area an additional effort of 2 percentage points of GDP is needed on top of the already envisaged fiscal effort until 2014[7]. Failing to do so would entail that government debt as a share of GDP would start to rise again towards 2030 as the budgetary impact of population ageing takes hold more firmly, and debt would be close to 90% of GDP in 2030. The situation is however quite different across the euro area Member States. Sustainability risks are particularly high in Belgium, Spain, Malta, the Netherlands, Cyprus and Slovenia. If one expands the time horizon towards 2060, sustainability challenges are still bigger, as pensions expenditure would be projected to rise from more than 12% of GDP today to 14% in 2060. Moreover, spending on health care and long-term care is projected to rise from 9% to 12% in 2060. Hence, in the very long-term, ageing-induced fiscal sustainability challenges remain important in most countries, with the risk being highest in Belgium, Cyprus, Luxembourg, Malta, the Netherlands, Slovenia and Finland. Greece and to a lesser extent Spain have implemented sustainability-enhancing pension reforms and others such as Italy and Portugal where the sustainability risks appear to be contained in a long-term perspective, conditional upon the full implementation of the planned ambitious fiscal consolidation and on maintaining high primary balance well beyond 2014[8]. This demonstrates the progress countries under stress have made to improve their long term sustainability.

Progress has been made with reforms of pension systems, less so with health care. A majority of Member States have adapted pension systems with the aim of putting them on a more sustainable footing against the background of population ageing. Last year a number of euro area Member States have made pension reforms which are having positive budgetary impact in the long term such as the Netherlands and Slovakia, which introduced an automatic link between life expectancy and the statutory retirement age. Nonetheless, further reform efforts are needed to align retirement age with life expectancy, restrict access to early retirement schemes, and enable longer working lives but also in the fields of health care and long-term care policies. In the care policy field, the challenge is to balance the need for universal health care and long-term care with an increasing demand related to ageing population, technological development and growing patient expectations in all age categories. Public health and long-term care expenditure accounted for close to 9% of GDP in 2010. It has seen a substantial increase in the recent decades in terms of spending as a share of GDP

[7] For details on the S1 indicator, see Chapter 1.3 of the Fiscal Sustainability Report 2012, *European Economy 8|2012 http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-8_en.pdf*

[8] For details on the S2 indicator, see Chapter 1.3 of the Fiscal Sustainability Report 2012.

and as a share of total government expenditure. This trend, amplified by population ageing, is expected to continue in the coming decades. The joint impact of demographic and non-demographic drivers is a projected increase in public spending in health and long-term care by 2 ½ or even 3 ½ pp. of GDP by 2060[9]. Overall, 70% of the projected increase in age-related public expenditure is due to health and long-term care (the other areas being pensions, education and unemployment benefits). As such, health and long-term care expenditure trends are a continuous challenge to sustainability of sound public finances. Therefore, sound reforms are thus needed to achieve both a more efficient use of limited public resources and the provision of high quality health care, improving the cost-effectiveness of public health care. Increased cost-effectiveness of healthcare systems may reduce or further postpone the burden of diseases and disability, and may as such may have a positive impact on labour participation,

Fiscal Frameworks

The strengthening of fiscal frameworks continues across the euro area. While the Directive on national budgetary frameworks has to be transposed by the end of 2013, euro area Member States pledged to advance this process to end 2012[10]. Despite substantial progress, there is still some way to go. Member States have to ensure timely and comprehensive statistical coverage for all general government sub-sectors, whereas forecasting provisions often lack transparency. Progress is somewhat more advanced regarding numerical fiscal rules: a wide array of national instruments are either in place or are being prepared to buttress national fiscal policy-making. Beyond the Directive itself, the framework for strengthened EU governance introduced with the other legislative texts of the 'six-pack' reform of the Stability and Growth Pact has helped to place the issue of effective national numerical fiscal rules high on the Member States' reform agenda. This is also supported by the inter-governmental TSCG which mandates the adoption of a structural budget balance rule enshrining the MTO at national level and safeguarded by a robust correction mechanism. In addition, the more recent agreement on the 'two-pack' legislation, targeted specifically at euro area Member States, will further reinforce domestic fiscal frameworks in the context of enhanced surveillance of budgetary processes; this will in particular feature a stronger role for independent fiscal institutions. Work on effective coordination arrangements for sub-national governments is being carried out in many euro area Member States, but the positive intentions need to be turned into concrete and enforceable arrangements, especially in decentralised countries such as Spain and Belgium. The push towards robust fiscal processes is also extending over a multi-annual perspective. Although many Member States report that Medium Term Budgetary Frameworks are in place or planned, efforts are still needed in order to fully comply with the Directive's specifications. Having an effective medium term fiscal planning reduces policy uncertainty and increases confidence.

2.2. Financial sector

Most risk indicators related to EU financial markets as well as market sentiment improved in the second half of 2012 and early 2013 as the intensity of self-fulfilling, negative confidence spirals has dissipated due to decisive policy action at all levels.

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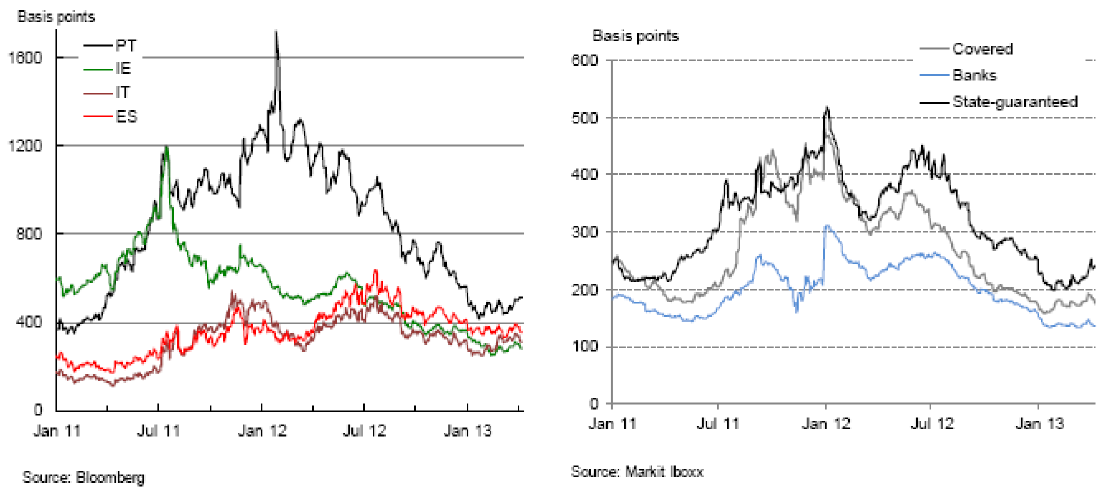
9 According to the Ageing Working Group Reference and the Ageing Working Group Risk scenarios, respectively, see Ageing Report 2012, available at: http://ec.europa.eu/economy_finance/publications/european_economy/2012/2012-ageing-report_en.htm

10 See European Council conclusions of 21 July 2011.

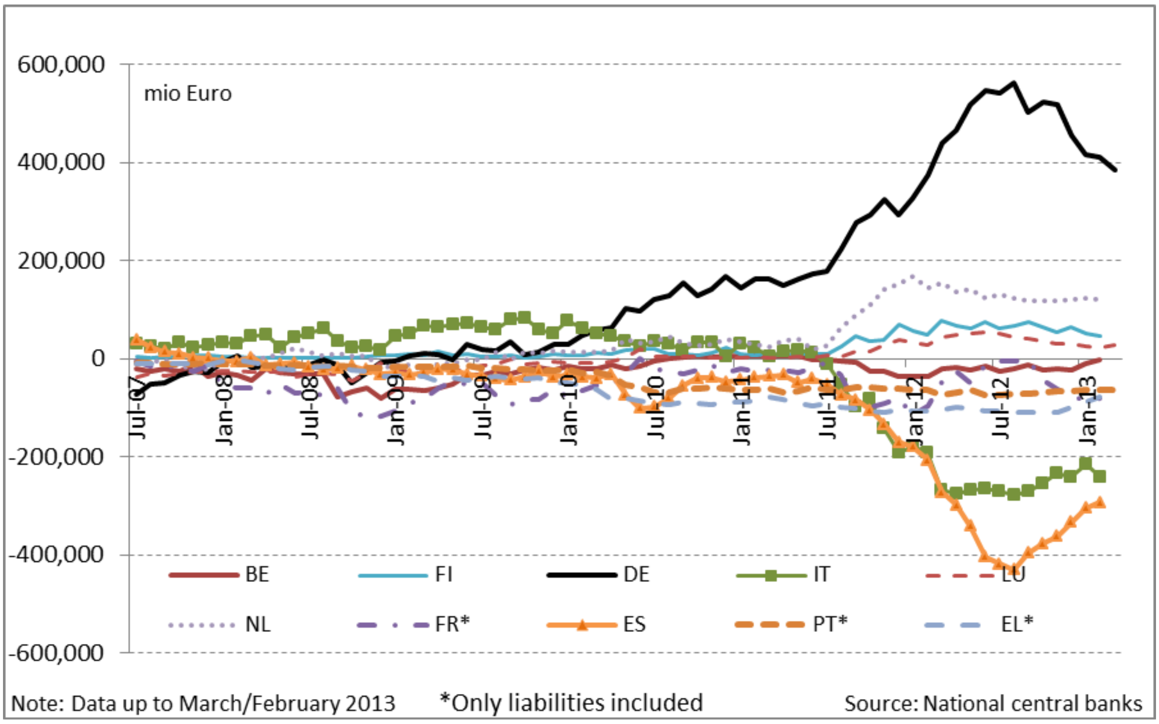
There was a broad based recovery of asset prices in most market segments. The reinforcing upward trends in risk premia previously observed regarding sovereigns and banks were reversed (see Figure 4). The decreasing perception of riskiness of euro area sovereign and bank debt have been reflected in the decline of bond yields in programme and vulnerable Member States and their spreads against the German Bund as well as the corresponding CDS spreads. This decreasing risk perception has also been observable in successful primary sovereign bond auctions, both in terms of bids received relative to the amounts requested and yields realised. Some Member States were able to tap the sovereign bond market with very long-term issues, while Ireland and Portugal have effectively prepared the grounds for a full return to market financing. Market sentiment has also been quite robust and tail risks have diminished as weak economic data, the uncertainty in the immediate aftermath of the Italian elections and uncertainty related to Cyprus has not led to a resurgence in the tensions that characterised so much of 2012 although these events led to a deterioration of confidence indicators and an increase in sovereign spreads, although the latter have been declining again as of April.

Figure 4 10-Year Euro area government bonds spreads to Germany and spreads of bonds issued by banks



Many EU banks have also returned to debt market financing and, since autumn 2012, banks from vulnerable Member States have also been able to issue substantial amounts of debt securities although bank bond issuance dried up in the aftermath of the events in Cyprus. At the same time, the retail deposit outflows from banks in several vulnerable Member States stabilised. As a consequence, banks' borrowing from central banks has been decreasing in most countries that were the most reliant upon it, as witnessed by the contraction in the Intra Euro-system balances (see Figure 5). Several banks have also started to redeem part of the fund borrowed on the occasion of the two ECB LTROs. The restitution is accounted for mostly by banks in the core, Germany and France in particular, but that also banks in more vulnerable countries are contributing, most notably Spain. The management of LTRO re-absorption will be extremely delicate and should be carried out in a careful way, especially at a time when pressure on the banking sector has started to ease but conditions are not yet back to normal and the risk of resuming funding difficulties is still present.

Figure 5 Intra Euro-system Balances



The positive market sentiment was spurred by several European level policy measures that impacted the markets in the last year. Perceptions about euro breakup have receded significantly starting in the last quarter of 2012. On the monetary side the ECB's announced a new programme aimed at restoring the transmission of monetary policy Outright Monetary Transactions (OMT) in September 2012. The OMT would come with strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. The OMT was successful in dispelling markets' concerns about the existence of any euro convertibility risk and has produced substantial moderating effects on sovereign bond yields, especially in Spain and Italy. On the regulatory front, progress in economic and fiscal governance as well as the agreement on the Single Supervisory Mechanism (SSM) also contributed to the reduction of risk premia. The SSM should be fully operational by July 2014 radically changing the supervisory landscape in Europe. The SSM will ensure a harmonised oversight with centralised supervision for the most significant banks only and those receiving public support. This will enhance high-quality and impartial banking supervision across the board, contributing to boost the resilience of the banking system in the medium term and dissipate doubts about the quality of banks' assets. As a consequence, the SSM will contribute to restoring confidence in the banking system and weaken the negative feedback loop between sovereigns and banks in the euro area. Taken together, important progress in reducing financial risks has already been achieved. Finally, with the permanent European Stability Mechanism becoming operational, the EU can rely on strong firewalls that can be put in place to avoid feedback loops and spill over effects between sovereigns and between sovereigns and their financial sector.

However, market conditions have not normalised and market fragmentation did not disappear which means that funding strains for banks in vulnerable countries remains prevalent. The return to full financial integration depends crucially on the preservation of a positive and ambitious effort to reform the financial framework. The loss of investor confidence observed in the last couple of months could reinforce the fragmentation of EU financial markets again. At the current juncture, national governments concentrate on the domestic effects of bank failures and often ignore cross-border externalities. To reap the benefits of the single market as well as financial stability, the euro area needs new supranational institutions that facilitate cross-border banking. The possibility of direct recapitalisation of banks by the ESM, which should be available soon, will also play a role in the dilution of the bank-sovereign link, both in the transition phase and the steady state.

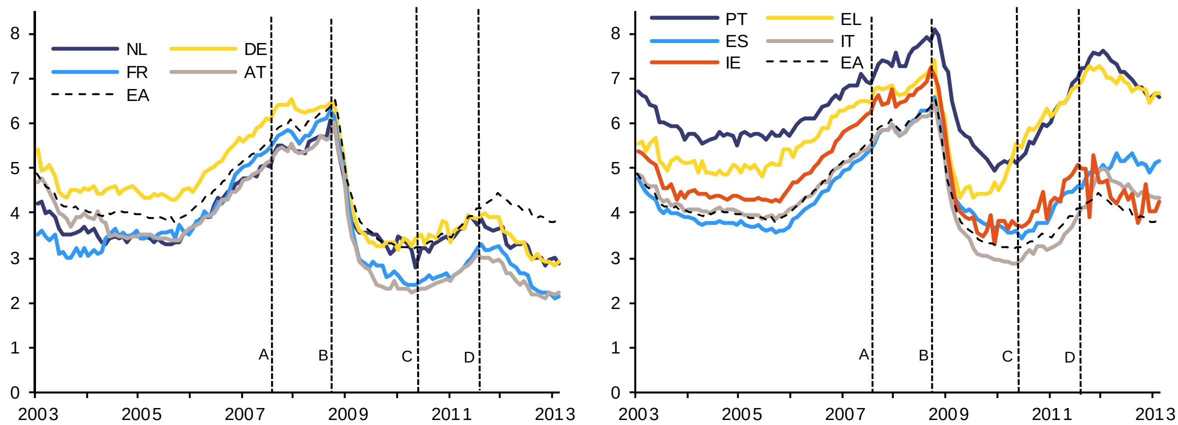
The crisis has showed how countries in a monetary union are vulnerable to sudden to asymmetric shocks and therefore also to potentially disruptive reversals in capital flows in the absence of coordination of their economic policies and real convergence of their business cycles. Some countries which had relatively higher inflation and interest rates before joining the monetary union, attracted massive capital inflows during the first decade of monetary unification and underwent since the beginning of the crisis equally massive private capital outflows, whose full effect has been partly cushioned by the possibility for banks to access central bank financing. In order to prevent similar threats for financial stability to materialise in the future, on the financial side, macro-prudential policy will have a crucial role to play. CRD4 and CRR already envisage many new macro tools, such as counter cyclical capital buffers (CCB) and buffers for systemically important financial institutions (SIFIs) that could help prevent the build-up of a similar situation in the future, and the ECB and ESRB need to ensure that their use is coordinated and done in the most efficient way.

Banks continued balance sheet repair. Euro area systemic banks also continued to reduce their leverage ratios with assets 23 times higher than equity in 2012. This ratio has come down considerably since 2008 when assets were 31 times higher than banks' equity. This improvement has mainly come about by an increase in equity. Systemic banks in the euro area continued to increase their solvency with the average core tier 1 rising from 10 towards 11% in the three first quarters of 2012. The weak macro-economic environment and the sometimes high levels of non-financial private sector indebtedness suggests that banks in the euro area should conserve capital buffers built up as a result of the EBA recapitalisation plan and continue strengthening their equity buffers, where needed. The economic outlook weighs on bank profitability via rising non-performing loans and provisioning needs. Shoring up capital should preferably be done by raising new equity, or by reducing dividends, executive compensation and share buybacks in favour of retained earnings, in order to avoid any unintended consequences on the credit flow. To illustrate the need to raise equity further still, it should be noted that the total doubtful and non-performing loans not covered by reserves as a percentage of total own funds is rising steadily in a number of countries under stress and some other countries. In programme countries, thorough evaluations have ensured a high level of capital in the banks to be able to complete the process of balance sheet repair. Some of those evaluations are now outdated and will need to be updated to take account of the most recent economic developments and to identify any remaining pockets of vulnerability and so reinforce the confidence in the sector as a whole.

The overall pace of decline in loan-to-deposit ratios over the last years is rather slow compared to the declines of bank balance sheets observed during previous banking crisis. In fact, on aggregate total assets in the euro area did not decline significantly since the beginning of the crisis. At the moment the pace can be compared to Japan, which experienced a very slow deleveraging process of its financial sector since 1997 because bad assets remained too long on the balance sheets of the banks. This had a big influence on the overall poor economic performance of Japan over the last decades. The aggregate loan-to-deposit ratio of euro area systemic banks was still 120% in June 2012. This means that euro area banks are reliant on wholesale funding and are vulnerable when these markets dry up. While increasing equity is definitely the economically preferred way to deleverage as the credit flow to the real economy is less affected, the current slow pace of asset adjustment and the current low-cost funding environment, point to a risk of loan forbearance. Therefore, legal and judicial obstacles to non-performing loan resolution should be resolved. Moreover, it is important that asset quality reviews that are held are based on a common set of definitions and methodology with credible backstops. This approach could enhance transparency of the bank balance sheet and so reinforce confidence in the sector as a whole.

In the euro area as a whole, the MFI lending volume to non-financial companies decreased in 2012 with -3.8% whereas the lending volume to households remained stable. Lending volumes in the countries under stress are even more subdued. Comparing the changes in bank lending volumes and bank lending rates gives some insight in the respective contributions by demand and supply to weak credit growth. In Italy – in particular for small firms – and Portugal, developments in bank lending conditions suggest a dominance of supply shocks while the case of Ireland suggests a dominant demand shock. In Spain, a situation consistent with a combined effect of negative demand and supply shocks emerges. Demand for loans is subdued because of the macro-economic environment, deleveraging pressures in the non-financial private sector and uncertainty weighing on investment decisions. Supply factors are contributing as well. Access to finance is particularly problematic for SMEs and start-ups in several Member States. According to the most recent edition of the ECB SAFE survey, access to bank loans continued to deteriorate in the euro area and rejection rates when applying for a bank loan increased to 15%. Almost one out of five firms (18%) reported that access to finance is their main problem. Despite the significant improvement in the sovereign bond yields and decline in funding costs for banks in countries under stress, the retail lending rates charged by bank to non-financial corporations and households have not yet significantly fallen and companies and households in some vulnerable countries are still charged significantly higher rates for borrowing than their peers in core countries (see Figure 6). This demonstrates that the Single Market for finance is currently significantly fragmented.

Figure 6 Retail interest rates: Loans to NFCs with an initial rate of fixation of less than one year up to EUR 1 million, %



Source: ECB Notes: A: Crisis outbreak; B: Lehman Brothers; C: First Greek programme; D: Sovereign contagion. Last data: January 2013.

Since the financing conditions of the sovereign are correlated to those of the banks and feedback loops exist between the financing conditions of sovereigns and the respective private sector, a more contained sovereign risk should via bank intermediation feed through in the cost of credit to the economy as a whole. Recent analysis suggests that the variation in lending conditions to the non-financial private sector is not only driven by the sovereign funding cost and the leverage of the private sector but also by the health characteristics of the national banking systems[11]. The quality of the loan portfolios, the profitability and the size of capital buffers of the national banking system contributed to the dispersion of bank lending rates at the country level (see Figure 7). This suggests that at the current juncture, higher lending rates may reflect the need to partially offset current or future losses suffered on impaired assets. Therefore, further bank balance sheet repair (see above) should lead to a normalisation of lending conditions in countries under stress. On top of that, the Single Market should be enforced, also in the short term.

[11] European Commission (2013), 'Drivers of diverging financing across member states', Quarterly Reporton the Euro Area, volume 12 issue 1.

Figure 7 Correlation's between composite MFI lending rate to the non-financial private sector and 10 year government bonds yields, non-performing loans, return on assets and tier 1 capital

Source: ECB

The subdued supply of bank lending, has led to a diversion of financing to market financing. Over the last 12 months corporate bond issuance in the euro area amounted to €117bn, an increase by +13.3% year-on-year. For the euro area as a whole, the amount of bond issuance more than offsets the decline in net lending flows over the same period which amounts to -€70bn once adjusted by sales and securitisation. When summing up the two sources of financing, it emerges that the total funding to the non-financial corporate sector remained positive over the last 12 months in the euro area (+€47bn). However, in some countries deep declines in lending volumes have not been made up by an increase in bond issuance (see Figure 8). This could be due to weak demand for credit and/or the fact that these bond markets are not well developed. Moreover, SMEs or households do not have direct access to market financing.

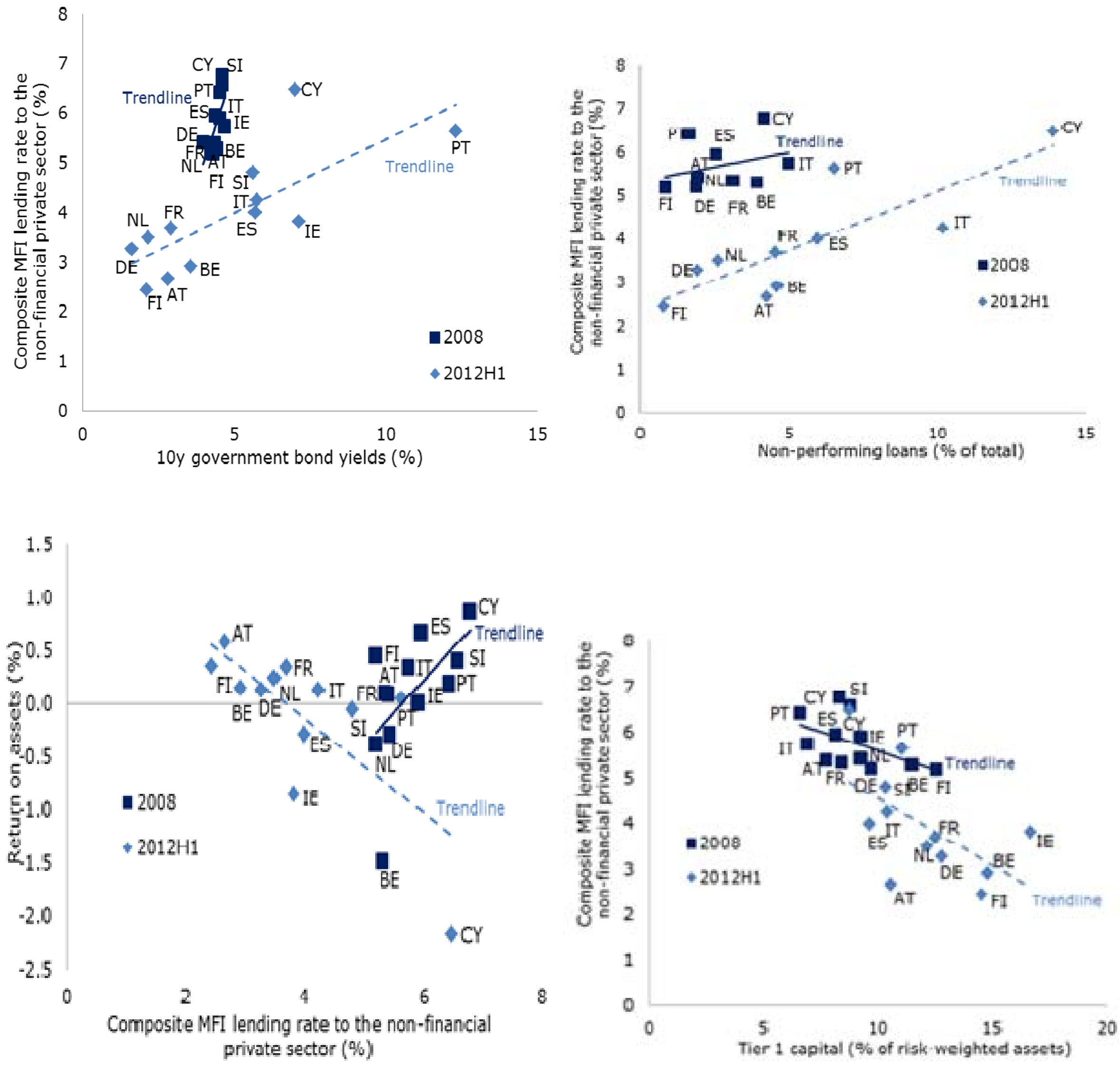
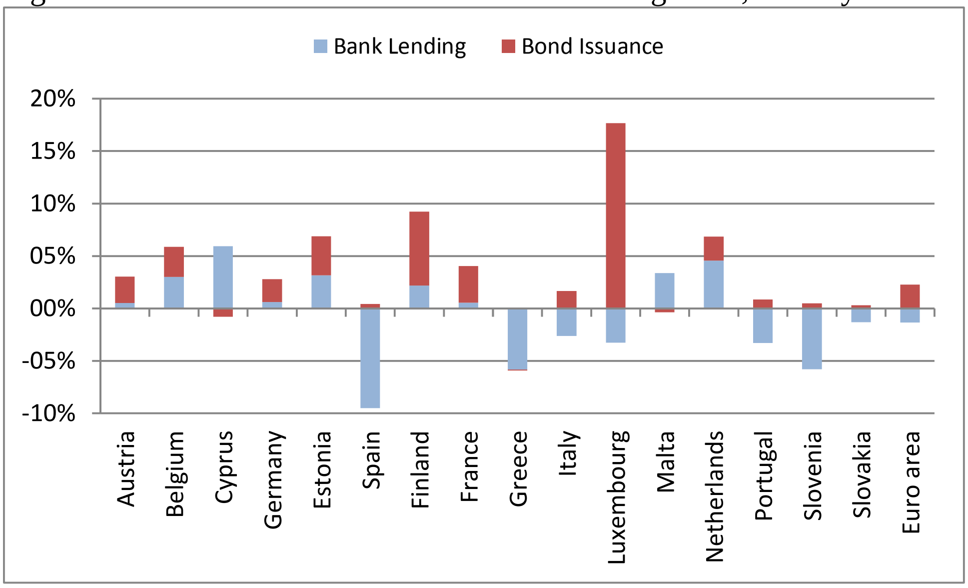


Figure 8 Contribution to total NFCs' annual credit growth, January 2013



Source: ECB

At this moment when lending volumes in Europe are declining, especially in the long-maturity segment of the business and in the more vulnerable countries, the paid-in capital of the EIB has been increased by EU Member States by 10 billion which would allow an increase in lending for the EU-27 as a whole by about 20 billion for each of the next three years. The annual lending will be equally distributed for strategic infrastructure, research, development and innovation, climate action and SMEs. In the countries under stress the EIB has developed a partnership with the EU where the EIB lending is combined with some risk sharing by the EU budget. In Greece for example, the EIB installed a EUR 500 million trade finance facility for the first time to support a trade volume of EUR 1.5 billion per year. In Portugal the EIB signed an innovative Portfolio State Guarantee, which provides for a lending envelope of up to EUR 6 billion over the next years.

A number of other initiatives could be considered to ease SMEs access to bank and non-bank financing in the EU and the euro area.[12] These include the development at EU and Member State level of measures aimed at improving the framework for venture capital, dedicated markets for SMEs and SME pooling, new securitisation instruments for SMEs, setting up standards for credit scoring assessments of SMEs and promoting non-traditional sources of finance such as leasing, supply chain finance or crowd funding.

2.3. Structural measures promoting growth and competitiveness

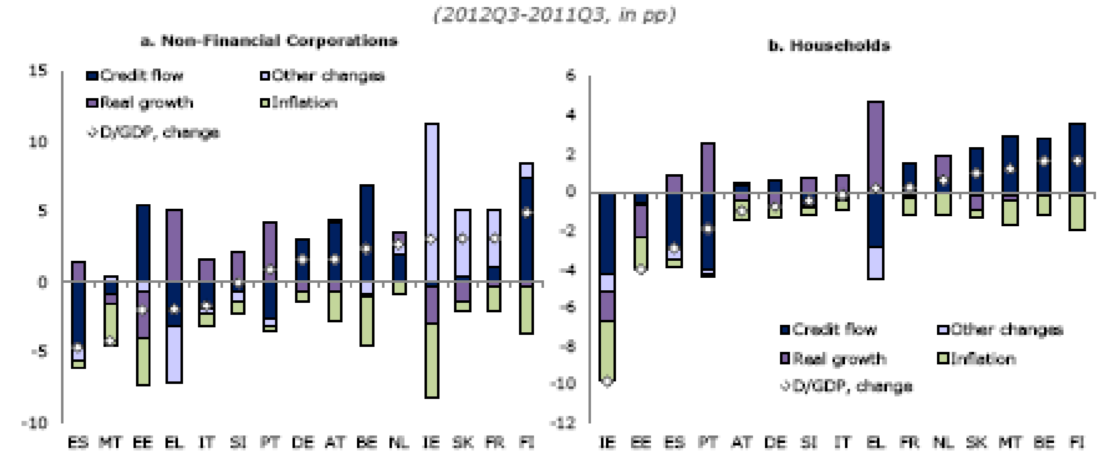
Deleveraging and rebalancing

Deleveraging in the non-financial private sector is ongoing, notably in vulnerable Member States as shown in Figure 9, but there is still a long way to go. Large drops in firm leverage can be identified in Spain, Estonia, Greece and Malta, and in households' leverage in Ireland, Estonia, Spain and Portugal. Significant increases on the other hand can be observed in France, Finland and Belgium (in both household and firm leverage). Countries more prone to face credit market pressures[13] seem to share, however, a deleveraging process characterized by simultaneous disrupted credit markets and economic recession: negative GDP growth and negative net credit flows. Looking ahead, a well-capitalised, viable and stable financial system appears to be of critical relevance to minimise any spread of contagion effects from private sector deleveraging to the rest of the economy and to guarantee adequate credit provision so that firms and households willing to borrow are able to do so at an adequate cost. The search for growth drivers is also of critical importance to the extent that those drivers are able, at least partially, to offset the transitory fall in domestic demand underlying the deleveraging in the private sector. This is of particular relevance in the current circumstances as the room for manoeuvre by the public sector to attenuate the negative impact on economic activity is extremely limited in countries whose public sector is also highly indebted and for which sovereign yields have increased significantly during the crisis.

[12] See Green Paper on the Long Term Financing of the European Economy, COM(2013) 150 final

[13] See "Assessing the private sector deleveraging dynamics", Quarterly report on the euro area, Volume 12 Issue 1, March 2013.

Figure 9 Decomposition of y-o-y changes debt-to-GDP ratio euro area countries



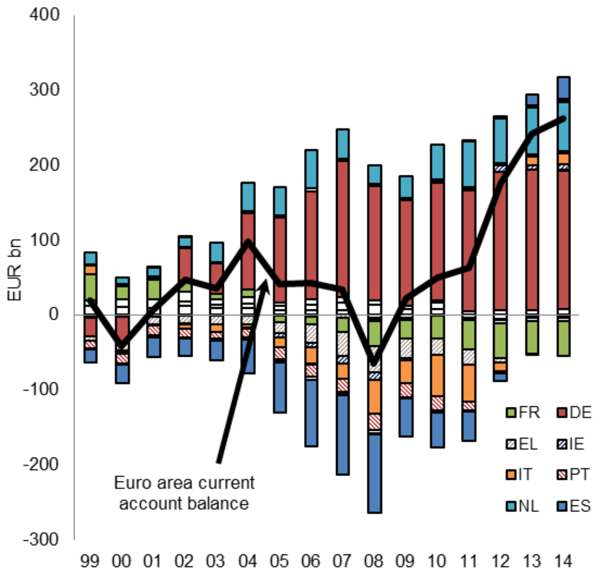
(1) Quarterly data for Cyprus and Luxembourg are not available after 2011Q2.
Source: Eurostat.

Rebalancing in the euro area is progressing, although most of the adjustment has taken place on the side of the deficit countries (see, for example, Buti and Turrini, 2012[14] and Commission, 2012[15]; see Figure 10). Faster adjustment in deficit than in surplus countries implies a positive bias for the euro area saving-investment balance. This achievement is in line with the assessment of euro area structural features - ageing, high income per capita levels, need for fiscal consolidation and private sector deleveraging in many Member States -, which also suggest a moderate surplus for the euro area. In the deficit countries, private sector deleveraging and fiscal consolidation has led to a compression in consumption and investment, and, therefore, imports although enhanced competitiveness is also an important determinant behind the improvement of exports. The external balances of several Member States in surplus have been declining in 2011 but have gone up again in 2012 and, according to the Spring Forecast, are expected to stabilise or decline very gradually in the years to come. The rise in the current account surplus last year might have been caused by safe haven-effects. In contrast, returning confidence in foreign financial assets, along with dissipating uncertainty, should contribute to reducing the surplus by bolstering investment and consumption. Moreover, low interest rates, relatively dynamic wage increases and relatively robust labour market developments should continue to underpin housing investment and private consumption. Nonetheless, there remain two main bottlenecks that hold back a more symmetric rebalancing process. The private sector of some of the surplus countries is heavily indebted with the on-going deleveraging weighing on domestic demand. Also, in a number of surplus countries, productivity growth in the services sector is low as restrictive regulation and a weak enforcement of competition in the services sector hold back investment, and the associated productivity gains.

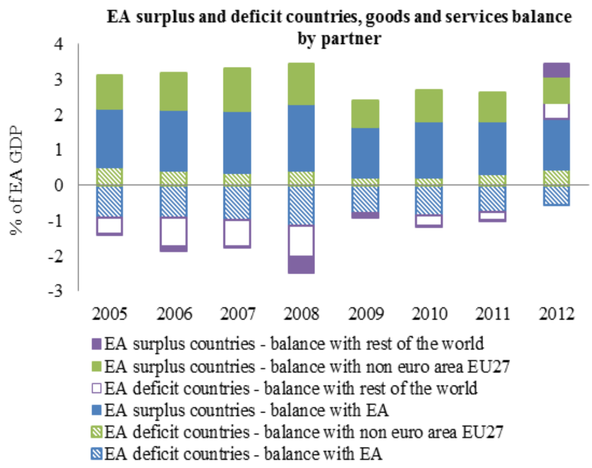
14 Buti, M. and A. Turrini (2012), 'Slow but steady? External adjustment within the Eurozone starts working', VoxEU.org, 12 November.

15 European Commission (2012), 'Current Account Surpluses in the EU,' *European Economy*, 9.

Figure 10 Current account balance in the euro area and euro area surplus and deficit countries, current account by partner



Source: Commission Services



Source: Commission Services

Going forward, the adjustment in intra euro area imbalances seems durable as it is dominated by non-cyclical components. First, the dynamism in exports by deficit countries is expected to continue, as structural reforms and reduction in production costs progressively translate in competitiveness gains. Second, a substantial part of the contraction in domestic demand in vulnerable countries is also of non-cyclical nature, to the extent that pre-crisis growth in domestic demand was driven by excessive credit inflows, unrealistic income expectations and speculative frenzy in asset markets. The downside of the latter development lies in its lasting impact on potential output, as vulnerable economies reallocate their factor endowments among sectors.

Since 2009, the pre-crisis trend of strong increases in the prices of non-tradables, in the deficit countries, has been discontinued. The prices of non-tradables lost dynamism or have fallen relative to export prices. The reduction in domestic demand and the fall in the prices of non-tradables, relative to tradables, provide an incentive for firms to divert their production capacity to exports and contributes to the reallocation of labour and capital from the non-tradable sectors (like construction and public administration) to the export-oriented industries. However, the pace of the intersectorial allocations depends heavily on the degree of domestic competition and on the existence/absence of barriers to the entry and exit of firms in the different sectors. Product market reforms (addressed below) have, therefore, a role in improving competition and providing the appropriate business environment for these reallocations to happen. Moreover the availability of financing for productive investment is also critical for a smooth adjustment in the productive structure of economies.

Structural reforms in product and service markets

Structural reforms in product and service markets play a crucial role not only by setting the basis for long-term sustainable productivity gains, but also by generating positive effects already in the short term through a number of different channels. As pointed out by OECD (2012)[16], positive confidence and wealth effects could stem from expected changes in future incomes, driven by reforms. This, in turn, could foster private investment and ease financial constraints, via improved collateral. A positive effect on interest rate spreads on sovereign debt, to the benefit of indebted countries, could also be achieved if structural reforms are perceived by financial markets as credible. In general, credibility is the keyword to prompt these short term effects: reforms should not remain on paper but need to be rapidly and fully implemented. Next to these confidence effects, structural reforms in product and services markets, by improving the adjustment capacity and flexibility of the economy, facilitate the transmission throughout the economy of measures in other key areas such as labour markets. In this context it is particularly important to identify a package of product and labour market reforms that is complementary.. Furthermore, in order to minimise the impact of private sector balance-sheet restructuring on economic activity and financial stability, the search for growth drivers is of critical importance to the extent that those drivers are able, at least partially, to offset the transitory fall in domestic demand. Finally, structural reforms assume particular relevance by guaranteeing a durable rebalancing process but also by attenuating the negative impact of deleveraging and ensuring the right conditions for sustainable economic growth.

Structural reforms enhancing competition by further market opening, particularly in the services sector and network industries are of particular importance. In order to increase firm-level and aggregate productivity growth, entry/exit barriers should be removed to improve competition and let more innovative firms enter the market. An environment fully supportive of a reallocation process would thus ensure that resources are channelled towards the most productive and innovative firms or sectors, while the least efficient ones reduce their size and eventually exit. Recent evidence (Andrews and Cingano, 2012)[17] shows that this process does not work evenly across the euro area, as the contribution of the allocation of employment across firms to labour productivity in manufacturing swings between around -5% in Greece and +70% in Finland (compared to a baseline scenario where employment is allocated randomly). Significant margin for a productivity-enhancing reallocation of resources still exists in some Member States (especially in Southern and Continental Europe). In particular, removing unjustified restrictions to entry in sectors such as retail trade, regulated professions, network industries and business services, would contribute to enhancing competition and would facilitate reallocation.

Product market reforms, by fostering competition and reducing excessive rents in protected sectors, would provide incentives to increase the efficiency of production processes and of resource allocation. Under increased competition, prices and margins come under pressure. While accelerating reallocation of resources, this will provide incumbents with incentives to make their production processes more efficient, in order to defend market shares and profit rates. At the same time, increased competition can foster product and process innovation (insofar as innovative firms are able to appropriate rents from innovation, which highlight the importance of a well-functioning intellectual property rights system) and, ultimately, boost productivity growth. Gains from more efficient production are, in turn, spread throughout the economy. This is especially true in sectors, such as services and network industries, whose output largely contributes as intermediate input in other sectors. Reforms increasing productivity in the former sectors, which are typically non-tradable, might then have significant spill-over effects on productivity in tradable sectors (such as

[16] OECD (2012). *Economic Policy Reforms 2012. Going for Growth*. Paris, OECD.

[17] Andrews, D. and F. Cingano (2012), "Public Policy and Resource Allocation: Evidence from Firms in OECD countries", OECD Economics Department Working Papers, No.996, OECD, Paris.

manufacturing), to the benefit of deficit countries. An ambitious implementation of the Services Directive, for which the transposition record seems rather mixed, is an important element of this type of reforms.

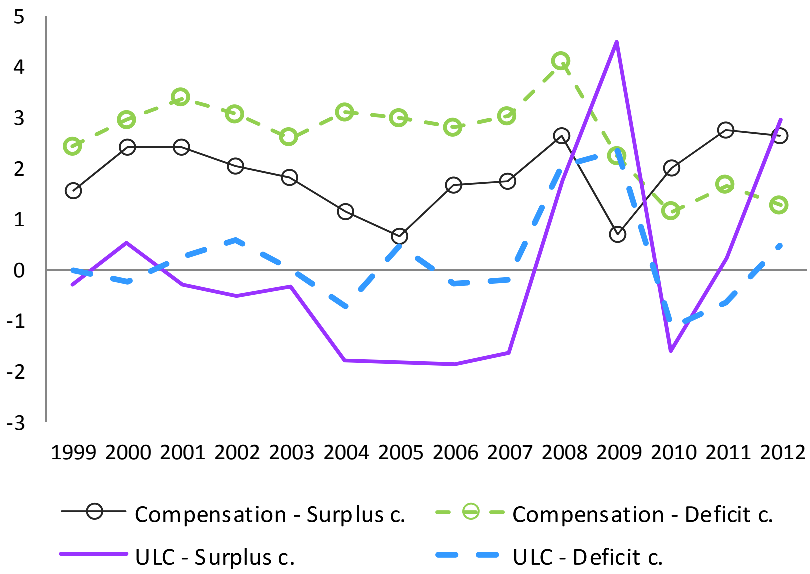
During the last year several Member States in the euro area have undertaken key structural reforms in product and service markets. The reform effort has been substantial in countries under financial assistance programmes and/or under market pressure (i.e., the vulnerable countries). Liberalisation measures have been adopted, although to a different extent, in network industries (e.g. in Greece, Italy, Portugal and Spain) and other service sectors (e.g. in Greece, Ireland, Italy and Portugal). Reforms in the competition framework (e.g., revision of the Competition law and increased resources for the Competition authorities) have been implemented in Austria, Belgium, Finland, Ireland, Luxembourg and Portugal. Still a strong reform effort is needed in this area, in particular as concerns the reduction of barriers in professional services. In Austria, Belgium, France, Germany, Italy and Slovenia, the untapped potential from opening access to regulated professions is still considerable. Finally, reforms of the housing and rental markets are also ongoing, notably in Spain, Portugal and Ireland, aiming, inter alia, to reduce the incentives for households to build up debt and to foster labour mobility.

Improving the regulatory environment in which EU industry and enterprises operate, would lead to competitiveness gains and enhance firm's ability to grow and create jobs. Business environment conditions can contribute to the smooth exit of less efficient firms. Firms' exit would be favoured by business-friendly bankruptcy legislations, striking the right balance between protection of creditors (aiming at increasing their recovery rate) and the reduction of exit costs for entrepreneurs (allowing a fast discharge of their debt in view of a "second chance" for good business plans). Allowing for out-of-court settlements and ensuring reasonable time to complete legal procedures in the case of business failure are crucial to this aim. In addition, companies that would have failed under normal market conditions should not be kept artificially alive in order not to put a break to the needed adjustment of the economy, while taking into account the social impact of such reallocation process by well-designed accompanying measures. Improving the business environment would also imply taking actions to increase the efficiency and transparency of the public administration, through administrative simplification at all levels of government, thereby reducing administrative burden, and adopting measures to improve the efficiency of civil justice. By decreasing costs, time and uncertainty of doing business, measures in these fields could increase the efficiency of operating firms, translating into lower prices and higher productivity, while creating favourable conditions to attract investment and promote the entry of new firms. Reforms aimed at reducing administrative burden, modernising public administrations and making civil justice more efficient have been taken recently in several euro area Member States, notably Greece, Italy, Portugal and Spain. However, these countries need to continue their efforts, given the large gap with respect to better ranked Member States. Reforms in the area of public administration and business environment are also recommended in countries such as Estonia, Finland, France, Slovakia and Slovenia.

Labour markets

Labour cost developments have been broadly supportive of the rebalancing of current accounts in the euro area. Where surplus countries growth of unit labour costs (ULC) and nominal compensations per employees has increased recently, both ULC and nominal compensations per employee started growing at lower pace in countries characterised by high current account deficits at the moment of the crisis (see Figure 11). Over 2007-2012, the fall in unit labour costs compared with competitors (i.e. the ULC-based real effective exchange rate) has been significant for vulnerable countries like Ireland, Greece, Spain and Portugal, even if the process of rebalancing would require some further effort in Greece and, to a minor extent, in Portugal (see Buti and Turrini 2012[18]). Looking forward, the process of wage adjustment will be further supported by ongoing reforms, especially of wage setting, in countries such as Greece and Spain. In Greece, for example, wage setting has become more decentralised, the favourability clause for firm-level collective contracts and the extension mechanism for sectoral collective contracts have been suspended and greater room created for work councils to conclude firm-level agreements. Similarly, in Spain, it has become easier to conclude firm-level agreements that derogate from sectoral contracts. Nevertheless, it should be also noted that the fall in nominal compensations was not always accompanied by a change in the same direction of the consumer price index, whether because of limited pass-through from the labour to the product market (due, for example, to not insufficiently competitive conditions on product markets) or growing non labour costs (i.e. taxes, capital costs, energy, see also box above), thereby posing a constraint on the potential improvement in cost competitiveness.

Figure 11 Unit labour costs and nominal compensation per employees in surplus deficit countries in the euro area



Surplus countries: BE, DE, LU, NL, AT, FI.
Deficit countries: EE, IE, EL, ES, FR, IT, CY, MT, PT, SI, SK.

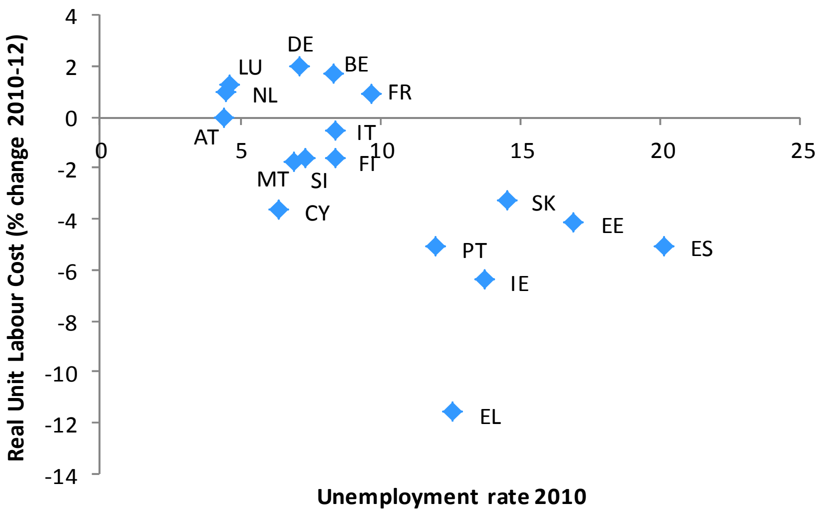
Source: Commission Services

[18] Buti, M. and A. Turrini (2012), 'Slow but steady? External adjustment within the Eurozone starts working', VoxEU.org, 12 November.

Labour cost developments are also indicative of an initial process of reallocation of resources. In vulnerable countries, nominal wages in the non-tradable sector fell somehow more significantly than those in the tradable sector (e.g., Buti and Turrini, 2012; European Commission, 2012), a tendency that provides for the necessary conditions for labour moving towards the tradable sector. This reallocation is key for a sustainable improvement of external positions in countries that have accumulated largely negative net investment positions over the past years. However, the process of labour reallocation needs to be supported by more fluid labour markets. In some countries, still rigid and segmented labour markets are by themselves obstacles to the process of reallocation, especially of the re-employment of workers that have been made redundant during the adjustment, who now face significant entry barriers back into the labour market. Reforms enhancing labour market adjustment and reducing labour market segmentation have been recently enacted or are ongoing in many of the euro area countries that were characterised by less flexible regulatory settings. Exit flexibility was enhanced in countries that have been historically characterised by stringent Employment Protection Legislation (EPL). Spain adopted reforms in 2010 and 2011 on the definition of fair dismissal and the size of severance pay. In Italy, the June 2012 labour market reform aimed to improve exit flexibility by revising the rules on dismissals – namely by limiting the scope for reinstatement, capping back-wages due in case of unfair dismissal and accelerating the dispute settlement process – while better regulating flexibility at entry through the introduction of disincentives against temporary and atypical contracts. Slovenia has approved a labour market reform that exempts employers from having to look for alternatives in case of dismissal. A reform that partially softens protection for workers with permanent contracts, whilst providing for security along the lines of the flexicurity model is under way in France. It is paramount to preserve the reform momentum on labour markets and implement the enacted reforms. Furthermore, this momentum can be added to by ambitious implementation of measures facilitating the free movement of workers within the Internal Market.

The scope of the correction in the relative prices of tradable and non-tradable sectors depends on the degree of pass-through from labour costs to prices, and thus inter alia on the degree of competition and firms' market power in the different sectors. To the extent that euro area vulnerable economies are price takers in most international markets, the observed significant reduction in labour costs, will mostly translate into higher profits and margins for the firms in that sector and the impact on export prices may be relatively weak. The increase in margins, and therefore the incomplete pass-through, supports the rebalancing process as it incentivises the reallocation of resources towards the tradables industry or by shifting production capacity (made available because of the contraction in domestic demand). Nevertheless, on the non-tradables sector, the incomplete pass-through is a potential reason for concern as it may indicate lack of competition in specific sectors. A reduction in the prices of non-tradables as a reaction to reductions in labour costs increases the economic efficiency. By dampening the impact that the reduction in labour costs has on the real disposable income, it also reduces the social hardship and avoids a steeper fall in domestic demand. Moreover, a decline in prices of non-tradables reduces production costs in the exporting firms and therefore also contributes to the external rebalancing of the economy.

Figure 12 Real unit labour cost dynamics and unemployment



Source: Commission Services

Real wage developments are also contributing to reducing unemployment divergences. The crisis had largely asymmetric effects on euro-area Member States' output and employment. The countries most hit were those with the most severe compression of domestic demand linked to current account reversals. Countries with large current account deficits at the start of the crisis tend now to have much higher unemployment (e.g. Greece, Spain). The fact that the dynamics of unit labour costs and wages is currently more subdued in this group of countries therefore bodes well not only for the rebalancing of external positions but also for reducing unemployment divergences within the euro area. As shown in Figure 12, countries with higher unemployment in 2010 are witnessing a slower growth in real unit labour costs, which points at real wages growing below labour productivity. This process should help the absorption of large unemployment pools recorded in some countries, even though it can be questioned if the speed at which real wages are adjusting is commensurate with the size of the challenge in some countries.

The risk exists that unemployment becomes increasingly structural. In the absence of an effective and quick absorption of cyclical unemployment, hysteresis effects, whereby unemployment becomes entrenched and less sensitive to wage dynamics, may materialise. Structural unemployment has significantly increased in some euro area countries. This would imply a loss of human capital and a reduction of the potential contribution of labour to growth looking forward. Tackling the risk of hysteresis requires tax and benefit systems and Active Labour Market policies providing incentives for the jobless to take up work, and creating an efficient infrastructure for matching on the labour market (e.g. effective Public Employment Services, adequate opportunities for training and re-training). Moreover, the use of well-designed job subsidies could help supporting labour demand for worker categories at risk of long-term unemployment and exclusion from the labour force (e.g. youth or displaced older workers).

	Growth and jobs						Competitiveness							Public Finances						Financial Stability			
	GDP per capita in PPS	GDP growth forecast	Employ-ment rate	Long-term unemplo y-ment*	Youth unemp-loyment (<25)*	Labour-force partici-pation rate*	Nominal unit labour costs*			Nominal compensation per employee		Current account balance*	Market share of exports (goods + services)*	General govern-ment debt*	General govern-ment budget position *	Overall tax burden	Sustai-nability indicator (S2)*	Average exit age from the labour force*	Life expecta ncy*	Private debt*	Doubtful and Non-performing loans (All Banks)	Long term interest rate spread vis-à-vis Germany	Return on equity (All Banks)
							Whole economy	Services	Manufa c-turing	Non Market Services ***	Private Sector ****												
	Level, EU27=100	Annual rate of change	Age group 15-64	% of active population		%	Annual rate of change					% of GDP	% of world total - 5 year change	% of GDP		Total taxes as % of GDP	High figure = weak sustain-ability	2010 or latest available	At 60 years	% of GDP	%	Percentage points	%
	2011	2013	2012	2012	2012	2012	2012	2012	2012	2012	2012	2012	2012	2012	2012	2011	2012		2011	2011/2012	Jun-12	Mar-12	Jun-12
BE	119	0	61.8	3.4	22	66.9	3.7	4.3	5.1	3.1	3.5	0.9	-15.6	99.6	-3.9	46.7	7.4	61.6	23.8	241	4.6	0.9	3.2
DE	121	0.4	72.8	2.5	7.9	77.1	2.9	2.3	4.9	2	2.7	6.4	-12.6	81.9	0.2	40	1.4	62.4	23.8	128	1.9	:	4.5**
EE	67	3	67.1	5.5	19.8	74.9	5.6	:	:	:	:	-3.1	6.9	10.1	-0.3	33	1.2	62.6	21.5	133	4.1	:	17.3
IE	129	1.1	58.8	9.1	29.5	69.2	0.2	:	:	:	:	5	-15.6	117.6	-7.6	30.4	:	64.1	23.5	310	:	2.5	-14.2
EL	79	-4.2	51.3	14.4	58.4	67.9	-6.2	-4.4	-16.7	-4.1	-4.7	-5.3	-26.9	156.9	-10	34.9	:	61.5	23.8	130	15.6	10	:
ES	98	-1.5	55.4	11.1	55.3	74.1	-3.4	-2.9	0.1	-2.3	0.5	-0.9	-14.1	84.2	-10.6	32.4	4.8	62.3	25.1	218	6	3.6	-5.2
FR	108	-0.1	63.9	4.1	25.5	71	1.7	:	:	:	:	-1.8	-14.1	90.2	-4.8	45.9	1.6	60.2	25.8	160	4.6	0.7	7.1
IT	100	-1.3	56.8	5.7	37.1	63.7	2.3	:	:	:	:	-0.5	-23.3	127	-3	42.8	-2.3	60.4	25.1	129	10.2	3.3	1.9
CY	94	-8.7	64.6	3.6	31.8	73.5	-0.1	-0.3	2.2	1.3	1.8	-4.8	-26.2	85.8	-6.3	35.2	8.2	62.8	23.6	289	13.9	5.7	-40.4
LU	271	0.8	65.8	1.6	18.6	69.4	3.2	:	:	:	:	5.6	-19.7	20.8	-0.8	38.1	9.7	59.4	23.8	326	:	0.2	8.7
MT	85	1.4	59	3	14.5	63.1	3.7	:	:	6	1.1	-0.8	2.7	72.1	-3.3	35.1	5.8	60.5	23.6	210	1.6	2.2	5.7
NL	131	-0.8	75.1	1.8	10	79.3	1.3	1.3	1.7	1.2	1.1	8.2	-11.6	71.2	-4.1	39	5.9	63.5	23.9	225	2,6	0.3	5.7
AT	129	0.6	72.5	1.1	9	75.9	3.4	5.2	3.1	2.9	3.1	3	-20.4	73.4	-2.5	43.7	4.1	60.9	24.1	161	4.3	0.4	8.3
PT	77	-2.3	61.8	7.7	38	73.9	-3.8	:	:	:	:	-1.9	-15.4	123.6	-6.4	36.1	:	62.6	24.2	256	6.5	4.8	0.9
SI	84	-2	64.1	4.3	23.2	70.4	0.7	1.1	1.4	-3.3	0.4	2.7	-19.5	54.1	-4	37.5	7.6	59.8	23.3	128	:	3.7	-0.7
SK	73	1	59.7	9.4	35	69.4	0.1	-0.4	-7.5	2.9	1.6	2	4.8	52.1	-4.3	28.8	6.9	58.8	20.4	76	3.8	2.6	8.9
FI	114	0.3	69.4	1.6	19.5	75.2	3.6	3.2	3	2.4	3.5	-1.6	-31.2	53	-1.9	43.6	5.8	61.7	23.9	179	0.8	0.3	9.5
EA	108	-0.4	63.8	5.3	23.7	72	1.4	:	:	:	:	1.8		92.7	-3.7	40.8	2.1	61.4	23.9 (2008	:	:	1.7	:
EU	100	-0.1	64.2	4.6	23.3	71.8	1.8	:	:	:	:	0.9		85.4	-4	40	2.6	61.5	23.7	:	:	1.6	:

* Variables mentioned in the European Council conclusions of March 2011.

** Income statement data for domestic medium and small banks and foreign-controlled institutions in Germany is not available.

*** ISIC Rev. 3 Codes L-P.

**** ISIC Rev. 3 Codes A-K

Sources: Commission services, Commission Spring Forecast, Eurostat and ECB