Council of the
European Union

Brussels, 23 November 2016
(OR. en)

14808/16

ECOFIN 1105
UEM 397
SOC 741
EMPL 499
COMPET 613
ENV 738
EDUC 398
RECH 331
ENER 400
JAI 996
EUROGROUP 42

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	23 November 2016
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2016) 391 final
Subject:	COMMISSION STAFF WORKING DOCUMENT Report on the Euro Area concerning the Recommendation for a COUNCIL RECOMMENDATION on the economic policy of the euro area

Delegations will find attached document SWD(2016) 391 final.

Encl.: SWD(2016) 391 final

EUROPEAN
COMMISSION

Brussels, 22.11.2016
SWD(2016) 391 final

COMMISSION STAFF WORKING DOCUMENT

Report on the Euro Area

concerning the

Recommendation for a

COUNCIL RECOMMENDATION

on the economic policy of the euro area

REPORT ON THE EURO AREA

CONTENTS

EXECUTIVE SUMMARY

The economic recovery in the euro area is continuing, though it remains fragile. *There has been significant progress in recent years: since 2015, euro area GDP has recovered its pre-crisis level in real terms and unemployment has declined to its lowest level since 2010-11. According to the Commission's Autumn forecast, real GDP is expected to grow by 1.7% in 2016 and maintain broadly similar dynamics over the 2017-2018 period. While this outlook is in line with the average for the industrialised economies, lingering legacies of the crisis, alongside increased uncertainty following the UK referendum and structural challenges, leave the euro area vulnerable to shocks. The continuation of the expansion in the euro area relies heavily on domestic demand.*

A coordinated approach to macroeconomic policies and structural reforms remains warranted. *The euro area is confronting the challenge of a slow and fragile economic recovery with little room to act in terms of monetary or fiscal policy. Aggregate demand growth remains sluggish, and inflation well below target, despite record low monetary policy rates. There is a risk that the standard measures of the cycle underestimate the level of slack in the economy. An effective response to break this vicious circle may be offered through coordinated action to mobilise resources for public and private investment and support the recovery. As part of the global agreement within the G20, euro area Member States are called to use all policy tools – monetary, fiscal and structural – individually and collectively to address the legacies of the financial crisis and strengthen growth, investment and financial stability. The European Central Bank is using its monetary policy tools extensively through the recourse to a series of unconventional policy measures. However, monetary policy cannot carry all of the burden in supporting the recovery, nor can it address country-specific issues. At the same time, fiscal policies are constrained in several Member States by a legacy of high debts and unfinished consolidation. Divergence among Member States remains pronounced. In order to ensure an effective contribution of fiscal policy to the euro area policy-mix, there is a need to pay more attention to the aggregate stance of fiscal policy, its composition and its implementation in different Member States. At the same time, there is a need to devise and implement an overall, euro-area wide strategy to address risks to the viability of the banking sector. There is also a need for a new wave of ambitious structural reforms - to foster productivity and growth, ensure social equity and facilitate the necessary economic adjustment within the euro area, reducing thereby the burden on monetary and fiscal policies.*

Challenges remain in the following interrelated areas:

- ***Unlocking potential growth, tackling high unemployment and increasing resilience.*** *Structural reforms which create stronger and more efficient national institutions and economic structures, in support of higher productivity, employment and convergence, have a key role in the proper functioning of EMU. Structural reform implementation would unleash opportunities, increase growth potential and support monetary policy through facilitating its transmission to the economy. Reform priorities include ensuring a more enabling institutional environment and business climate, completing the single market, removing barriers to and creating opportunities for investment. Well-designed labour market policies, well integrated with adequate social protection systems to facilitate smooth job transitions, can support labour market reintegration and promote social fairness. Lower tax wedges on labour can help foster job creation. Member States that have implemented such reforms are more resilient with a better employment and social performance.*

- ***Addressing debt overhangs and investment weaknesses.*** *Some Member States, notably those hit most severely by the crisis, find their capacity to sustain demand constrained by large public and/or private debt overhangs and high levels of non-performing loans (NPLs),* *while investment remains weakened. These Member States need to stimulate investment through the pursuit of more growth-friendly reforms, including the removal of barriers to competition and investment, and by the definition of medium-term policies in a number of sectors to provide certainty to investors. At the same time, they need to ensure an orderly deleveraging in the private sector through the work out of or writing off of non-viable private debt, so that capital can reallocate more quickly and efficiently.*

- ***Securing external and internal rebalancing within the euro area.*** *The high current account surplus in the euro area is nourished by positive terms of trade effects from falling oil prices and recent falls in the external value of the euro, but remains largely the result of weak domestic demand and an excess of savings over investment. While previously large external deficits in some Member States have been corrected, large surpluses continue to accumulate in Member States without significant deleveraging needs. Member States in deficits or with a large stock of external debt would benefit from raising productivity and competitiveness to support deleveraging of accumulated debt and to secure the ongoing improvement in current account positions. Further adjustment is also needed by surplus Member States – especially when they already enjoy strong net external positions - to strengthen domestic demand, including policies to further boost investment and foster a more efficient use of excessive savings.*

- ***Ensuring an appropriate fiscal stance for the euro area as a whole.*** *Taking into account the monetary policy stance at the current juncture, ensuring a coherent policy mix requires fiscal policy to support the economic recovery and investment. Equally important is that the overall euro area stance is differentiated depending on the situations of Member States in terms of sustainability and stabilisation (as reflected by their requirements under the Stability and Growth Pact), while taking into account the spillovers across euro area Member States.*

- ***Improving the composition and governance of public finances.*** *A more active use of spending reviews, more efficient and effective taxation structures and efficient expenditure and revenue administrations are essential for the euro area where sound, fair and growth enhancing fiscal policies are a matter of common interest. Similarly, effective national fiscal frameworks are necessary to strengthen the credibility of Member State policies. Efforts are still necessary to improve the composition of public expenditure and revenues to maximise their impact on growth, while reducing the burden on the private sector.*

- ***Breaking the bank-sovereign loop and completing Capital Markets Union (CMU).*** *While the overall resilience of the euro area banking sector has increased since the crisis, pressure on banks has mounted due to a number of factors, such as high levels of non-performing loans, inadequate business models and overcapacity in some Member States, all resulting in low profitability and risks to viability. . The relatively high reliance on banks in financing the euro area economy makes the euro area more vulnerable in times of crisis and can exacerbate an economic downturn. Furthermore, insolvency procedures fail to maximise the prospects for asset recovery, delaying debt restructuring and hampering lenders' willingness to provide funding to firms, reducing credit to the economy and investment. The most important CMU initiatives are those that will broaden the sources of financing, giving a stronger role to capital (equity and bond) markets. In addition, the swift implementation of tools to address legacy debt and the high level of NPLs is needed.*

- ***Completing Banking Union.*** *A European Deposit Insurance Scheme (EDIS) and a common backstop for the Single Resolution Fund remain to be put in place. Together with the further risk reduction measures in the banking sector that will be proposed by the Commission in*

November, EDIS would enhance financial stability, weaken the link between banks and Member State's public finances and reinforce depositor confidence. The common fiscal backstop for the Single Resolution Fund would underpin the credibility of resolution in the face of large shocks by ensuring that adequate funding is credibly available to resolve the affected banks in the most efficient manner.

- ***Completing the EMU architecture.*** *Over the last year, some progress has been made on the initiatives presented in the Five Presidents' Report on completing Europe's EMU, such as the increased role of the euro area dimension in the European Semester, the recommendation on the National Productivity Boards and the establishment of the European Fiscal Board within the Commission. Work is also ongoing on improving transparency and reducing complexity of fiscal rules. However, agreement on other initiatives with crucial importance for EMU, such as the European Deposit Insurance Scheme proposed by the Commission in November 2015, is still missing. Moreover, there are broader challenges to address in the light of the Five Presidents' Report. The Commission has announced its intention to present in March 2017 a White Paper on the future of Europe, which will also include the future of EMU. Agreeing on an operational way forward requires a shared sense of ownership and a common sense of purpose among all euro area Member States and EU institutions, and also among non-euro area Member States, as a strong EMU will help to address the challenges facing the EU more forcefully and will have a positive impact on non-euro area Member States as well.*

1. Macroeconomic conditions and the policy mix

1.1 The fiscal stance for the euro area as a whole

The ECB has taken unprecedented measures to ease monetary and financial conditions. The accommodative monetary policy has triggered the expected positive effects on bank liquidity and the price of financial assets, especially government securities, and should ultimately support both output and inflation. However, the positive effects of such unconventional monetary policy measures on growth and inflation are challenged by hurdles such as private sector deleveraging, weak global demand, risk aversion driven by uncertainty about future demand prospects. According to the Commission's Autumn forecast, real GDP is expected to grow by 1.7% in 2016, 1.5% in 2017 and 1.7% in 2018.

Figure 1: Public deficit and debt in the euro area (as % of GDP)

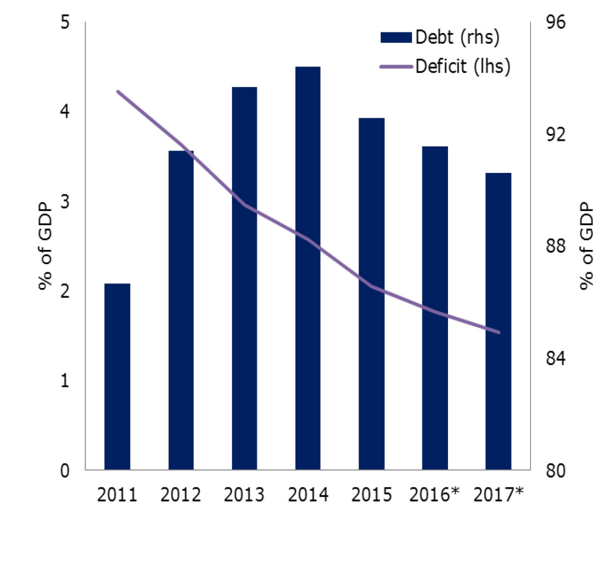
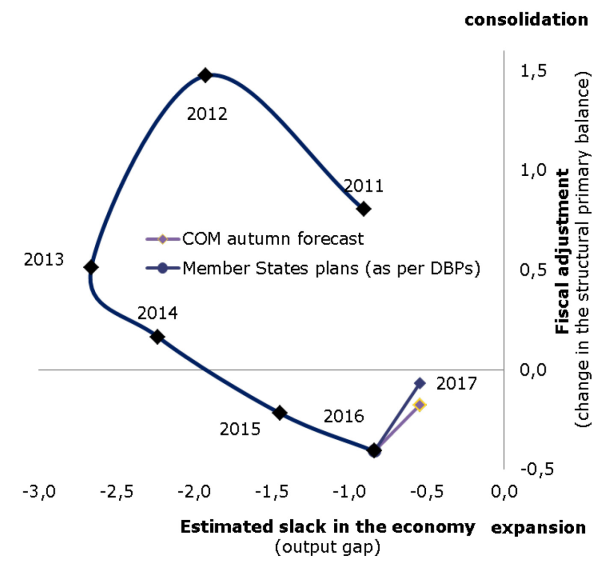


Figure 2: Euro area fiscal stance over the period 2011-2017, change in the structural primary balance



Source: European Commission, 2016 autumn forecast. Note to Figure 2: No feedback loops have been considered in terms of the responsiveness of the estimated output gap to different stances of fiscal policy. Figure 2 shows the orientation of the euro area's fiscal policy on the vertical axis as measured by the change in the structural primary balance and the amount of unused capacity in the economy on the horizontal axis. The euro area aggregate displayed in this Figure excludes Greece, which is under a stability support programme.

At the current juncture, fiscal policy could contribute more to support the recovery in the short term while ensuring sustainable public finances. Fiscal multipliers (the impact of fiscal policy on GDP) and the spillover effects (the impact on other countries' GDP) are likely much larger if monetary policy operates in a zero interest rate environment, compared with normal times.[1] At the same time, government debt remains high (see Figure 1) and there is still a need to make public finances sustainable in the medium run in a number of Member States. Deficit-spending may, in such cases, exacerbate confidence problems rather than address them. Ultimately, and against the background of high uncertainty, the euro area needs to balance direct support to demand and a prudent fiscal policy inspiring broad trust. The Stability and Growth Pact (SGP) is meant to frame this balance between short-term stabilisation needs and long-term sustainability concerns, and the potential gains from improving the quality of public finances should not be overlooked (see Section 1.2).

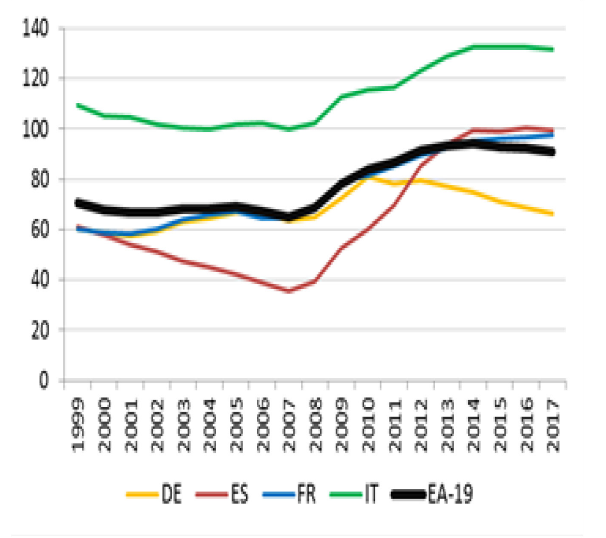
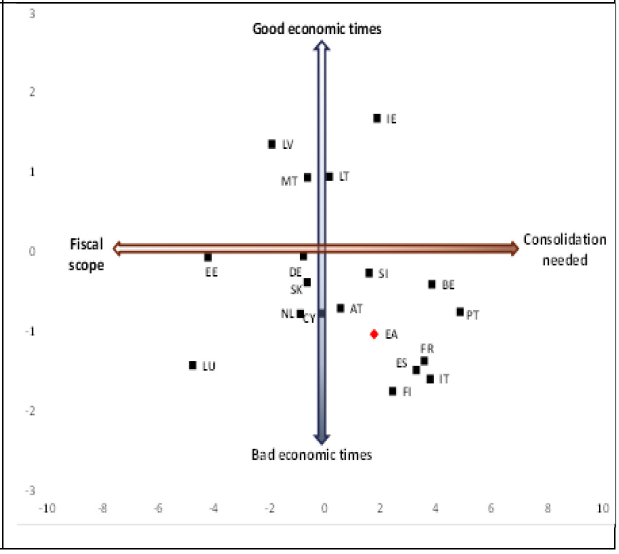
[1] See section 1.2 and Box 1 in particular.

In light of the slow recovery and risks in the macroeconomic environment, there is a case for a moderately expansionary fiscal stance for the euro area at this point in time[2]. Pursuing a positive fiscal stance at the aggregate euro area level comes with both economic and legal constraints. The former relate essentially to the need to balance macroeconomic stabilisation needs in the short term with the preservation of the sustainability of public finances in the medium run. The latter refer to the operation of the EU fiscal surveillance framework in certain circumstances. Based on estimates from the Commission services, a fiscal expansion of up to 0.5% of GDP at the level of the euro area as a whole is considered desirable for 2017 in the present circumstances. This figure results from an assessment of the situation of the levels of economic activity, spare capacity, unemployment and inflation. Such an expansionary fiscal stance would reduce the share of unused productive capacity in the euro area, while supporting monetary policy and avoiding unnecessary overheating of the economy.

In the medium term, it is crucial to reduce public debt to restore fiscal buffers and avoid pro-cyclical policy. In order to guard against pro-cyclicality, efforts to reduce public debt and restore fiscal buffers should be increased as growth strengthens. Such a fiscal stance needs to differentiate the fiscal effort by individual Member States taking into account their respective position vis-à-vis the requirements under the SGP and their stabilisation needs, as well as spillovers across euro area countries. Indeed, public debt is now receding slightly from its peak of 92% in 2015 but levels remain very high, for instance in the seven Member States above the euro area average: Greece (182% of GDP in 2016), Italy (133%), Portugal (130%), Cyprus (107%), Belgium (107%), Spain (99%) and France (96%) (see Figure 3).

The overall euro area stance should translate differently into national policies, depending on the situation of each Member State in terms of sustainability and stabilisation. In this respect the fiscal stance in the euro area results from a dysfunctional composition: Member States enjoying fiscal room for manoeuvre are not making use of it to provide the needed support to nominal GDP growth; by contrast Member States that may be close to the limits of their fiscal space are not adjusting towards a more balanced budget or are even pursuing expansionary policies, at the risk of not complying with the EU fiscal rules. Figure 4 provides some indications on the trade-off individual Member States face, based on two indicators. The Commission provides specific orientations for the conduct of fiscal policy for 2017 for each euro area Member State in its Opinions on the Draft Budgetary Plans based on an in-depth analysis of their economic and budgetary situation, combining these and other indicators and experts' judgement.

[2] See the Commission (2016) Communication "Towards a positive fiscal stance for the euro area".

Figure 3: Graph Government debt-to-GDP ratio since the euro: average and selected Member States (%)	**Figure 4: A Fiscal map for the euro area in 2016**
	

Source: European Commission 2016 autumn forecast, COFOG. Note for Figure 4: Consolidation needs or fiscal scope in this graph are expressed by the S1 indicator (2016 scenario), which gives an indication of medium-term fiscal sustainability; it measures the additional adjustment required, in terms of a cumulated gradual improvement in the structural primary balance over five years (starting from 2017), to reach a 60% public debt-to-GDP ratio by 2031, including financing for any future additional expenditure arising from an ageing population until 2031. Good (bad) economic times are measured by the output gap in 2016.

Designing an appropriate fiscal stance for the euro area requires close coordination of national fiscal policies while ensuring compliance with the rules of the SGP. In the absence of a central fiscal capacity, the coordination of national fiscal stances could be based on Member States in the Excessive Deficit Procedure and others still needing to progress towards their medium-term budgetary objectives continuing to do so, as recommended to them. Member States with fiscal space would be encouraged to carry out a more expansionary fiscal policy, including by making full use of the tools of the Investment Plan for Europe in order to maximise the impact on the real economy.

1.2 Improving the composition of fiscal policies

Importantly, Member States can contribute to both stabilisation and sustainability by improving the composition and governance of their public finances. Boosting growth and employment and ensuring sustainable public finances does not only depend on the development of the budget balance, but crucially also of the composition and efficiency of public finances. As shown in Figures 5 and 6, the major part of the consolidation in past years relied on revenue measures. This contrasts with findings by European Commission (2014)[3] that expenditure-based consolidation, in general, tends to weigh less on growth and have more persistent effects on deficit and debt levels. At the same time, within expenditure, growth-friendly items such as investment should be safeguarded, while reforms in key spending areas

[3] European Commission (2014), "Expenditure trends in the EU and expenditure based consolidations" in Report on Public Finances in EMU (2014), part IV; http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee9_en.pdf

remain crucial to contain pressures. The structure of taxation can also be improved to be more growth- and employment-friendly.

Figure 5: Composition of fiscal effort (2011-17), euro area (% GDP)

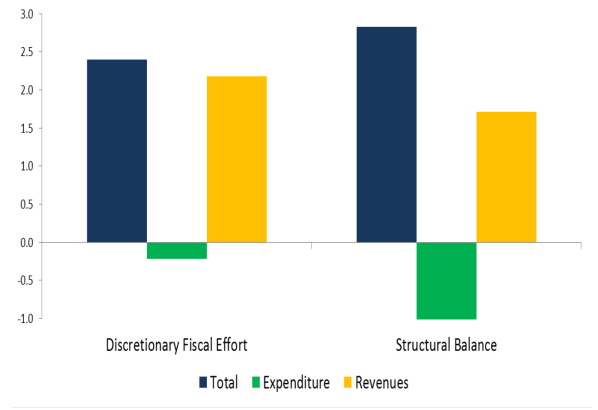
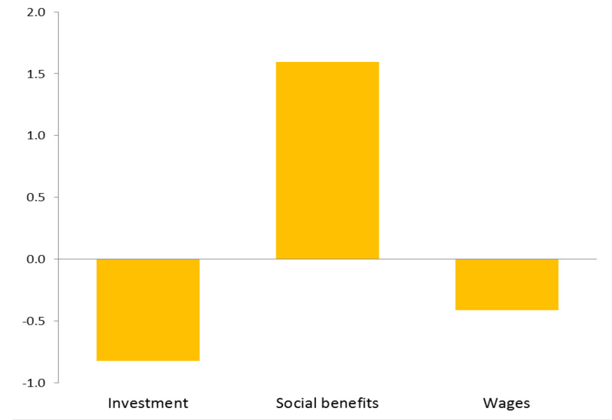


Figure 6: Composition of fiscal effort on expenditure side (2009-17), euro area (% GDP)



Source: European Commission 2016 autumn forecast, COFOG. Figure 5 shows the Discretionary Fiscal Effort (DFE), which is another way of estimating the tone of fiscal policy. This is a complementary indicator to the change in the structural (primary) balance. Both the DFE and the change in the structural balance signal that the bulk of the fiscal adjustment undertaken in the euro area over the past years stemmed from revenue increases rather than cuts in expenditures. Figure 6 shows that the compression of government investment was particularly large and played a significant role in the fiscal consolidation.

Public and private investment has an important role to play in stimulating aggregate demand in the short term and aggregate supply over the long term. Public investment has fallen over recent years and is not expected to pick up substantially. According to Member States' plans, public investment is hardly expected to recover from the historical lows reached in the wake of the crisis. Private investment, although recovering, remains subdued as well. Persistently low capital accumulation in the euro area is a double source of concern, since it hinders growth momentum in the short term while it can also have long-term consequences through lower potential output. Indeed, several Member States face the need to adequately maintain or upgrade their infrastructure networks, which would raise output both in the short and the long term, especially when investment efficiency is high.

An improvement in the composition of 2017 budgets could increase GDP growth by 0.15 percentage points, which is not negligible. The current plans by Member States foresee an increase by 5% in spending in investments. Increasing this to 20%, while compensating it with the halving of the increase in other government expenditures would improve the contribution of the government budgets to growth by 0.15%. Research indicates that government investments have a higher impact on the economy as from the first year, with respect to other government expenditures, and that such an impact is very large in a situation in which monetary policy is constrained and economic agents are highly indebted. Investment based stimulus may also generate spillovers in the whole euro area, although the short-term macroeconomic gain should not be exaggerated. The spillover effects of a fiscal stimulus is generally weak in normal times. However, this may not hold true at the current juncture with very low and persistent inflation and very low interest rates. In that context, public investment in surplus countries could have significant positive GDP spillovers to the rest of the Eurozone (see Box 1).

Box 1. Output and spillover effects of fiscal policy[4]

The impact of fiscal policy on economic activity and its spillovers across euro area countries is a much debated issue, and it is particularly topical in the current discussion on the appropriate economic policy for the euro area. The model (QUEST) used by the services of the Commission can serve to assess the impact of fiscal expansion in surplus countries on the euro area economy (see In 't Veld 2016). In particular, the simulations consider debt-financed increases in government investment in Germany and the Netherlands. The analysis assumes that monetary policy in the euro area operates in a zero interest rate environment for two years. This is consistent with the European Commission's forecast of euro area inflation remaining low and below target in 2017-18.

The QUEST simulations show that fiscal multipliers (the impact of fiscal policy on GDP) and the spillover effects (the impact on other countries' GDP) are much larger if monetary policy operates in a zero interest rate environment, compared with normal times. In the latter case, if inflation was at target and the euro area economy operating at full capacity ("normal times"), a fiscal expansion in Germany and the Netherlands would logically lead to a tightening of monetary policy, in the sense of a rise of interest rates. This would crowd out private demand and dampen the positive GDP response. GDP spillovers in other euro area regions would be negligible as positive trade spillovers from the fiscal expansion would be offset by lower domestic demand, due to higher interest rates.

However, at the current juncture, with zero interest rates, multipliers and spillovers effects are larger. In the case of high efficiency of public investment, in line with other studies on infrastructure investment, additional government investment of 1% of GDP in Germany and the Netherlands, sustained over 10 years, could raise domestic GDP by 1.1 and 0.9 per cent, respectively. There is a somewhat smaller positive GDP effect for the Netherlands, as the country is characterised by larger trade openness, which implies stronger demand leakage to imports. Over the 10-year horizon, real GDP in Germany and the Netherlands would increase by more than 2 per cent. Long-term GDP effects exceed the short-term impact because government investment raises the productivity of private capital and labour over a sustained period of time (positive supply effect).

In this scenario, the real GDP in other euro area regions (France, Italy, Spain and the rest of the euro area) would increase by around a range of 0.3-0.5 percentage points already after one year. The spillovers derive from the direct trade effect (more exports to Germany and the Netherlands) and some depreciation of the exchange rate (more exports also to the rest of the world).

The impact on public finances in Germany and the Netherlands is not as unfavourable as might be expected, as higher growth would also boost tax returns. Government debt would in fact be less than 2% of GDP higher in Germany after ten years, and a bit more in the Netherlands, while debt ratios in the rest of the euro area would actually fall by around 2 percentage points due to the positive GDP spillover. In case of a permanent increase in public investment, debt ratios in Germany and the Netherlands would actually decline in the long run and the stimulus would become self-financing.

Several instruments of the Investment Plan for Europe offer ways for Member States to magnify the financial firepower of their public interventions into the real economy, with benefits at home and across borders. This is for instance the case if Member States choose to make better use of innovative financial instruments under the European Structural and

[4] See In 't Veld, J. (2016): Public Investment Stimulus in Surplus Countries and their Euro Area Spillovers, European Economy Economic Brief 16, and in http://voxeu.org/article/public-investment-stimulus-spillovers-eurozone. See also Blanchard, O., Ch. Erceg, J. Lindé (2015): Jump Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?, NBER Working Papers 21426.

Investment Funds. This is also the case where Member States decide to contribute to the deployment of the European Fund for Strategic Investments (EFSI). For instance, guarantees to the EFSI are a particularly effective way for Member States with fiscal space to make good on their commitments to do their part to support the recovery in the euro area[5].

Looking at composition of public finances from a more medium term perspective, significant progress has been achieved in terms of pension system efficiency. However, there is scope for further steps to ensure sustainable, efficient and adequate pension systems in several cases. Further policy actions are required[6], encompassing: i) complementing enacted pension reforms with flanking policies, including by boosting retirement incomes by extending working lives, for example by linking the retirement age to life expectancy and by supporting other complementary means of retirement incomes; ii) putting in place resilience-enhancing measures to ensure that public pension system sustainability can be preserved even under adverse conditions; iii) adopting policies that support productivity, employment and potential growth in general; and, iv) anchoring political and societal support among all stakeholders for existing reforms so as to ensure their lasting success.

Increasing health care and long-term care expenditure makes ensuring the fiscal sustainability of health systems an urgent challenge in the euro area. Driven by population ageing and technological developments, public expenditure on health care and long-term care is expected to increase significantly in the coming decades. Next to the fiscal challenges, health systems face many common structural challenges, which need to be addressed via a country-specific policy mix. To safeguard universal access to cost effective public health and healthcare services, further policy action is needed enabling the individual to stay healthy for longer, while making health systems more effective, accessible and resilient.[7] Policy options include: i) strengthening the governance framework to support and strengthen efficiency, transparency and accountability; ii) improving the financing mix, including by ensuring that benefits packages are based on cost-effectiveness criteria whenever possible; iii) moving health systems away from the traditional hospital-centric model; iv) strengthening the cost-effective use and the affordability of medicines; v) supporting delivering long-term care services at home rather than in institutional settings when appropriate; and vi) ensuring adequate numbers and qualification-mix of health care and long-term care workforce.

A well-designed tax system can contribute to sustainable public finances, boost economic growth and employment, and improve social fairness. A particular concern in this regard is the very high tax burden on labour in the euro area. Shifting the tax burden away from labour to more "growth-friendly" tax bases (e.g. consumption, property and environmental taxes), while reducing the scope for aggressive tax practices by large corporations can help boost employment (see Box 2). Removing the bias towards debt financing for corporations would help the development of alternative and more varied capital sources for companies. Simplifying tax systems and addressing tax fraud and tax avoidance are essential to make tax

[5] Contributions to the EFSI can take the form of cash or guarantee. While cash contributions, unlike guarantees, are deficit- and debt-increasing in statistical terms, they are neutralised for the purpose of assessment of compliance with the Stability and Growth Pact.

[6] See the Note for the Eurogroup (2016), *'Pension sustainability in the euro area – fiscal risks associated to demographic and macroeconomic uncertainties and policy options'*, European Commission, ares(2016)2896019. http://www.consilium.europa.eu/en/meetings/eurogroup/2016/06/issues-note-pension-sustainability-euro-area_pdf

[7] See European Commission (ECFIN)-Economic Policy Committee ('EPC) (2016 forthcoming), *'Joint report on health care and long-term care systems and fiscal sustainability'*, European Economy, Institutional papers 037.

systems more efficient and fairer, and fund public policies with the least burden on the private sector.

A more active use of spending reviews is particularly relevant for the euro area where sound fiscal policies are a matter of common interest. Spending reviews are widely recognised as a helpful tool to enhance the quality of public finances; they can be used to achieve savings and foster the quality of public services. A number of factors appear particularly important for spending reviews to be able to deliver the best results: (i) sustained political commitment at a high national level, throughout the project; (ii) design and implementation based on best practices, including a clear strategic mandate; (iii) progress and the outcome regularly monitored and communicated to the public; and (iv) consistency with annual and multiannual budget planning. Accordingly, the Eurogroup has endorsed these factors as common principles for improving the quality of public finances through the use of spending reviews.[8]

Effective national fiscal frameworks strengthen the credibility of Member States' policies, reduce uncertainty on policies and reinforce confidence of the private sector. Ensuring the effective functioning of the upgraded frameworks remains a challenge. Realistic and unbiased macroeconomic forecasts are essential for sound budgetary planning in accordance with the applicable numerical fiscal rules. Credible and effective multiannual planning is instrumental for a predictable, transparent and efficient conduct of fiscal policy; in this respect, there is considerable scope for improving the quality, content and binding force of the medium-term fiscal plans. Transparent assessments provided by capable independent fiscal institutions are also critical to enhance accountability and anchor expectations, at both national and euro area level.

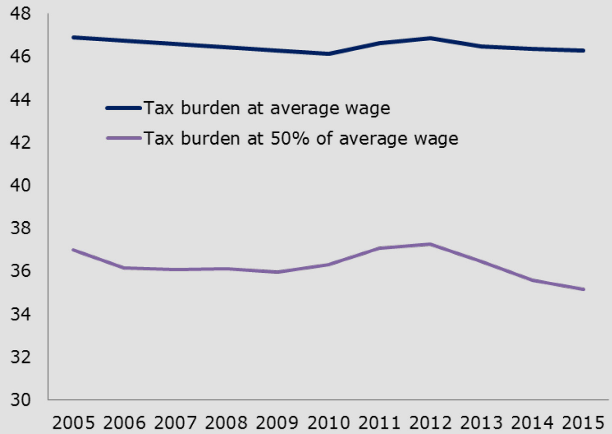
Box 2. Addressing the tax burden on labour

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average.

In the years prior to the crisis, several Member States took measures to gradually reduce the tax burden on labour although these were often of limited ambition. In the context of the crisis, however, many Member States raised taxes, including labour taxes, to contribute to consolidation efforts. Reducing the tax wedge on lower earners can improve the incentives to work while increasing income near the bottom of the income distribution. When circumstances allowed, some Member States again implemented measures to reduce labour taxes, focussing in particular on low-income earners. Figure (a) illustrates these developments, showing the euro area average tax burden on labour for a single worker earning the average wage and for a single worker earning a low wage (50% of the average wage). The drop in the tax burden for low wage earners since 2012 reflects more ambitious measures in notably France and Italy, which face a low employment rate of low-skilled. Also a reduction of the tax burden for low wage earners in Slovakia and Spain contributed to this decreasing trend, although to a more limited extent.

[8] Eurogroup statement - thematic discussions on growth and jobs: common principles for improving expenditure allocation, Brussels, 9 September 2016; http://www.consilium.europa.eu/en/press/press-releases/2016/09/09-eurogroup-statement/

Figure (a) - The euro area average tax burden on labour for a single worker

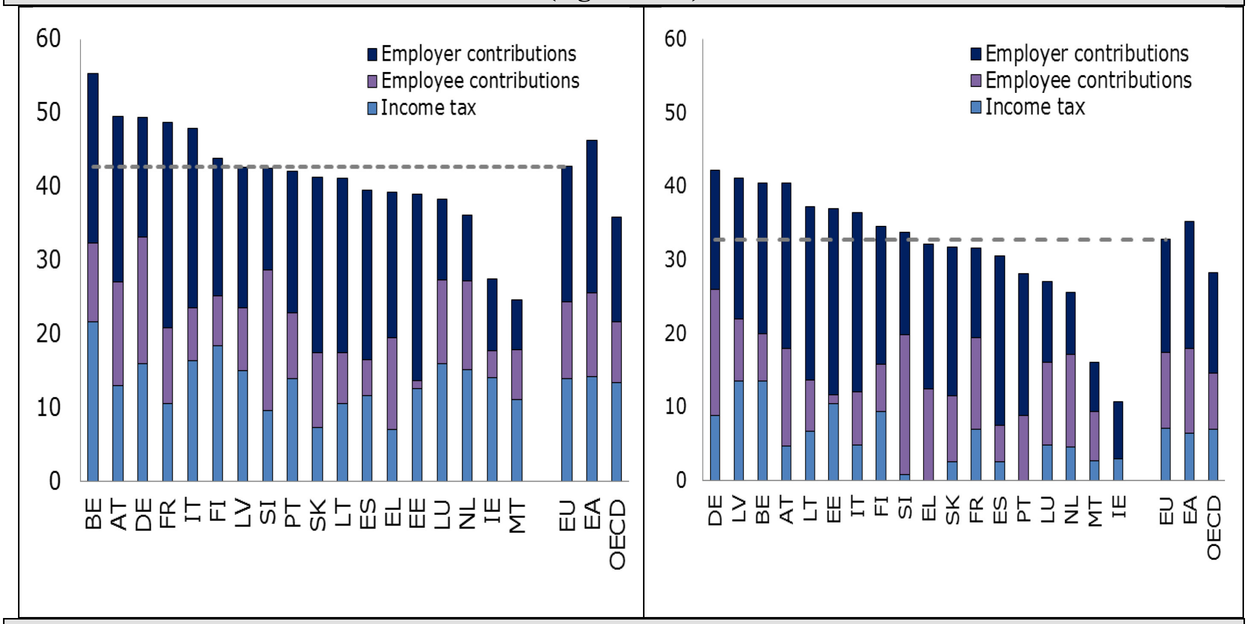


Notes: The indicator shown in the graph is the tax wedge on labour. The tax wedge is defined as the sum of personal income taxes and employee and employer social security contributions net of family allowances, expressed as a percentage of total labour costs (the sum of the gross wage and social security contributions paid by the employer). As data for Latvia, Lithuania and Malta is not available for 2015, data for 2014 has been used instead. No recent data is available for Cyprus. The averages are GDP-weighted.
Source: European Commission Tax and Benefits Indicator database based on OECD data.

Within the euro area, there are large differences between Member States in terms of the size of the tax burden on labour and its composition (employer social security contributions, employee social security contributions, personal income taxes), as illustrated in in Figure (b) below. Moreover, the graphs show that most Member States having a high burden on the average wage also have a high burden on low wage, although the opposite does not hold. The line in the graphs represents the benchmark of the EU average whereas the non-weighted OECD average is included in the graph for broader comparability.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as benefits, social insurance and wage-setting systems as well as other forms of taxation. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Figure (b) - The 2015 tax burden on labour at the average wage (left chart) and a low wage (right chart)



Notes: The indicator shown in the left-hand graph is the tax wedge on labour for a single person at the average wage. The indicator shown in the right-hand graph is the tax wedge on labour for a single person at 50% of the average wage. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

2. Macroeconomic imbalances and investment

The euro area surplus has been rising since the crisis. The euro area current account position swung from a deficit of 0.7% of GDP in 2008 to a surplus of 3.4% of GDP in 2015[9] (see Figure 7). For a relatively closed economy like the euro area, such a large and rapid swing is unusual. It is largely the result of positive terms of trade effects from falling oil prices and euro exchange rate depreciation, weak domestic demand and a savings-investment imbalance, with persistent aggregate demand dynamics that lag behind that of economic activity.

Real domestic demand for the euro-area is expected to recover to levels prevailing before the economic crisis only in 2016 (Figure 8). This persistent degree of slack underpins the current historically low levels of core inflation, which create a challenging environment for deleveraging and euro area rebalancing. Furthermore, persistently low aggregate demand risks having a more permanent impact on aggregate supply.

Large current account deficits have adjusted to more balanced positions or surpluses in most Member States, while large current account surpluses still persist. Countries with high external liabilities made major strides in correcting their excessive current account deficits, which was necessary to ensure the sustainability of their external positions. This was initially the result of a contraction in domestic demand and more recently has been driven by export growth. Conversely, current account surpluses continued rising, notably in Germany and the Netherlands, partly driven also by euro exchange rate depreciation and terms-of-trade effects from lower oil prices. In 2015, the surpluses of Germany and the Netherlands accounted for 72% and 16% respectively of the euro area surplus.

[9] See also the Commission's (2016) Alert Mechanism Report.

Developments in cost competitiveness are increasingly converging across Member States. For example, the dispersion in changes in unit labour costs continues to fall, implying that countries that lost competitiveness in relative terms before the crisis are now recovering it. The low inflation environment in relatively more competitive countries is reducing the room for further gains. Among Member States that faced large external adjustment needs, the reduction in ULCs followed mainly from increased labour productivity. Rising hourly wages in Germany and Austria have contributed somewhat to the external rebalancing process.

The net international investment positions (NIIP) continues to improve, although at a relatively slow pace and with significant differences remaining across Member States. Many debtor countries remain vulnerable on account of the large negative NIIPs that were accumulated in the pre-crisis period as a result of large and persisting current account deficits. Winding down large stocks of negative liabilities requires maintaining current account balances in positive territory or small deficits, which in turn implies limited room for expanding domestic demand in these countries with large negative liabilities. As large and negative NIIPs are generally coupled with large stocks of private or government debt, the maintenance of prudent current account positions in net debtor countries is also the counterpart of a necessary internal deleveraging process. The extent to which the deleveraging process in net debtor countries comes at the expense of their recovery prospects crucially depends on the inflation environment and debt-deflation risks, the room for further competiveness gains, reforms and domestic demand dynamics in the net creditor surplus countries. Creditor countries have further increased their positive NIIP over the past few years. Although this does not generate stability risks, it exposes creditors to potentially significant valuation risks.

Deleveraging in all sectors of the economy continues, but is uneven. Private sector debt remains high in a number of Member States. In 2015, debt stocks in consolidated terms represented 59.8% and 78.7% of euro area GDP for households and non-financial corporations, down from 63.1% and 81.9% of GDP respectively in 2009. These aggregate figures mask a wide range of levels across Member States. Household indebtedness has increased in some Member States with already elevated debt levels and fallen in some Member States with moderate debt levels, increasing the dispersion in household debt across the euro area Member States. Households are not fully availing themselves of the low interest rate environment, for example to improve the terms of their loans. Furthermore, the low nominal growth environment does not facilitate larger reductions in indebtedness ratios, even when active deleveraging is taking place.

Figure 7: The Euro area current account balance

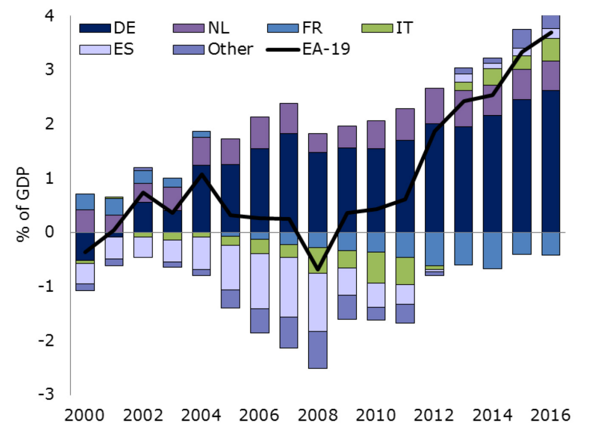
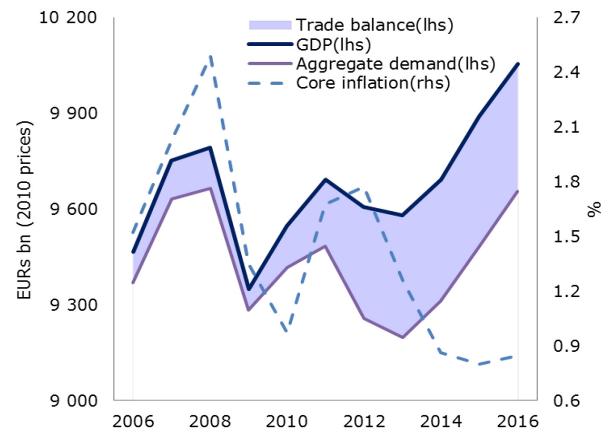
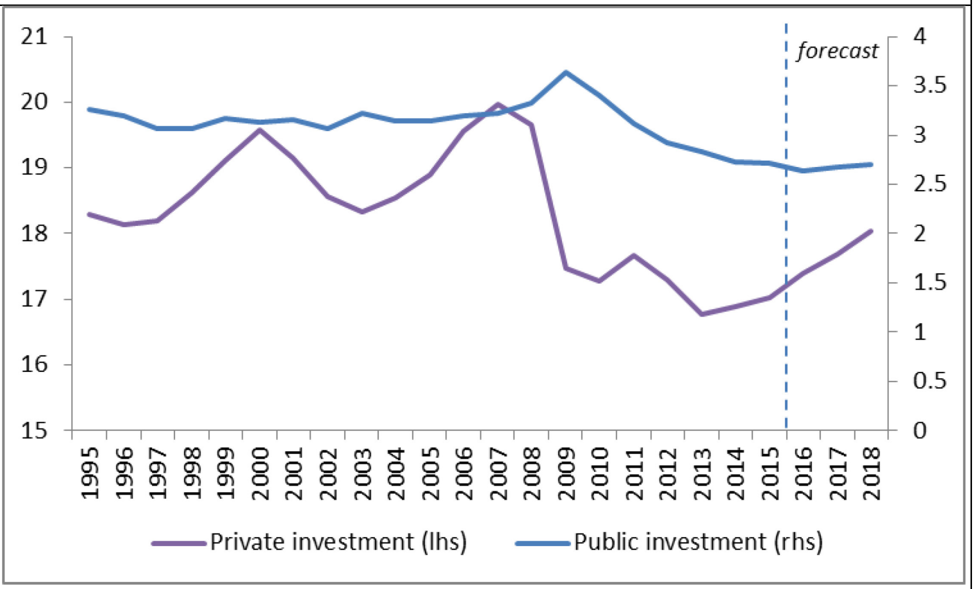


Figure 8: Euro area output, domestic demand, trade balance and core inflation



Investment in Europe has fallen in recent years. The weakness of investment (see Figure 9) is explained by a number of factors[10]. First, sluggish economic growth has dampened investment via the accelerator channel: as businesses expect a weak economic outlook, they are less inclined to invest. Second, an increase in risk aversion as well as high levels of economic and policy uncertainty are also weighing on investment demand.[11] Political uncertainty in some euro area and other EU Member States may be playing a role here. Third, in some Member States, strong deleveraging pressures in the private and the public sector and a high level of NPLs is acting as a drag on the banking sector and on the availability of credit for investment, with pronounced effects given the high dependence of the private economy on banks as a source of funding. This effect may be exacerbated for small firms who have less access to credit, and in some Member States, where average firm size tends to be smaller. Finally, barriers to entry, activity and exit reduce the incentive of firms to invest and also hamper the reallocation of resources. Public investment is forecast to remain low over the forecast period, while there are expectations of some recovery as concerns private investment.

Figure 9: Private and Public Investment in the euro area
(Gross fixed capital formation, % of GDP)



Investment in intangible assets has been relatively more dynamic. Intangibles were less affected by the economic crisis than investments in (non-residential) tangible assets. Between 1995 and 2014, the volume of annual investment in intangible assets increased by 87% in the EU-28, while the annual volume of tangible non-residential investments increased by only 30%. Intangible investment is crucial for economic growth and productivity within a knowledge-based economy. Empirical evidence confirms the decisive role of R&D as a source of (productivity) growth. The importance of intangibles includes but also goes well beyond R&D[12], suggesting the need to strike the right balance between stimulating investments in tangible and intangible assets.

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[10] See also ECB (2016) "Public Investment in Europe", ECB Economic Bulletin, Issue 2 / 2016.

[11] See also Palenzuela, D.R., Dees S. (eds) (2016) 'Savings and investment behaviour in the euro area', ECB Occasional Paper Series 167, January 2016.

[12] For example, see Roth, F., Thum, A.-E. (2013). Intangible capital and labor productivity growth: Panel evidence for the EU from 1998–2005. Review of Income and Wealth, Series 59, Number 3, September 2013, pp. 486 – 508. DOI: 10.1111/roiw.12009

Tackling bottlenecks to investment, increasing opportunities for and stimulating investment is key to improving the EU's growth potential. Removing barriers to investment could spur more growth and also help to reduce external imbalances within the euro area. In euro area Member States with high external liabilities, which continue to display very negative net international investment positions, facilitating investment is needed to boost productivity and improve non-cost competitiveness. By lifting the growth path, structural reforms would facilitate the reduction of debt to GDP ratios (both public and private) and also help address high internal imbalances, notably in the form of high unemployment, that have partly replaced the external imbalances. In euro area Member States with persistent current account surpluses, stronger investment and/or consumption would contribute to strengthening growth prospects and further rebalancing within the euro area. In addition, the joint removal of barriers to investment in Member States with external surpluses and in Member States with high external debt would also facilitate the rebalancing process through cross-border spillovers. A recovery of public investment could also help leverage private investment.

The removal of investment bottlenecks requires structural reforms at the Member State level. This issue is addressed in the Third Pillar of the Investment Plan for Europe (see Box 3) and reflected in the European Semester analysis and country-specific recommendations. In addition, the Single Market remains to be completed, especially in the services sector, where a lack of ambition in the implementation of the Services Directive, as well as persistent country heterogeneity, contributes to an underperformance of the sector. Removing obstacles to investment also raises the effectiveness of other macroeconomic and structural policies. For example, in the context of very low interest rates, the monetary transmission channel is weaker if firms cannot take advantage of expansionary monetary policies to invest. The same holds for initiatives aimed at facilitating access to finance (e.g. within CMU).

Box 3. Third Pillar of the Investment Plan in the euro area Member States

While the initiatives under the first and second pillars of the Investment Plan for Europe are expected to yield increasingly tangible results, action is also advancing on the third pillar, which aims at improving the business environment in Europe to make it more conducive to investment. Initiatives under the third pillar include measures at EU and national level to provide greater regulatory predictability, remove bottlenecks to investment, and further reinforce the Single Market. The Commission has already launched intensive work across all relevant areas of EU competence, such as initiatives to develop the Capital Market Union (e.g. lowering capital charges under Solvency II) and a better use of EU funds (e.g. combination of ESI funds) as well as other actions in a number of areas with direct impact on investment decisions in Europe. At the Member State level, the European Semester also places a particular emphasis on the identification of investment challenges[13] and the related reforms.

The review of investment challenges carried out in the context of the European Semester shows that the most frequent barriers to investment in the euro area include inefficiencies in public administration, an unfavourable business environment, and high sector-specific administrative and regulatory burdens. However, barriers to investment vary across euro area Member States. In some of them, barriers may also include a lack of transparency in public administration, a high level of taxation

[13] In November 2015, the Commission presented together with the 2016 Annual Growth Survey, a document identifying key challenges and regulatory barriers to investment in each Member State. Commission Staff Working Document (2015) 'Member States Investment Challenges', SWD(2015)400.

and overly complex taxation systems, product and labour markets distortions, weaknesses in research and innovation frameworks, and barriers to accessing finance, particularly for SMEs.

The assessment of actions taken so far to address investment challenges shows that progress across categories of barriers[14] and across Member States has been uneven and that more needs to done. Three groups of Member States can be distinguished. The euro area Member States heavily hit by the crisis appear to have been overall the most active in addressing barriers to investment across the board. In the euro area cohesion Member, actions have been taken to address barriers to investment, in particular in the area of 'Public Administration/ Business Environment'. By contrast, in other euro area Member States, actions have been more limited notably in the areas of 'Public Administration/ Business Environment' and 'Sector-specific Regulation, which represent the main categories of barriers to investment in that group.

Reflecting the increasing importance of the third pillar in the euro area policy strategy, the number of investment related recommendations has increased in the CSRs proposed in 2016. However, these recommendations will only result in better conditions for investment if they are implemented. An assessment of the level of implementation of the 2015 CSRs related to investment challenges shows that only about 60% have seen at least some progress. Therefore speeding up the adoption and implementation of national reforms is crucial to improve the investment environment and complementarity with other EU policy initiatives.

3. Structural reforms, adjustment capacity and social fairness

Structural reforms are necessary to address the decline in potential output growth in the euro area. Compared to the pre-crisis period, the medium term growth potential of the euro area has virtually halved. This is in part linked to demographic and broader developments, but it also reflects what are known as "hysteresis effects" resulting from the crisis: the economy's weak performance over a prolonged period of time can degrade physical capital and the productivity and participation of the workforce to such an extent that it permanently reduces growth potential. As highlighted in the Annual Growth Survey (2017), lifting the EU's growth potential requires structural policies to boost employment and productivity. The European Commission has carried a model-based benchmarking exercise that shows that if Member States were to close half of the observed gaps with best performers in areas such as market competition and regulation, labour market and skills-upgrading, tax structure and R&D, euro area GDP would be boosted by close to 6% after 10 years.[15] The long term decline in potential growth may also reflect the fading out of the impact of strong advancements in European integration, such as the creation of the common market in the 1960s, the move towards the single market, the creation of euro and successive enlargements of the EU, which have opened up markets to more competition and have spurred a strong and lasting drive for productivity growth in past decades.

Significant structural differences and asymmetries in Member States' ability to respond to economic shocks remain. While economic differences are to some extent inevitable in a monetary union, large and persistent differences are a serious concern for several reasons. They can: (i) make the single monetary policy less effective, in particular if monetary policy is constrained by the zero lower bound; (ii) turn into lasting differences in structural growth; (iii) spill over to other Member States; and/or (iv) undermine citizens' trust in the EMU.

[14] These categories are 1) Public Administration/Business Environment; 2) Labour Market/Education, 3) Financial Sector/ Taxation; 4) Research, Development and Innovation; and 5) Sector-specific Regulation.

[15] Varga, J., In't Veld, J. (2014), 'The potential growth impact of structural reforms in the EU — A benchmarking exercise', European Commission, European Economy Economic Paper 541, December 2014.

A significant degree of economic convergence and adaptability among members is necessary for the good functioning of the EMU. In a monetary union, in the absence of the exchange rate as an adjustment tool among participating countries, labour and product markets must be able to contain the impact and to facilitate adjustment after an asymmetric shock. Even a common shock can have very asymmetric effects across the euro area, and have a long-lasting impact. These asymmetries reflect, at least in part, persisting rigidities in product and labour markets, which hamper the response of both prices and quantities to shocks or output gap differences and therefore slow down the adjustment process. This has severe consequences: most of the Member States with more rigid economic structures (as measured by widely used product and labour market indicators) experienced a particularly strong downturn during the crisis and sluggish adjustment afterwards.[16]

Reforms aimed at more competitive and effective services sectors are important for improving the euro area's adjustment capacity. For example, the large size of the services sector and its interaction with the rest of the economy, where it is increasingly an input to production, make developments in market services essential for competitiveness and long-term growth.[17] However, available economic indicators generally reveal underperforming services sectors in the EU, as evidenced through unfavourable productivity-wage dynamics, relatively high mark-ups and inefficient resource allocation[18]. At the heart of it, high regulatory barriers remaining in the services sectors as well as large heterogeneity among Member States, hampers not only individual Member State economies, but also the functioning of the Single Market and the overall growth prospects of the euro area.[19]

Appropriate wage setting mechanisms and properly designed employment protection regulations can also contribute to a balanced adjustment to shocks. Effective automatic fiscal stabilisers may help to minimise the persistence of the effects of economic shocks, supporting households' incomes and stabilising consumption and the economy even in the transition to new jobs, and through activation measures that facilitate the return to work. Active labour market policies that improve labour market matching and facilitate the return to work in the open labour market are important to limit the hysteresis effects of the adjustment process. Combined with appropriate incentives to work, they increase the contribution of labour to potential GDP-per-capita growth by preventing scarring effects that translate into socially-costly longer unemployment spells and exits towards inactivity.

The improvement in the euro area labour market, with a steady reduction in unemployment, is welcome but insufficient. Jobs are being created at a robust pace, but the employment rate remains below its 2008 level. The euro area unemployment rate has fallen by 2 percentage points since the start of the recovery, but also remains above the pre-crisis average at 10.1%. The observed reduction in unemployment has been mainly due to a decline in separation rates, while job-finding rates improved somewhat. Despite some convergence in unemployment rates, with the largest falls in Member States more severely hit during the crisis, large differences persist with unemployment rates ranging from 23.5% in Greece to 4.3% in Germany, and labour mobility remaining low on average in the euro area. Wage gains have been moderate in 2015 at slightly above 1%, which in the context of low inflation has been translated almost entirely into real wages.

[16] See also Quarterly Report on the Euro Area, Vol. 14 No. 4 (2015).
[17] See, for example, World Bank (2016), "EU Regular Economic Report. Growth, Jobs and Integration: Services to the Rescue", Fall 2016.
[18] Thum-Thysen, A., Canton, E. (2015), "Estimation of service sector mark-ups determined by structural reform indicators", European Commission, Economic Papers 547, April 2015.
[19] Canton, E., D. Ciriaci and I. Solera (2014), "The Economic Impact of Professional Services Liberalisation", European Commission, Economic Papers 533, September 2014.

Differences in labour market adjustment capacity among euro area Member States affect both employment and social performance. Temporary differences in unemployment rates may be transformed into persistent growth and income divergences. There is notably a risk of important market inefficiencies in terms of matching of unemployed people with vacant posts and that unemployment becomes entrenched with accompanying negative spill-over effects. These shortcomings not only challenge the smooth functioning of the euro area, but also risk undermining public support for the euro, by falsely blaming it for income inequality and high poverty rates which rather reflect deeper trends and insufficient reforms in the specific economies.

The latest trends in income inequality and in poverty are positive, but levels are still unsatisfactory. Income inequality trends since the mid-1990s have been largely driven by technological changes, which involve a stronger demand for high-skilled workers and are a common trend across developed economies. A main source of income inequality is wage inequality which, in turn, results from skill-biased technological change. While wages increase for skilled workers, due to higher productivity, less skilled workers face wage stagnation or also less employment opportunities. In addition, capital income, which tends to be highly concentrated, has increased and tax and benefit systems have become, to some extent, less distributive.[20] Poverty increased significantly in the euro area during the economic crisis and remains very high. In 2015, in the euro area, 23% of people were at risk of poverty or social exclusion, slightly less than in 2014.[21] At the same time, the median real disposable income has stagnated or fallen in a number of advanced economies in recent years, mostly in the prolonged aftermath of the Great Recession. **These trends further increase the importance of adopting structural reforms which can address them and take distributional effects into account.** Widening income inequalities can weaken the foundations of market economies and finally dampen economic growth. Moreover, certain reforms can have short-term costs, which may vary across societal groups, while being beneficial in the long run. Therefore, taking into account the redistributive effects of reforms can help improve social cohesion and adherence to reforms while being beneficial to growth.[22]

A number of reforms unambiguously reduce inequality while promoting GDP and productivity growth, but their effects may only show up in the longer run. Competition-enhancing structural reforms have positive long-run effects on growth, adjustment capacity and resource reallocation. At the same time, reforms in the education sector such as increasing the quality and the access to education and training contributes to increasing employment, economic growth and to reduce inequality, although their positive effects take longer to materialise.[23] Increased childcare provision and early-learning education can play an important role in reducing inequality and increasing labour market participation and potential growth over the long term. Vocational training, as well as lifelong re-training opportunities help to mitigate the negative effect of skill-biased technical change, because they improve the skills endowment of workers and may act against labour market hysteresis caused by the crisis. Growth-friendly tax and transfer systems can also reduce income inequality (see also

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[20] Going for Growth (2015). Chapter 2 "The effect of pro-growth structural reforms on income inequality".

[21] For more details, see European Commission (2017), "Draft Joint Employment Report".

[22] Pichelmann, K. (2015): "When 'Secular Stagnation' meets Piketty's capitalism in the 21st century. Growth and inequality trends in Europe reconsidered", European Economy Economic Papers 551; Cingano, F. (2014): "Trends in Income Inequality and its Impact on Economic Growth", OECD Social, Employment and Migration Working Papers No. 163.

[23] Varga, J., In't Veld, J. (2014), 'The potential growth impact of structural reforms in the EU — A benchmarking exercise', European Commission, European Economy Economic Paper 541, December 2014.

Box 2 on reducing the tax wedge on lower earners, which can increase the incentives to work while increasing income near the bottom of the income distribution).

Some structural reforms may involve a trade-off between higher growth and higher inequality. The distributional effect of product and labour market reforms is not clear a priori. For example, on the one hand, the creation of job opportunities warranted by reforms which address rigidities, such as on the use of part-time jobs, may help to draw women or the young into work, reducing income disparities between the full-time employed and the unemployed. A reduction in minimum wages, as well as the revision of the generosity of unemployment benefits and a reduction in employment protection tend to have positive effects both on job creation and labour market participation. On the other hand, they also reduce the reservation wage and may allow the emergence of new low-wage jobs or reduce job tenure, hurting the quality of employment. Reforms that end up creating a dual market, moreover, might also have a negative effect on productivity, and therefore also on wages, by making firms more willing to hire, but less willing to keep workers and reducing incentives for both employers and workers to invest in their skills.[24]

An appropriate combination of reforms is important to have positive net distributional effects. Reforms that boost innovation and are therefore good for the economy as a whole, for instance, tend to increase wage dispersion because they increase the demand for (and the wages of) skilled workers, making others obsolete. Appropriate redistributive reforms as well as policies aimed at upskilling could therefore mitigate this potential negative effect. A stronger focus on flexicurity, shifting the protection from the job to the worker, can minimize the loss of wage income during a transition from one job to another and therefore minimize the negative redistributive effects of flexibility-enhancing labour market reforms. Euro area Member States that have implemented labour market reforms along these lines are more resilient and show a better employment and social performance.

Over the last year, the euro area has made some progress in addressing its main structural challenges, but much remains to be done. A number of Member States implemented structural reforms strengthening economic resilience in the post-crisis period, opening up several markets and improving the conditions for investment. On labour issues, reform activity in the field of employment protection legislation has been intense, particularly in Member States with both large cumulated imbalances and stringent job protection legislation before the crisis, which had slowed down or even hampered the reallocation of jobs and workers towards more productive activities, resulting in high and persistent unemployment. However, despite the broadly-supported evidence of the positive economic impact of structural reforms, progress in implementing credible reforms is often quite slow in many Member States and differences in economic structures remain.

4. Financial sector developments and policy

Financial markets have shown remarkable resilience despite increased uncertainty. Investors became increasingly risk-averse early in the year, as concerns about a global slowdown and the impact of low interest rates on the profitability of the financial sector took hold. This was followed by the surprise results of the UK referendum in June and most recently the US Presidential elections, which affected financial markets to different degrees. The 2016 EU-wide European Banking Authority's stress tests results concluded that the

[24] Blanchard and Landier (2002) "The Perverse Effects Of Partial Labour Market Reform: Fixed-Term Contracts In France," Economic Journal, 112 (June).

capital position of the EU banking system was satisfactory. Despite the significant capital erosion imposed by the adverse scenario, banks would still be in a position to absorb an even stronger economic shock, were it to occur. Financial markets have been resilient in 2016, without showing signs of dislocation or liquidity shortage, supported also by a continued accommodative monetary policy in the euro area.

In a challenging external and financial environment, euro-area systemic stress has risen somewhat, but remains contained, clearly below the levels recorded during previous crisis episodes (Figure 10). While the overall resilience of euro-area banks has continued to rise, and is much higher than prior to the last financial crisis, banks continue to be confronted with an outlook of low profitability and high stocks of non-performing loans in certain jurisdictions. Alongside the weak economic recovery and low-interest-rate environment, a rather high cost base following limited progress in restructuring has further dampened banks' profitability. Risks also extend to the real economy, with remaining high levels of public and non-financial private debt in some Member States.

- **With regard to policy developments, the supervisory, macro-prudential, and resolution frameworks are now fully operational.** The Single Supervisory Mechanism (SSM) is responsible for the direct supervision of the most significant euro-area banks, and carries out the Supervisory review and Evaluation Process through ECB-led joint review teams. The macro-prudential framework is meant to strike an appropriate balance between granting sufficient flexibility to Member States in implementing macro-prudential tools in line with national structural and cyclical conditions, while ensuring coordination at EU level and the proper functioning of the internal market. It is currently being reviewed to ensure that it is effective in addressing financial-stability risks. Member States have transposed the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Scheme Directive, and as of January 2016 the Single Resolution Board is operational.
- **The Capital Market Union (CMU) seeks to create a single market for capital in Europe and is the third pillar of the Commission's Investment Plan for Europe.** CMU aims to contribute to a more balanced structure of financial intermediation, by boosting and integrating market-based funding. It should therefore contribute to both cross-border stabilisation supporting demand and diversification in funding sources. CMU is conceived for the whole EU, but it is particularly relevant for euro area, which relies more on traditional bank funding than the rest of the EU. By the end of 2016, the European Council has called for an agreement on three initiatives. First, a proposal for Simple, Transparent and Standardised (STS) securitisations to establish more risk-sensitive capital charges for STS securitisation. Second, modernising the Prospectus rules to increase access to capital markets for smaller companies. Third, proposals for revising the European Venture Capital Fund and the European Social Entrepreneurship Fund Regulations to strengthen Europe's venture capital markets.
- **As part of the agenda for Better Regulation, a public consultation was launched on the state of the EU's regulatory framework for financial services.** Follow-up actions will focus on four main areas. First, ensuring a wider flow of finance to small and medium-sized firms and long-term investments. Second, a more proportionate application of rules to promote competition and safeguard the diversity and dynamism of the financial system. Third, a better balance between the costs and benefits of statutory and reporting requirements which provide the competent authorities with essential data to perform market oversight and ensure a proper functioning of financial markets. Fourth, a

more consistent and forward-looking regulatory framework. The Commission will present the outcome of the Call for Evidence, including the respective follow-up actions, in November.

Figure 10: ECB's Composite Indicator of Systemic Stress

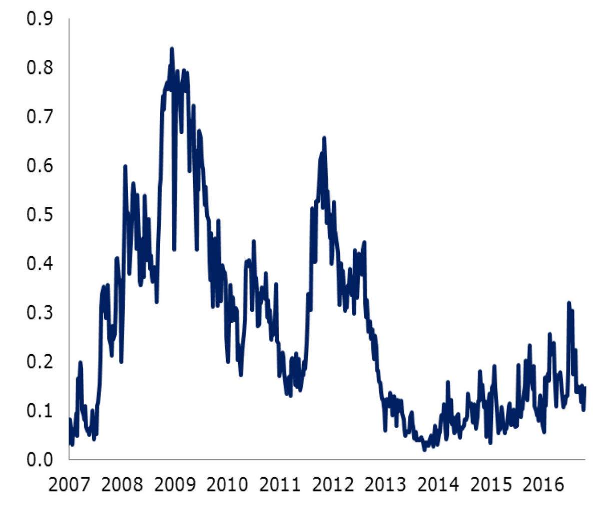
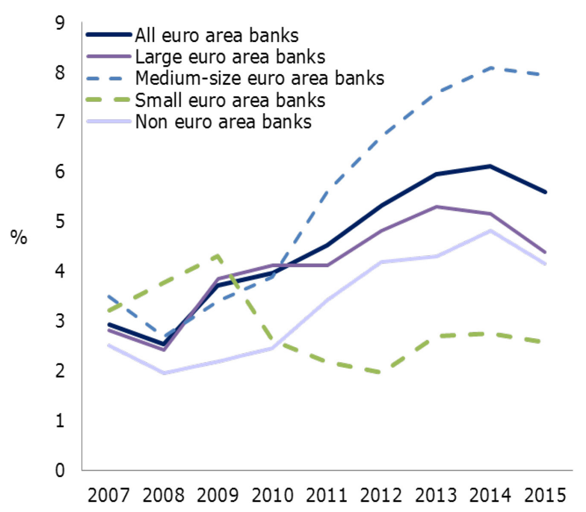


Figure 11: Gross non-performing debt % of total gross debt instruments



Sources: Thomson Reuters, ECB and ECB calculations, European Commission. Notes: The Composite Indicator of Systemic Stress is unit-free and constrained to lie within the interval (0, 1). See Hollo, D., Kremer, M. and Lo Duca, M., ''CISS - a composite indicator of systemic stress in the financial system'', Working Paper Series, No 1426, ECB, March 2012.

Looking ahead, a central challenge in the financial sector concerns the completion of the Banking Union. Banking Union will allow for the consistent application of banking rules in participating Member States, which are mainly part of the euro area. Currently, the elements of Banking Union rest on the foundation of the Single Rulebook and two pillars – the Single Supervisory Mechanism and the Single Resolution Mechanism. An important aim of Banking Union is to break the sovereign-bank loop, which is accomplished through risk reduction and removing barriers that segment the single market for banking services. However, it also implies a move towards risk sharing at the euro-area level. Risk sharing is still partial, and the sovereign-bank link is not yet completely broken.

A European Deposit Insurance Scheme (EDIS) and a common backstop for the Single Resolution Mechanism are still to be put in place. Crises affecting banks are commonly macro-economic and general in nature, following e.g. asset market collapses and economic downturns. The current set-up of national deposit guarantee schemes may be vulnerable to large national shocks, in particular when a sovereign and a national banking sector are perceived to be in a fragile situation. The proposal under discussion envisages a full European system of deposit guarantees, administered by a Single Resolution and Deposit Insurance Board. EDIS would be established to insure national deposit guarantee schemes, which would remain part of the scheme. A common backstop for the Single Resolution Mechanism would underpin the credibility of resolution, which requires large amounts of resources in the face of large shocks. The backstop should facilitate borrowing by the Single Resolution Fund, and ensure that adequate funding is credibly available to resolve the affected banks in the most efficient manner. Ultimately, the banking sector would be liable for repayment by means of levies. This work should proceed in parallel to the adoption of the further risk-reduction measures in the banking sector that the Commission is going to propose shortly to address the outstanding elements of the post-crisis reforms in the banking area, in line with international standards agreed in Basel and the Financial Stability Board. A complete Banking Union would break the sovereign-bank loop and reduce barriers to cross-border banking. The EU would be able to reap the full benefits of the single market for banking services, and thus increase cross-border competition and facilitate consolidation. Without it, there is the risk of perpetuating the situation of low profitability and low efficiency in the sector.

Some challenges are pertinent for the euro area in particular, since the economy is still pressed by low growth and high unemployment. Banks' low profitability and high levels of non-performing loans (NPLs) put pressure on banks' balance sheets and hinder the resolution of internal euro area imbalances (see Section 2 above). Six out of seven Member States with the highest levels of NPLs are part of the euro area. Since the financial crisis, the NPL ratio for the euro area has risen markedly (see Figure 11), although there are important divergences across Member States and across banks. As also highlighted in Section 2, high NPL ratios have a significant negative impact on banks' profitability and their ability to provide credit to the economy. They become an impediment to economic growth in the affected Member States, and risk becoming a source of systemic risk within the euro area.

High levels of NPLs are largely a country-specific concern, but there are also cross-border spill-over effects. In general, Member States are best placed to deal with NPL resolution within their own jurisdiction. However, depending on the scale of the problem, high NPL ratios can also pose pan-euro-area risks. Market tensions can quickly lead to concerns for financial stability in one Member State, which can spread to one or more other Member States. This systemic aspect of the NPL problem suggests scope for a euro-area-wide discussion on a policy response that could assist Member States to deal with their NPL problems.

Linked to the problem of high NPLs are deficiencies in Member States' insolvency frameworks. There is a high degree of heterogeneity in the performance of insolvency frameworks across Member States, where the estimated average duration of corporate insolvency proceedings ranges from less than one year to well above four years. In many cases, insolvency procedures fail to maximise the prospects for asset recovery. This hampers lenders' willingness to provide funding to firms, resulting in less credit provided to the economy. Furthermore, as highly indebted companies use their profit to repay debts, delays in debt restructuring lead to lower investments. All in all, excessively leveraged banks and firms are more vulnerable to negative shocks. The Commission is putting great emphasis on implementing a *second chance approach* to insolvency. The Insolvency Recommendation of 2014 aims to establish minimum standards regarding pre-insolvency and recovery proceedings. Only a few Member States have so far implemented these Recommendations, and those implementing have done so only partially. Work is also ongoing to benchmark national insolvency regimes.

The relatively large reliance on banks in financing the economy makes the euro area more vulnerable in times of crisis and can exacerbate an economic downturn. The financial crisis led to significant restructuring and deleveraging needs in the banking sector. Consequently, the euro-area banking sector has gone through an extended period of reduced lending volumes. In turn, enterprises, and particularly small and medium-sized firms, which typically rely on bank funding, had difficulties obtaining sufficient funding. Traditional bank funding also requires overcollateralization, and so banks are less keen to finance innovation. An important element of CMU initiatives will be initiatives to broaden the sources of financing in the euro area, giving a stronger role to capital markets. This should reduce the risks of one funding channel becoming temporarily impaired.

The scarcity of euro-denominated safe assets is an obstacle to breaking the sovereign-bank loop and weighs on financial stability and growth. Following the global financial crisis and the sovereign debt crisis, the credit ratings of some euro area Member States were lowered, which reduced the supply of euro-denominated safe assets. At the same time, demand for these assets has continued to increase, partially due to recent regulatory reforms, which require banks to hold more liquid and secure assets. This situation reduces the efficiency of functioning of EMU, preserving the sovereign-bank loop. In a crisis situation, it could also create incentives for capital flight from weaker to stronger jurisdictions. It may put downward pressure on the yields of AAA-rated bonds denominated in euro, distorting inter-temporal decisions and affecting the viability of financial institutions, in particular pension funds. Finally, it may interact with zero lower bound constraints for interest rates, by dampening output.[25] How a better match between the supply and demand of safe assets can be achieved in the euro area should be a matter for policy consideration.

5. Completing the EMU as a key driver for stability and growth

The euro area faces the challenge of completing its EMU architecture - to strengthen the resilience of the euro area against negative economic shocks and to support long-term growth. Despite the progress made in the past few years, the EMU framework is not yet in a position to deliver what its citizens ultimately expect from it: economic prosperity and security based on sustainable growth and price stability, high employment and financial stability. Over the last year, some progress on the EMU initiatives has been made. In the meantime, issues such as the UK referendum, immigration and security have become prominent but completing the EMU remains pressing. Maintaining the current uncompleted state of EMU's architecture create real economic costs due to sub-optimal policies and risks making EMU unable to effectively weather significant economic shocks if they occur.

Important work under Stage 1 of the work on EMU deepening is ongoing and a number of initiatives are underway to improving the economic governance toolbox.

- **In October 2015, the Commission indicated it would explore ways to streamline the methodology for assessing compliance with the Stability and Growth Pact (SGP).** This aims to improve transparency and reduce complexity in the application of the fiscal rules, without changing the existing legislation, In April 2016 it received a formal mandate by Ministers to explore possibilities to increase predictability and transparency in the implementation of the SGP, including through a greater focus on the so-called expenditure benchmark. Work on the latter is moving forward, with the majority of Member States subscribing to the approach proposed by the Commission. The Economic and Financial Committee has been tasked to report back to Ministers in December 2016.

- **The Council adopted the recommendation to set up National Productivity Boards on 20 September 2016.** Euro area Member States now have an 18 months period following Council adoption in which to implement the recommendation**.** The Boards will help to improve the coordination of policies and the surveillance of competiveness developments within the Union. Competitiveness in the euro area requires high productivity and growth potential, maximising growth, jobs and social inclusion, while keeping the costs of production in line with trading partners, without creating damaging imbalances in external

[25] Caballero, J. J. et al (2016), "Safe asset scarcity and aggregate demand, NBER Working Paper No.22044.

accounts. Coordination of policies having a bearing on competitiveness should help to ensure that domestic economic developments in each country of the monetary union are compatible and consistent among them. It should also prevent negative spillovers which may arise from a sudden unwinding of economic imbalances. The Boards will help linking the euro area and domestic dimension of structural reforms and in this way improve ownership and strengthen implementation.

- **The European Fiscal Board (EFB) became operational in October 2016.** This independent Board will assess ex-post how the EU fiscal framework has been implemented and advise on the fiscal stance. Moreover, the EFB may also make suggestions for the future evolution of the fiscal framework. In carrying out its mission, the EFB will cooperate closely with national fiscal councils across the EU so as to benefit from their expertise in fiscal matters and their country-specific knowledge.

- **In October 2015 the Commission proposed a three-step approach to strengthen euro area representation in the IMF with gradual implementation by 2025.** The approach emphasised the need to strengthen coordination among the euro area Member States via a regular consultation framework, to update the coordination infrastructure and existing coordination arrangements in IMF matters in Brussels, and to enhance coordination in Washington alongside an improved accountability towards the Council and European Parliament. Later steps include improving the representation of the euro area through a rearrangement of constituencies at the IMF and moving towards a unified representation for the euro area in a single seat. In June 2016, the Council agreed on some improvements in coordination of IMF issues and agreed to continue discussions on further strengthening the coordination.

To move forward, Member States must resolve their differences about the long-term vision of EMU. A reflection is needed on how a fair and sustainable balance can be found between opposing views. The translation of the Five Presidents' report into detailed second stage actions requires a shared sense of ownership and a common sense of purpose among all euro area Member States and EU institutions. The resulting model for the completion of EMU will have to combine risk sharing and risk reduction in a way that makes it both economically and politically attractive and viable.

The model for the completion of EMU has to deliver the appropriate punch. It has to ensure the appropriate mix of financial market stability, adequate incentives for the private and public actors at European and national levels to make the right policy choices, and facilitate a policy mix at European and national levels to support fair and sustained growth and ensure fiscal sustainability. The sovereign-bank loop needs to be fully severed, while taking care of moral hazard and strengthening market discipline.

Stage 2 initiatives advocated by the Five Presidents' Report include more fundamental reforms such as the setting up of a stabilisation function and a more binding process to facilitate convergence. For example, a stabilisation function would help Member States to better deal with shocks that cannot be managed at the national level alone. One overarching requirement for political acceptance of this initiative is to credibly prevent the risks of permanent transfers that are not democratically legitimised. Another imperative is that the stabilisation capacity does not undermine the incentives for sound fiscal policy-making, nor the incentives to address national structural weaknesses. The Five Presidents' Report states that significant and sustained convergence towards similarly resilient economies should be a condition for access to a shock absorption mechanism to be set up for the euro area. The common stabilisation capacity could take many forms in practice. In line with the message of the Five Presidents' Report, a move in this direction should be accompanied by a stricter application of the common fiscal framework at national level.

Preparation of these more fundamental reforms towards completion of EMU in stage 2 has been initiated. First and foremost, a broad debate on the measures required has taken place in 2016 with stakeholders. Workshops and conferences have taken place in all euro area Member States and a dedicated webpage[26] has been set up to present the outcome of this consultation. The Commission is planning to present in March 2017 its ideas on the future steps of the EU.

[26] https://ec.europa.eu/priorities/national-consultations-emu-deepening_en.

PRELIMINARY ASSESSMENT OF IMPLEMENTATION OF THE 2016 EARS[27]

	Summary assessment
2016 Euro Area Recommendations	
CSR1 Pursue policies that support the recovery, foster convergence, facilitate the correction of macroeconomic imbalances and improve adjustment capacity. To this end, Member States, particularly those with large stocks of private and foreign debt, should implement reforms that enhance productivity, foster job creation, raise competitiveness and improve the business environment. Member States with large current account surpluses should implement as a priority measures, including structural reforms, that help strengthen their domestic demand and growth potential.	The euro area has made **limited progress** in addressing CSR 1: • The correction of existing macroeconomic imbalances is taking place, but the process is uneven and slow. • Significant progress has been achieved among net debtor countries in correcting their external imbalances, although stocks of net foreign liabilities remain high. • In contrast, countries with large surpluses and positive stocks of net liabilities have not corrected their surpluses. • There has been some progress in structural reform implementation.
CSR2 Implement reforms that combine (i) flexible and reliable labour contracts that promote smooth labour market transitions and avoid a two-tier labour market; (ii) comprehensive lifelong learning strategies; (iii) effective policies to help the unemployed re-enter the labour market, (iv) adequate and sustainable social protection systems that contribute effectively and efficiently throughout the life cycle both to social inclusion and labour market integration and, (v) open and competitive product and services markets. Reduce the tax wedge on labour, particularly on low-earners, in a budgetary-neutral way to foster job creation.	The euro area has made **some progress** in addressing CSR2: • Progress has been made in implementing flexible and reliable labour contracts that promote labour market transitions and avoid a two-tier labour market, particularly in the euro area Member States with both large cumulated imbalances and stringent job protection legislation before the crisis. • Some progress has been made in implementing comprehensive lifelong learning strategies. • Some progress has been made in implementing effective policies to help unemployed re-enter the labour market • Some progress has been made in implementing modern social protection systems that support those in need and provide incentives for labour market integration. • Limited progress has been made in reducing the tax wedge on labour.
CSR3 Pursue fiscal policies in full respect of the Stability and Growth Pact. For 2016, the objective of a broadly neutral aggregate fiscal stance in the euro area appears appropriate in order to reflect a balance between long-term	The euro area has made **some** progress in addressing CSR 3: • Most Member States broadly complied with the Stability and Growth Pact in 2016. Some benefitted from the flexibility arrangement to promote structural reforms and investment. Two Member States required new deadlines to correct

[27] A fuller assessment, based on individual country's progress with the CSRs flagged as relevant for the implementation of the 2016 EARs, will be presented in the country reports of Spring 2017.

fiscal sustainability and short-term macroeconomic stabilisation. With a view to 2017, reduce public debt to restore fiscal buffers and avoid pro-cyclicality. Differentiate the fiscal effort by individual Member States in line with their respective positions vis-à-vis the requirements under the SGP while considering stabilisation needs, as well as taking into account possible spillovers across euro area countries. To this end, review the euro area fiscal stance in the context of the Stability Programmes and the Draft Budgetary Plans.	their excessive deficits. • For 2016, a slightly expansionary fiscal stance is expected, which is deemed appropriate for stabilisation purposes in a still tepid recovery, despite fiscal sustainability needs. • For 2017, public debt is expected to fall moderately. • Some progress has been made in the coordination of fiscal policies, in particular in terms of delivery of an appropriate aggregate fiscal stance. However, the distribution of the aggregate fiscal stance remains sub-optimal across Member States. • The euro area fiscal stance was discussed among Member States in the EWG and the Eurogroup in summer 2016 based on the Stability Programmes.
CSR4 Facilitate the gradual reduction of banks' non-performing loans and improve insolvency proceedings for businesses and households. In Member States with large stocks of private debt, promote an orderly deleveraging, including by facilitating the resolution of unviable private debt.	The euro area has made **some progress** in addressing CSR 4: • The supervisory, the macro-prudential, and resolution frameworks have become fully operational. The Single Resolution Fund have all the resolution powers in place. • Following the evaluation of the implementation by Member States of the Insolvency Recommendation of 2014, the Commission has engaged in preparing a legislative initiative on pre-insolvency and recovery proceedings. The initiative aims at providing tools that would allow viable businesses in distress to be rescued and honest but bankrupt individuals to be given a second chance.
CSR5 Work towards completing the Economic and Monetary Union, in full respect of the internal market and in an open and transparent manner, further exploring the legal, economic and political aspects of the more long-term measures contained in the Five Presidents' Report.	The euro area has made **some progress** in addressing CSR 5: • The Council adopted the recommendation to set up National Productivity Boards on 20 September 2016. • The Members of the European Fiscal Board (EFB) have been appointed and the EFB became operational in October 2016. • Regarding external representation, in June 2016, the Council agreed on some minimal improvements in coordination of IMF issues and agreed to continue discussions on further strengthening the coordination. • An Ad-hoc Working Group (AHWG) in the Council was set up, which worked on a roadmap to complete the Banking Union. The roadmap was adopted by the Council in June 2016.