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ANNEXE 2

ANNUAL GROWTH SURVEY

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MACRO-ECONOMIC REPORT

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Member States' actions in 2011-2012 will be critical in averting a "lost-decade scenario". Policy priorities, timing and content will have to be set according to national circumstances and reflect inter alia the risks to fiscal sustainability and the need to correct excessive imbalances. The most urgent task is to break the vicious circle at work in some Member States of unsustainable debt, financial market disruption and low economic growth. While the draft National Reform Programmes submitted in November acknowledge the urgency of addressing the macro-economic challenges in an integrated way, they often fall short of proposing adequate policy responses.

This supporting document therefore aims at pinpointing measures that have the highest potential of delivering positive macro-economic effects and that Member States could consider implementing in the coming two year. The first section sets the scene by looking at the imbalances and weaknesses that had emerged before the crisis and at the legacy of the worst economic crisis since the Great Depression in the 1930s. The second section focuses on the need to set public finances back on track. The third section makes the case for healing the financial sector swiftly. The last section highlights the urgency of structural reforms to correct macroeconomic imbalances and to fix the ailing growth drivers.

1. EUROPE GOING THROUGH PARTICULARLY CHALLENGING TIMES

The European economy is slowly emerging from the deepest recession in decades. The economic crisis resulted in a large loss in economic activity in the EU, accompanied with millions of jobs lost and a high human cost. The structural weaknesses pre-dating the crisis which had not been tackled adequately became blatantly apparent.

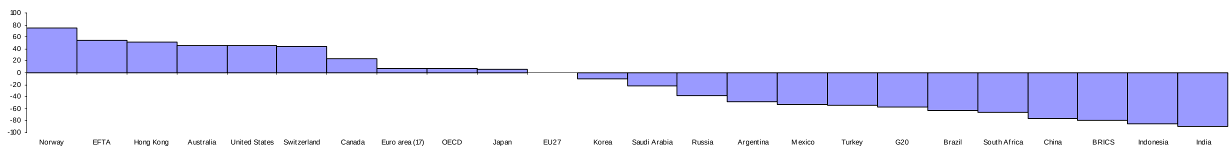
***The EU suffered from structural weaknesses before the crisis*.**

While the EU is a wealthy area, its economic growth in the past decade has been weak by international standards (see Graph 1)**.** In terms of GDP per capita, the EU-27 is much richer than the G20 average, but remains well below many non-EU OECD countries and the OECD as a whole. At the same time, its growth performance since 2000 has been very disappointing, below all the developed economies bar Japan and clearly behind most emerging economies. This means that the gap with regard to other developed economies is increasing. As catching up cannot explain the difference, EU's weak growth performance must be related to structural weaknesses. When one goes beyond GDP-type indicators, this overall dull picture conceals some strength in terms of life standards, such as relatively low income inequality, high life expectancy and relatively high environmental performance (for instance as measured by CO2 emissions by unit of output).

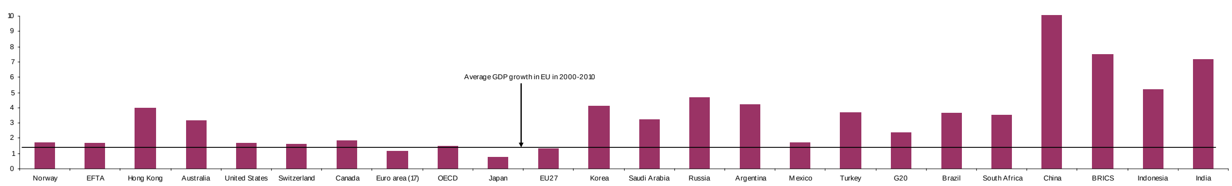
Various "bottlenecks" held back growth in the EU over the past decade. Standard growth accounting reveals that before the crisis (2001-07) labour productivity was the main driving force behind growth, while labour utilisation and the increase in working-age population only accounted for around one fourth of total growth; in particular, decreasing labour market participation of youth and prime-age men and a reduction in hours worked per persons were dragging growth down in the EU-27 (see Graph 2). The crisis darkened the picture further. It led to a contraction of GDP, with a sharp increase in unemployment and a significant drop in total factor productivity (TFP), mostly explained by the strong decrease in capacity utilisation. The EU and the euro area are clearly lagging behind the US and Japan as regards both TFP levels and labour utilisation; on the latter, the difference is especially profound at both ends of the age spectrum, as seen in the blatant difference in employment rates (see Graph 3).

Graph 1: **GDP level and growth**

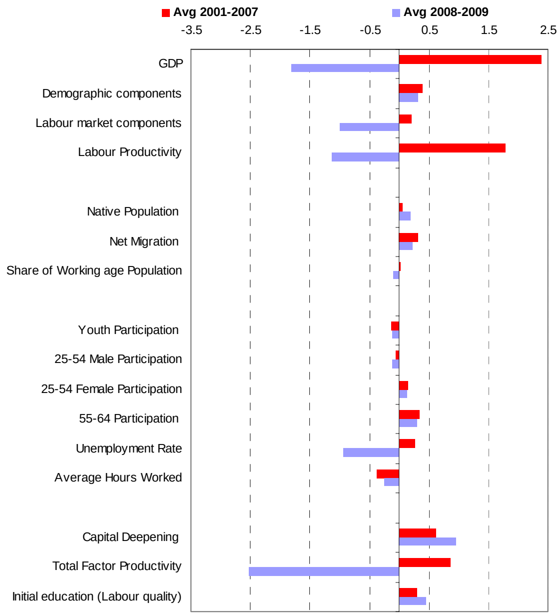
GDP per capita in 2010 *(% differential vis-à-vis EU-27 in PPS)*



Average economic growth in 2000-2010

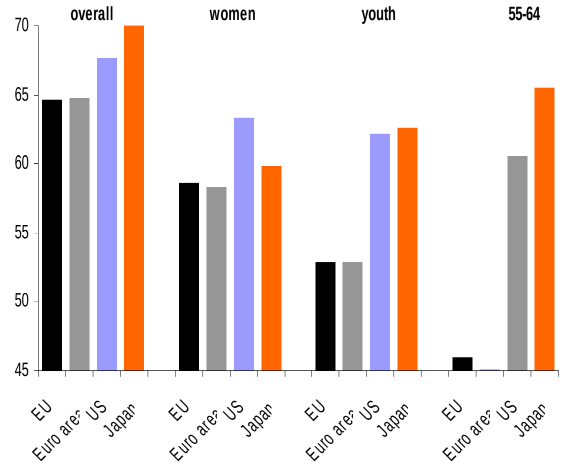


Graph 2: **Decomposition of GDP growth**



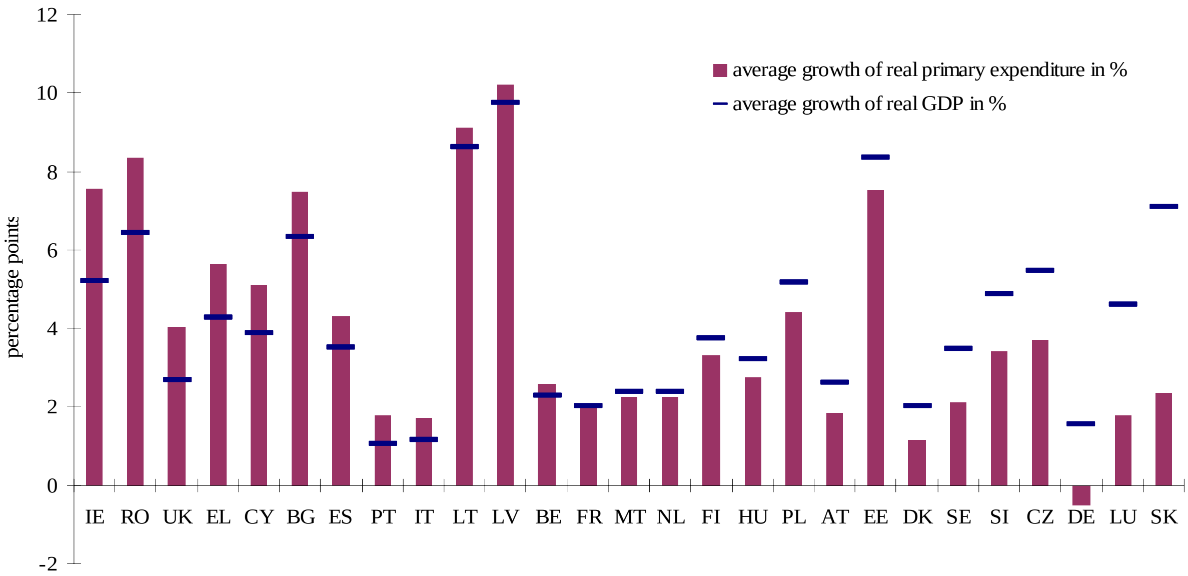
Graph 3: **Employment rate**

Total employment over working age population 20-64



Graph 4: **Real primary expenditure versus real GDP growth**

Average growth rates 2003-2007



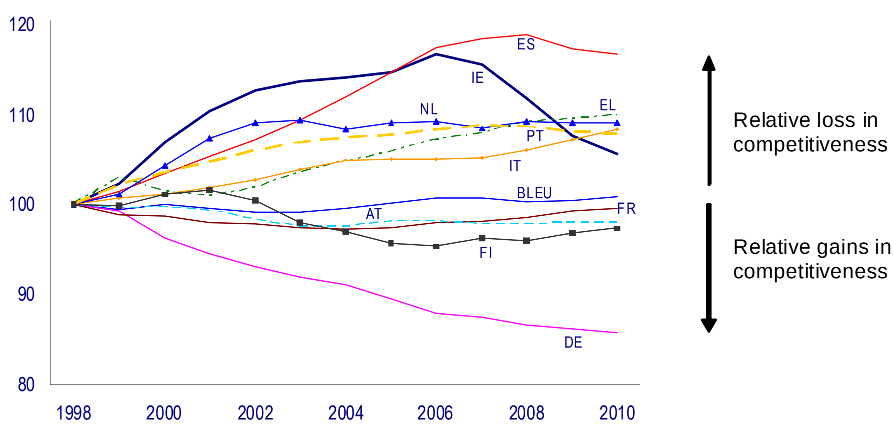
Note: Member States are ordered by the size of the excess of average real primary expenditure growth over average real GDP growth.

In the years preceding the crisis, several EU Member States deviated from the basic principles of prudent fiscal policy making. Significant revenue windfalls generated by the economic expansion in 2003-2007 were only partially used to accelerate fiscal adjustment. A non-negligible part went into additional spending: the growth rate of primary expenditure exceeded the average rate of economic growth in twelve EU Member States in the good times preceding the crisis (2003-2007), by a large margin in some cases (see Graph 4).The untenable nature of this policy choice became apparent with the onset of the crisis, when the collapse of government revenues suddenly revealed vulnerable underlying budgetary positions with, in many cases, little or no fiscal space left to respond to the economic contraction.

Over the decade preceding the crisis, macroeconomic imbalances in the EU increased considerably as well. Some Member States saw the building-up of significant domestic imbalances. This was reflected in the strong divergence in current accounts and competitiveness developments, as seen in Graph 5 for the euro area. Moreover, some euro area Member States have experienced a worrying loss in export market shares. External imbalances were fed by inappropriate responses of wages to productivity developments, excessive credit growth in the private sector, housing price bubbles as well as structural weaknesses of domestic demand[1].

Graph 5: **Evolution of price competitiveness relative to the rest of the euro area**

(indices; 1998 = 100, increases represent losses in competitiveness)

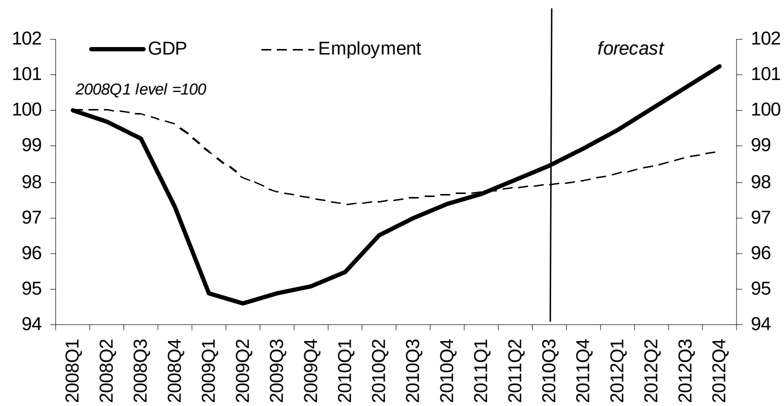


1 See European Commission (2010), Surveillance of intra-euro-area competitiveness and imbalances, European Economy 1.

Impact of crisis on the real economy and employment

Graph 6: **GDP and employment**

(2008Q1=100)



Sources: Eurostat; ECFIN Autumn forecast

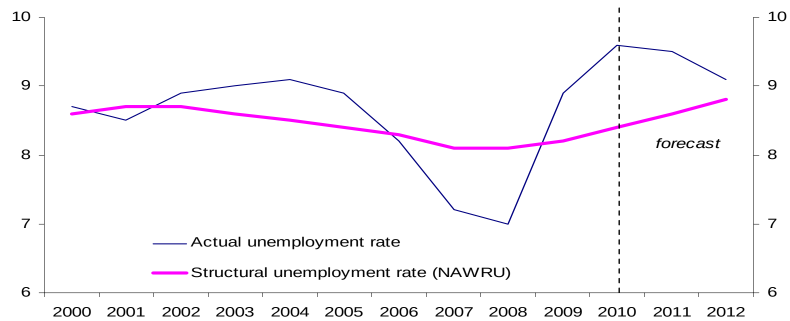
Note: the profile for forecast employment – available on an annual basis only – has been interpolated linearly to deduce its quarterly profile.

The deep contraction in GDP wiped out on average four years of growth. The loss in output in 2008 and 2009 sent the EU GDP back to 2006 level. The EU is expected to recover the output level seen in the first quarter of 2008 – before the crisis hit the real economy – in the second quarter of 2012 only, according to the Commission's Autumn 2010 economic forecast (Graph 6). By the end of 2011, only ten Member States are projected to have returned to their output levels in 2008 or above. By the end of 2012, eleven Member States are still expected to remain at output levels below those preceding the crisis. Employment is projected still to fall short of its pre-crisis level at the end of 2012 (by over 1%).

The crisis has taken a heavy toll on Europe's societies with a sharp rise in unemployment. The unemployed represented 7% of the labour force in the EU-27 in 2008. In 2010, they accounted for almost 10%, with the prospect of the unemployment rate remaining above 9% in 2012, as displayed in Graph 7. The unemployment rate is particularly high, exceeding 12%, in Estonia, Ireland, Greece, Slovakia, Latvia, Lithuania and Spain. Long-term unemployment – those unemployed for more than one year – has increased steeply and currently represents around 40% of total unemployment in the EU. This highlights the risk of durable exclusion from the labour market. The rate of unemployment is particularly high amongst the low-skilled, the migrants and the youth. Youth unemployment exceeds 20% in more than half of the EU Member States and reaches 42% in one country (Spain).

Graph 7: **Actual and structural unemployment rates in the EU-27**

(2008Q1=100)

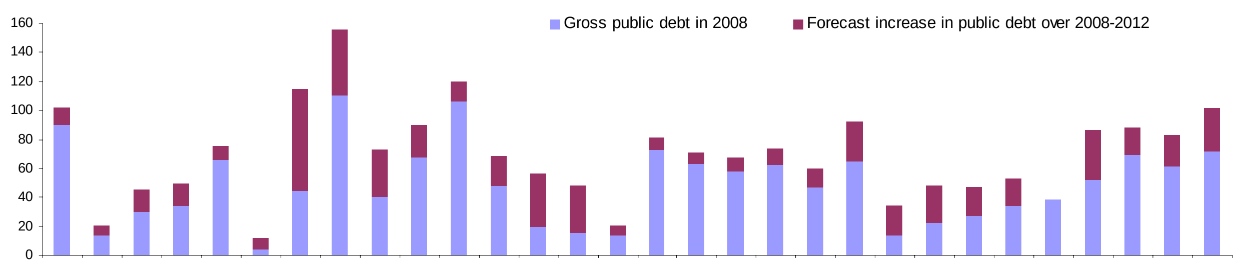


The crisis decreased potential growth further through the strong rise in structural unemployment and the sharp drop in the investment rate. Potential output growth in the EU-27 is expected to be particularly low (1.1%) over the forecasting horizon (2010-12), owing to both low productivity growth and low labour utilisation. The situation is expected to be even more lacklustre in the euro area, with broadly similar but more acute patterns. The lower use of labour is related to the significant rise in NAWRU (see Graph 7) but also to the further decline in average hours worked per worker and the contraction of working-age population. Potential growth will also be affected by slower capital accumulation resulting from historically low investment rates in the wake of the crisis, and by slow total factor productivity growth which is gradually recovering but only towards the already weak pre-crisis path.

Fiscal imbalances aggravated, with a slow reduction of macro imbalances

Graph 8: **Public debt level in 2008 and its forecast rise over 2008-2012**

(% GDP)



Sources: ECFIN Autumn forecast

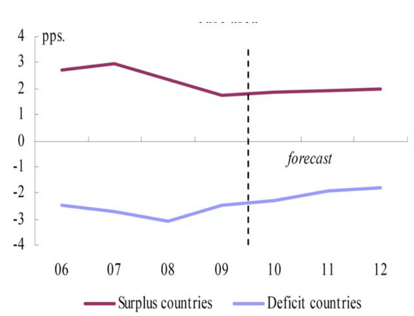
The crisis had a dramatic impact on public finances in the euro area and the EU. Within a short period of time, government debt-to-GDP ratios increased sharply in almost all Member States wiping out the moderate progress achieved in the pre-crisis years (see Graph 8). At the end of 2010 gross government debt is expected to have climbed to around 84% of GDP in the euro area and around 79% of GDP in the EU, some 20 percentage points above the 2007 levels. At current policies the upward trend is set to continue.

The current sharp deterioration of public finances results from a decline in revenues and increased pressures on expenditure as well as discretionary fiscal stimuli. Government finances in some Member States had become dependent upon highly cyclical or temporary revenue sources. This contributed to the collapse in government revenues on the back of a sharp contraction in economic activity while government expenditures were broadly kept at previously planned levels. Member States allowed their automatic stabilisers to fully function, which helped to soften the impact of global crisis on real economy. However, as this was insufficient to stem the fall in demand and avert the risk of a meltdown of financial systems, most EU governments also implemented discretionary fiscal measures under the common framework of the European Economic Recovery Programme launched by the European Commission in December 2008.

This recent added pressure on public finances comes on top of the negative public finance effects of demographic ageing. This process has been in the offing for a long time and, in the absence of reforms taken soon, will inexorably produce a significant budgetary burden in the long-term, which will further aggravate the already worrying fiscal situation. With unchanged policies, public support for the elderly in terms of provision of pensions and other old-age benefits (healthcare and long-term care) is projected to increase by some 4½ percentage points of GDP in the EU over the next 50 years. In around one third of the Member States, the increase in ageing-related government spending is likely to exceed 7 percentage points of GDP.

The crisis has only partly, and temporarily, corrected the large macroeconomic imbalances prevailing in many Member States before its outbreak. As the current recession has compressed excessive demand and removed or mitigated some drivers of divergence (i.e. housing market bubbles and credit expansion), the current account deficits have decreased. However, current account imbalances remain significant, especially within the euro area, and are not expected to unwind quickly, as seen in Graph 9. Graph 10 shows that those EU Member States which recorded a large deficit (surplus) in the balance of goods and services at the onset of the crisis were generally still in deficit (surplus) two years later, when economic activity picked up. This partly reflects structural weaknesses, such as weaknesses in domestic demand (in surplus countries) and weak price and cost competitiveness, often combined with high debt levels (in deficit countries).

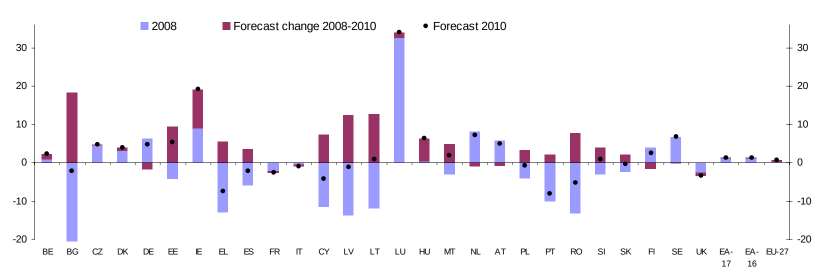
Graph 9: **Decomposition of the current account, euro area**



Sources: ECFIN Autumn forecast.

Graph 10: **Balance of goods and services and its forecast change up to 2010**

(positive values= surplus; negative values= deficit; % GDP)

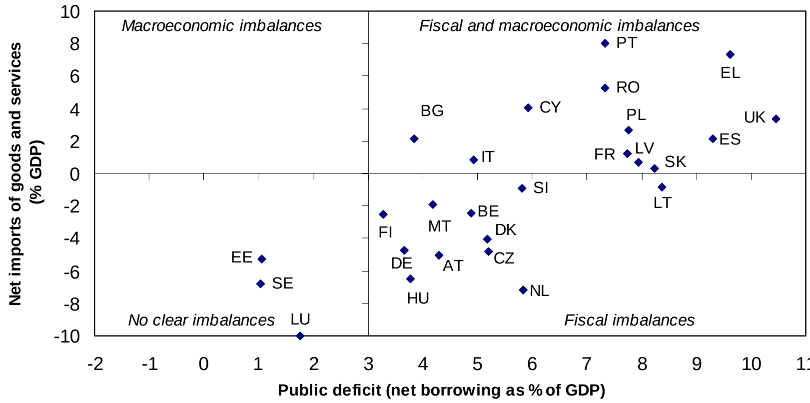


Note: Euro area Member States are identified as surplus or deficit countries on the basis of their current account position in 2006.

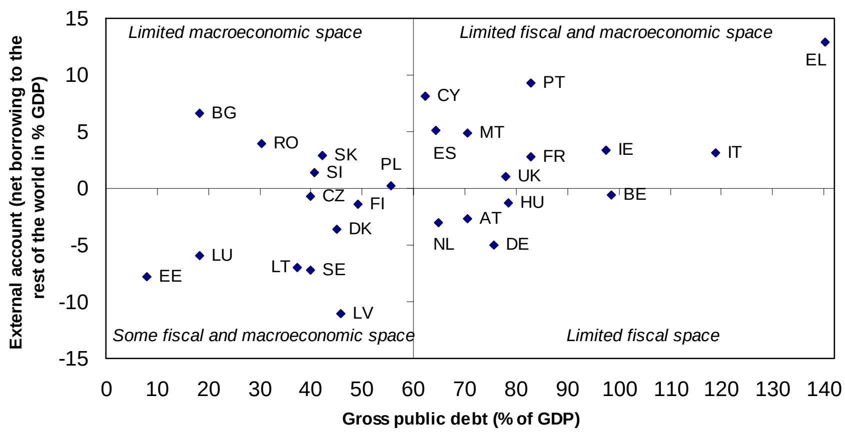
The need for differentiated policy responses across Member States

Graph 11: **Differentiated starting conditions in 2010**

*Public deficit /net import of good and services***



*Public debt /external account deficit**



Source: ECFIN Autumn forecast

**External account deficit means net borrowing vis-à-vis the rest of the world (current account plus capital transactions). This concept shows the annual change in external indebtedness.*

*** Net imports of goods and services is also called 'deficit in the balance of goods and services', and is directly influenced by price competitiveness. The surplus for LU exceeds 30% of GDP, outside the boundaries of this chart.*

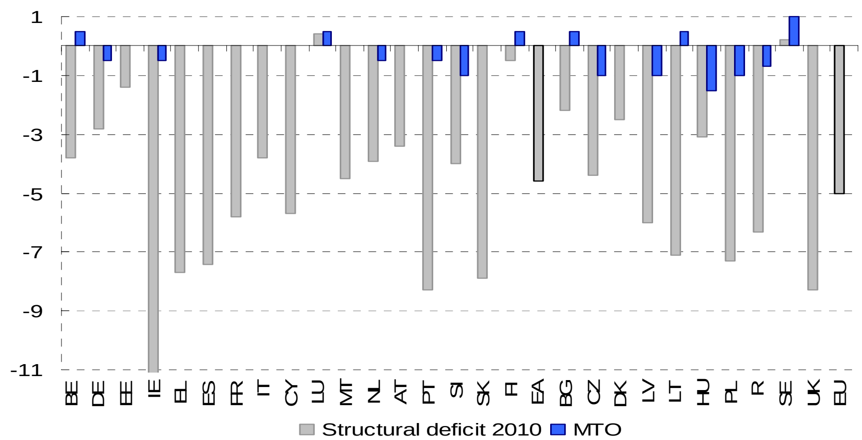
EU Member States experienced highly different fiscal and external conditions, which call for tailor-made policies. Graph 11 shows in a purely illustrative manner and using different indicators that some Member States face particularly pressing challenges in terms of adjusting their unsustainable public finances and correcting their external imbalances. A one-size-fits-all approach will not work, and Member States' priorities in 2011-2012 should be shaped inter alia by risks to fiscal sustainability and the need to correct imbalances. Member States with large fiscal and/or macroeconomic imbalances face a hard constraint on their policy options and should, as a matter of priority, correct existing imbalances. Member States without major macroeconomic problems or discernable risks should strive to improve longer-term growth drivers, while preventing the occurrence of future imbalances.

2. REINING IN PUBLIC DEBT THROUGH A RIGOROUS AND DURABLE FISCAL CONSOLIDATION

The need to consolidate now

Graph 12: **Structural deficits and MTOs**

(% GDP)



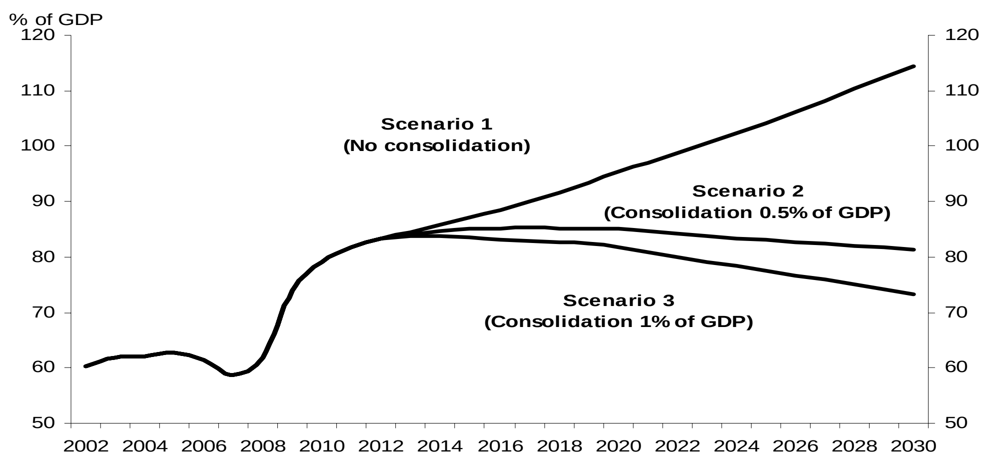
While the crisis has hit government budgets in all EU Member States, the actual state of public finances varies significantly across Member States. As displayed in Graph 12, the distance of the deficit – corrected for the business cycle and one-off measures, i.e. structural deficit – from the medium-term budgetary objective (MTO) is particularly large (more than five percentage points of GDP) in twelve Member States. Member States which followed a more cautious course of fiscal policy ahead of the unprecedented economic downturn are in a comparatively better situation. They had more fiscal space to lean against the headwinds of the recession and, as a result, have accumulated lower fiscal imbalances during the crisis.

Withdrawing the discretionary fiscal stimulus implemented during the crisis will not be sufficient to restore long-term sustainability of public finances. The debt-to-GDP ratio will not only suffer from the accumulation of public deficits but also from the implicit liabilities foreseeable with population ageing and the expected slow medium-term growth in the euro area and the EU**.** Moreover, government debt ratios in the EU have now reached levels beyond which additional government borrowing acts as a drag on economic growth rather than stimulating it. Servicing high government debt levels requires higher potentially distortive taxes and crowds out productive government spending through higher interest expenditure or both. Further debt building is also likely to increase the risk premia on government bonds further, raising the debt servicing burden even more, generating an unsustainable dynamic and eventually casting doubt on governments' solvency in financial markets.

The adjustment effort required to put public finances back to a sustainable path is very significant and should be complemented by growth policies. Simple simulations indicate that an annual improvement of the structural budget balance of 0.5% of GDP - the conventional benchmark under the provisions of the Stability and Growth Pact (SGP) - would clearly be insufficient in many EU Member States to bring the debt to GDP ratio close to the Treaty-based threshold of 60% of GDP in the foreseeable future (see Graph 13). Only fiscal corrections of 1% of GDP per year or more would put debt levels in percent of GDP on a firm downward path over the coming two decades. However, fiscal consolidation, while absolutely necessary, might not always be sufficient to reverse adverse debt dynamics quickly and durably. Stronger output growth is imperative to increase fiscal revenue and lower unemployment-related expenditures, while automatically reducing the level of debt expressed as a share of GDP.

Graph 13: **Public debt projection in the EU**

Percentage of GDP



Note: the projections assume the given rate of consolidation for each Member State until it meets its medium-term budgetary objective (MTO).

As a result, fiscal policy makers in the EU face a formidable double challenge: putting fiscal policy back on a sustainable path while protecting or supporting short-run economic growth and employment. Under current circumstances, there is reason to believe that getting public finances in order will have a positive impact on economic growth in the medium run. Delaying fiscal adjustment would only push out and compound the problem. It would seriously compromise our ability to actively shape our future, and heavily mortgage future generations.

Although the degree of urgency is not the same in all Member States, consolidation remains a key policy priority for all. In 2010, fiscal policy continued to support aggregate demand in the EU and the euro area. As economic recovery is expected to gain gradually momentum in the coming years, it is time to switch the policy stance. Member States with very large structural budget deficits or very high public debt-to-GDP ratios should be frontloading their adjustment in 2011-12. This should be the case in particular for Member States facing high levels of financial distress: some Member States such as Greece and Ireland will accelerate their adjustment in both years, while Spain and Portugal will only do so in 2012.

Key ingredients for a durable and growth-friendly consolidation

History provides rich evidence on how to turn fiscal consolidation into a success in terms of both its lasting effect on public finances through time and the impact on economic growth. The lessons of the past concern five interrelated dimensions of fiscal policy making: the composition of fiscal adjustment, the credibility of the policy strategy, the institutional context, complementary policy initiatives and the burden sharing across society.

(1) *Composition of fiscal adjustment:* The single most important factor discriminating between success and failure of fiscal consolidation is the composition of adjustment. Expenditure-based corrections, especially corrections of current primary expenditure, are more likely to produce a lasting improvement in public finances and a milder, under some circumstances even a positive, impact on short-run economic growth than revenue-based corrections. Curbing expenditure developments is less distortive for growth than raising the tax burden, which is already high in the EU though significant variation exists among the Member States. In terms of credibility, expenditure cuts demonstrate a stronger commitment of the government to pursuing consolidation efforts. Revenue increases and cuts of investment expenditure may be easier to implement politically, yet weigh on the medium- to long-run growth prospects of an economy and are often reversed over time. In many Member States expenditure control will have to be supplemented by revenue-raising measures. Due attention should also be given to the quality of taxation, by collecting revenues in an efficient way and minimising the negative impact on economic growth while taking equity considerations into account. Broadening tax bases, for example by removing environmentally harmful tax exemptions or tax credits, is preferable to increasing tax rates. Some existing tax expenditures may have no sound economic rationale or provide incentives not in line with their original aims. Tax on immovable property followed by consumption taxes, including environmentally related taxes, are least distortive, while personal income taxes and corporate income taxes could have a more harmful impact on growth.

(2) *Credibility of the policy strategy:* Convincing and credible plans can generate expectations of lower real interest rates and lower future tax liabilities and, hence, have the potential of boosting consumption spending of private households and investment spending of firms. In practice, the credibility of a multi-annual adjustment plan can be bolstered by front-loading legislation setting out in a legally binding way a roadmap of successive measures that contribute to the planned multi-annual adjustment.

(3) *Fiscal institutions:* The success of fiscal consolidation also depends on the government's capacity effectively to implement the agreed policy measures via adequate national fiscal frameworks. The quality of the institutional and procedural arrangements governing budgetary policies, such as fiscal rules and multi-annual fiscal frameworks, influences the

ability of governments to draw up and effectively put into practice fiscal consolidation programmes without creating excessive political and economic frictions.

(4) *Flanking policies:* Budgetary policies typically interact with other instruments of economic policy making. This is also the case for fiscal consolidation. The complementary implementation of structural reforms will raise the odds of achieving a lasting fiscal correction, which also protects economic growth in the short run. The channels through which structural reforms help fiscal consolidation are twofold: directly by capping or flattening existing expenditure trends and indirectly by improving the functioning of markets which, in the end, supports economic activity. In actual fact, it is the structural reform dimension which confers and ensures the lasting character of a fiscal adjustment. Some structural reforms, notably reforms of pension systems, could have a positive impact on public finances already in the medium term through curbing expenditures and increasing labour supply.

(5) *Socially-balanced fiscal adjustments:* Ensuring sound public budgets is a necessary condition to avoid that public debt growing out of control puts in jeopardy our social security systems in the future. In order to achieve the necessary political acceptance, the burden of adjustment needs to be distributed fairly across the different layers of society. Adjustments skewed towards specific constituencies are likely to be reverted as the political composition of governments change endangering the sustainability of fiscal adjustment.

Policy priorities

In order to address the challenges outlined above, action is needed in particular in the following areas in 2011-2012:

- **At the EU level**, the legislative proposals to strengthen economic governance should be adopted according to the fast-track agreement between the co-legislators.
- **Consolidation in all EU Member States should imperatively start – or continue – in 2011.** The planned pace of the fiscal consolidation should be ambitious, and will have to go well beyond the benchmark of 0.5% of GDP per annum in structural terms in most Member States. Member States facing very large structural budget deficits, very high levels of public debt or high levels of financial distress need to frontload their efforts in 2011. Where economic growth or revenues turn out to be higher than expected, fiscal consolidation should be accelerated.
- **Member States in excessive deficit procedure should set out the expenditure path and the broad measures they intend to take in order to achieve the elimination of their excessive deficits.**
- **All Member States should primarily adjust government expenditure, while protecting growth friendly expenditure** e.g. in the area of public infrastructure, education and research and innovation. All Member States, especially those in excessive deficit procedure, should pursue prudent fiscal policy by keeping public expenditure growth firmly below the rate of medium term trend GDP growth. This should be complemented by efforts to raise the cost-

efficiency of public expenditures. Where adjustment needs are particularly pressing, expenditure should be reduced. All Member States need to demonstrate that their Stability or Convergence Programmes are based on prudent growth and revenue forecasts.

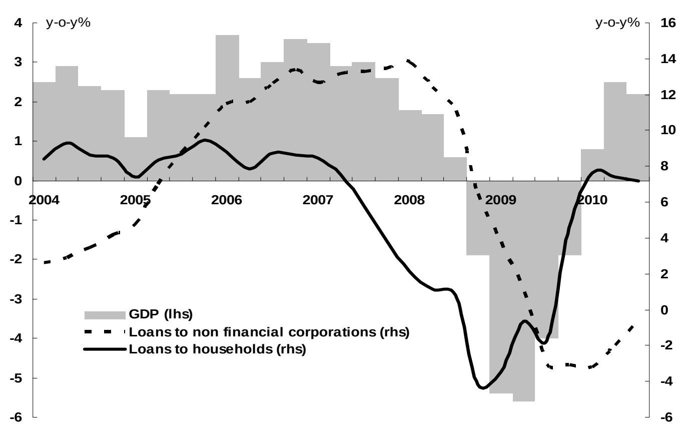
- **When a contribution from taxes is necessary, economic distortions should be minimised.** At any given level of the overall tax burden, tax systems should be reviewed to make them more employment, environment and growth-friendly, for example via "green tax reforms" which consist of increasing environmental taxes while reducing other more distortionary taxes. Broadening the tax base is preferable to raising tax rates.

- **Pension reforms, aiming *inter alia* at raising the effective retirement age, should be enacted and implemented without delay.** This will ensure the sustainability of public finances and lead to an increase in active population. Health care systems need to be rigorously monitored and, where needed, reformed to ensure greater cost-efficiency and sustainability, especially in regard to demographic ageing.

- **Member States are encouraged to improve their domestic fiscal frameworks**, in the area of national systems of public accounting and statistics, macroeconomic and budgetary forecasts, numerical fiscal rules, medium term budgetary frameworks, transparency of general government finances and comprehensive scope of budgetary frameworks.

3. HEALING THE FINANCIAL SECTOR SWIFTLY TO FIND THE PATH TO RECOVERY

Graph 14: **Bank lending in the EU**



Source: ECB.

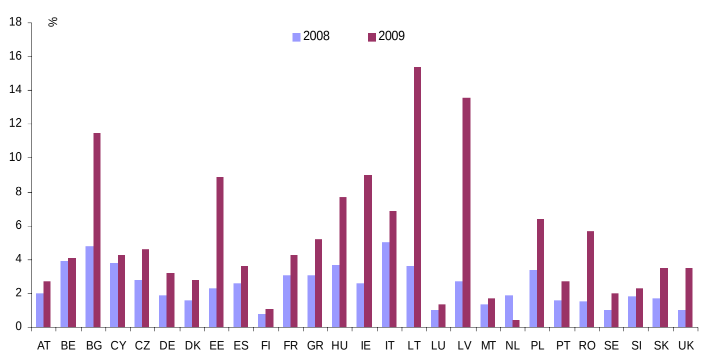
There is a strong correlation between a healthy credit expansion and sustained economic development. Since the outbreak of the financial crisis, credit growth is subdued, notably in corporate lending, as banks have tightened credit standards and firms' demand for financing is low given the poor economic outlook. Since the beginning of 2010 a pick-up in lending is noticeable and coincides with a timid recovery (see Graph 14). The ECB Bank Lending Survey of October 2010 shows that banks have stopped tightening lending conditions for enterprises and an easing of standards is expected for households. However, the lending conditions are not consistent with a strong economic recovery, especially regarding the loans to non-financial corporations (see Annex table).

Balance sheet repair in the banking sector is essential to improve cost efficiency, restore competitiveness and return to normal lending. Yet, banks' profitability outlook is uncertain amid a sluggish recovery, heavy exposures to the real estate sector and tensions in the sovereign debt market. The negative feedback-loop from the real economy to the financial sector has been reinforced in some Member States with high household and non-financial corporate sector indebtedness. As a result, the level of non-performing loans has increased considerably and may increase further in the near term (Graph 15). Recently the overall situation of the banking sector has shown tentative improvement, with higher profits and a strengthening of the capital buffers, though in some cases it reflects capital injections by the government.

A swift exit from sizable public support to banks will remove possible distortions to competition in the financial industry. In more than half of the Member States government assistance exceeded 5% of GDP and included measures such as capital injections, liquidity interventions, asset relief and guarantees (see Graph 16). Exit strategies from public support to banks have been initiated while maintaining flexibility in order to address possible macro-financial stability concerns. Cross border effects of the public interventions have to be taken into account due to the high financial integration in the European Union as illustrated by the level of banking sector assets abroad which attains 50% of GDP for many Member States (see Graph 14).

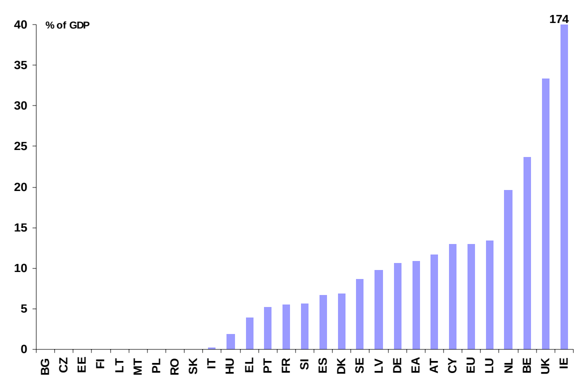
Graph 15: **Non-performing loans in the EU**

Percentage of total loans



Source: ECB, IMF

Graph 16: **Public interventions in the EU banking sector**

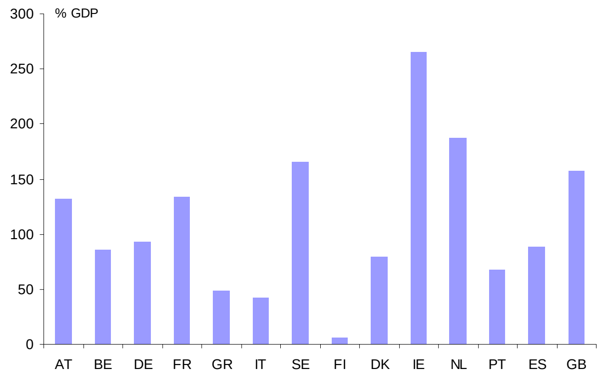


Source: Commission Services (January 2010).

Confidence in the banking sector is a prerequisite for maintaining financial stability. One of the tools to maintain confidence on the speed of the exit strategies is the stress test exercise. The objective of the exercise is to assess the banking sector's resilience to low-probability but high-impact events. The sensitivity of the capital buffer is examined to adverse economic and financial conditions. Based on rigorous assumptions, the next EU-wide stress test exercise will be conducted in 2011. The results of the next exercise will be available in June 2011. A good cooperation among national supervisors and EU authorities is critical in this context as well as a clear and transparent communication of the results and their implications.

Graph 17: **Banking sector assets abroad**

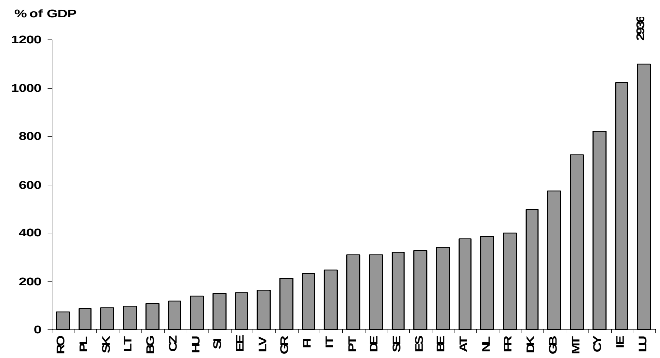
Percentage of GDP



Source: BIS, Eurostat

Graph 18: **Total banking sector assets**

Percentage of GDP



Source: ECB

The recent crisis has exposed a clear gap in the EU regulatory framework for the banking sector and strengthened the case for action at EU level. The interconnectedness of banks and financial institutions across EU Member States – and with non-EU countries – underscores the importance to monitor developments in the financial sector in an international context. The size of the banking sector assets measured as a percentage of GDP points to the particular vulnerability of some Member States in case of a systemic crisis and the blatant insufficiency of the fiscal means to deal with major financial disruptions (Graph 18). Accordingly, at the EU level the regulatory and supervisory framework has been strengthened and should be completed rapidly. In October 2010, the Commission outlined the aims of the legal framework for crisis management in the financial sector, which will be proposed in spring 2011. The overriding aim is to allow a bank to fail – irrespective of its size – while ensuring the continuity of essential banking services, minimising the impact of that failure on the financial system and avoiding costs to taxpayers. This is essential to avoid the 'moral hazard' that arises from the perception that some banks are too big to fail. Beyond equipping the authorities with common and effective tools and powers to tackle bank crisis, it is also essential to ensure a smooth cooperation among the Member States and the EU institutions both in advance of and during a crisis.

A permanent "European Stability Mechanism" will be established by euro area Member States to safeguard the financial stability of the euro area as whole. It will replace the current European Stabilisation Mechanism, which consists of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), which will remain in force until June 2013.

Basel III rules impose tougher capital requirements on banks, which will enhance macro-financial stability. In September 2010, the Basel Committee on Banking Supervision announced a substantial strengthening of existing capital definitions. In general, banks' capital will be lower according to the new definition, which increases the gap with the regulatory requirements. In addition to stricter definitions, the minimum capital requirements will also be gradually increased.

Policy priorities

In order to address the challenges that were outlined above, action is needed in particular in the following areas in 2011-2012. In this, coordination at EU level is of paramount importance.

- Restructuring of banks, and particularly those which received significant amounts of State aid, is essential to restore their long-term viability and ensure a properly functioning credit channel. Bank restructuring will therefore safeguard financial stability and underpin the provision of credit to the real economy. Public financial support for the banking sector as a whole should be gradually withdrawn, taking into account the need to safeguard financial stability.

- **Progress is needed in establishing a permanent mechanism for resolving sovereign debt crises so as to provide certainty and stability in financial markets.** In 2013, the new European Stability Mechanism will provide stability in markets and complement the new framework for reinforced economic governance, aiming at an effective and rigorous economic surveillance, including reviewing the effectiveness of the current financial backstops.

- **The implementation of financial reforms must continue,** including a reinforcement of the regulatory and supervisory framework and addressing the market failures exposed by the crisis. At EU level, the regulatory framework must be further reinforced, while the quality of supervision should be enhanced by the ESRB and European Supervisory Authorities, which are operational as of the beginning of 2011.

- **Banks will be required progressively to strengthen their capital base so as to improve their capacity to withstand adverse shocks.** This is in accordance with the recently agreed Basel III framework. In addition, another more ambitious and stringent EU-wide stress test will be conducted in 2011 with a view to assessing the resilience of the banking sector.

4. STRUCTURAL REFORMS TO SUPPORT GROWTH AND CORRECT MACROECONOMIC IMBALANCES

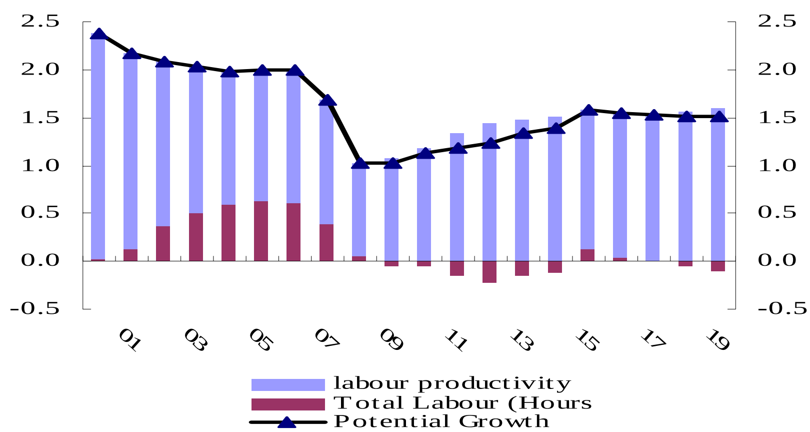
Structural reforms can serve two goals: restoring the main growth drivers, and preventing or correcting imbalances as a key framework condition for growth. These reforms can boost the use of labour and labour productivity. Structural reforms can also help restore competitiveness and reduce external imbalances in the short run by reducing price and wage rigidities.Facilitating the needed reallocation of labour and capital across sectors and firms is instrumental for both growth and the reduction of external imbalances. While many structural measures could support both growth and macroeconomic adjustment, some of them, such as educational policies, require more time to pay off and are better suited to unlock long-term growth drivers. Nevertheless, this does not mean that action to strengthen these policies should be deferred.

Accelerating reforms to raise growth and jobs

In the absence of resolute policies, potential growth is likely to remain weak in the coming decade[2]. Over the period 2011-20, the average potential growth rate is projected to be around 1½% in the EU-27 in absence of policy changes, as seen in Graph 19. This is significantly lower than the rates observed in the EU in the past two decades, which were, moreover, much lower than those recorded in the US. This is accounted for by the pronounced underutilisation of labour in the wake of the crisis, combined with the contraction of labour due to population ageing at the end of the period and fairly slow productivity growth in the EU-27. Most Member States have been strongly affected by the crisis, through both capital accumulation and labour utilisation, and are expected to record a reduction in their labour resources at the end of the decade owing to the population ageing.

Graph 19: **Potential output growth up to 2020 in the EU-27**

Macroeconomic scenario based on the production function approach



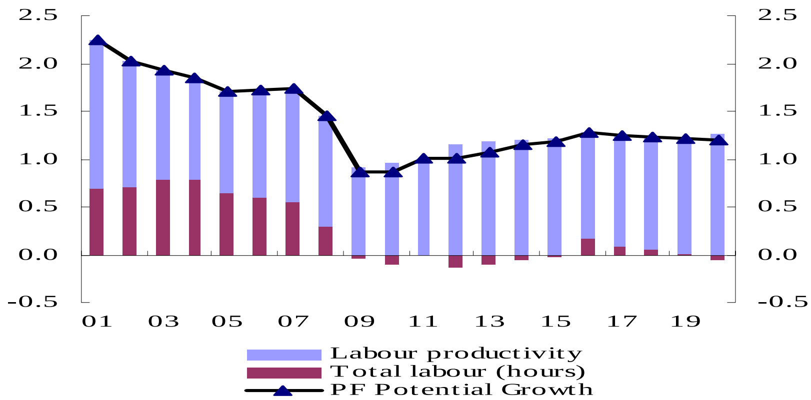
Source: ECFIN Autumn forecast

Confirming past trends, the growth outlook is even worse in the euro area. Over the period 2001-2010, average potential growth was 1. 6% in the euro area, as compared with 1.8% in the EU-27 (Graph 20). The picture for output growth and productivity growth will be particularly gloomy for the euro area in the decade ahead, as both are expected to stand at around 1¼% on average. However, the projected use of labour is very similar to that expected for the EU as a whole.

[2] Potential growth corresponds to a concept of sustainable trend growth compatible with supply-side conditions, correcting for the short-term cyclical fluctuations in actual GDP growth.

Graph 20: **Potential output growth up to 2020 in the euro area**

Macroeconomic scenario based on the production function approach



Source: ECFIN Autumn forecast

The experiences from past economic and financial crises indicate that policy responses matter greatly. For example, the deep recessions which started in 1991 in Sweden and Finland were relatively short lived and did not result in a reduction in potential output growth. This was *inter alia* thanks to significant restructuring of their economies. On the other hand, an insufficient policy reaction to the financial crisis, combined with mounting competitive pressures from emerging economies, contributed to the slowdown in long-run potential growth in Japan in the course of 1990s.

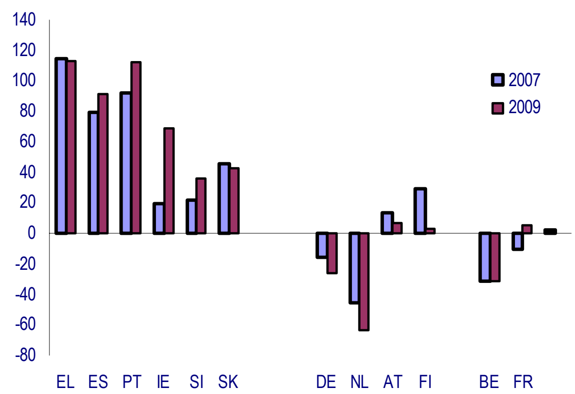
Urgent actions are required both at national and EU level. EU-level policies will contribute to raising growth by, for instance, strengthening the Single Market and facilitating the conditions for investment In all Member States, removing the most important bottlenecks to growth in the medium-term would imply frontloaded structural reform efforts (for more detail, see the progress report on Europe 2020 annexed to the Annual Growth Survey).

Correcting macro imbalances and restoring the key framework condition of growth

Tackling external imbalances is particularly relevant for the euro area and will require comprehensive structural reforms geared at speeding-up and improving adjustment. The correction of imbalances is crucial for the EU and even more so for the euro area, as a monetary union. Imbalances in some euro area Member States may also undermine the credibility of the single currency. Economic policy actions will be needed in many different areas including in labour, product and services markets. The policy response will have to differ significantly across Member States and will have to be carefully designed to address the specific vulnerabilities and needs of the country concerned while taking into account potential spillovers across the EU. In general, structural policies should strive to make the economies more flexible to cater for the adjustment needs in the EU.

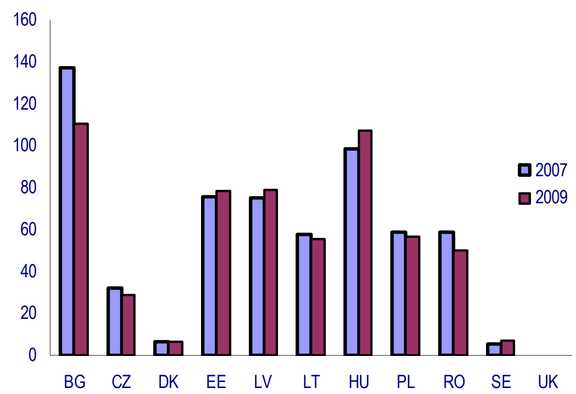
Graph 21: **Net external financial liabilities; euro area Member States**

% GDP



Graph 22: **Net external financial liabilities; non-euro area Member States**

% GDP (different scale from Graph 23)



Note: Data are not available for Cyprus, United Kingdom, Malta and Luxembourg

For Member States showing large current account deficits, weak competitiveness and weak adjustment capacity, large price and cost adjustments will be needed to restore domestic and external competitiveness. An important metric to assess the sustainability of current account deficits is the overall net foreign asset position, measuring the level of external debt (Graphs 21 and 22). Despite the reduction in the level of current account deficits following the crisis, large deficit Member States have continued to see their debt grow vis-à-vis the rest of the world. While market mechanisms could drive this adjustment by a strong contraction in domestic demand and a large unemployment rise, a faster and less painful adjustment could be achieved via appropriate wage policies. These would include changes to wage indexation rules, appropriate signals from public sector wage settlements and more efficient wage setting mechanisms. Product market reforms will also be necessary to tackle nominal rigidities and reduce the final good prices by lowering the embedded rent (i.e. lower mark-up of prices over costs). The full implementation of the services directive, which will enhance competition in regulated services, is a particularly important policy step. Policies to strengthen non-price competitiveness are also essential in this respect.

Measures tackling the nominal rigidities would need to be completed by structural measures supporting the reallocation of labour across firms and sectors. Moving the economy to a more sustainable path will require unwinding all past excesses and therefore not only improving the price-competitiveness of the export sector and reducing the relative prices of non-tradable. The price rebalancing will be associated with rechanneling of capital and labour resources from the non-tradable to the tradable sector, directly exposed to foreign competition. On the labour side, this reallocation will include an adaptation of employment protection legislation and better financial incentives to move from unemployment to employment. This reallocation will be supported by relative wage adjustment between tradable and non-tradable sectors. Active labour market policies will have a supporting role: strengthening placement agencies, providing training, and better targeting active labour market policies to most vulnerable groups. The improvement in the business environment, implying enhancing competition in regulated services and further reduction in administrative burdens, may support capital mobility in the direction of the most productive sectors.

In Member States with large current account surpluses, the sources of persistently weak domestic demand need to be identified. Recent data are encouraging and indicate that an adjustment is ongoing with domestic demand increasingly gaining strength and past (corporate) balance sheet adjustment processes coming to an end. However, where domestic demand still remains somewhat subdued due to a policy or market failure, appropriate policies should be put in place. Such policies could include further liberalisation of the services sector and improving the conditions for investment.

Policies need to be put in place to prevent imbalances from emerging in the future. The conditions that have led to excessive credit growth and asset price bubbles will need to be reviewed. A key challenge for policy makers will therefore be to devise and put in place structural reforms that limit the occurrence of credit and asset price excesses but also to devise specific instruments to cool-off demand if necessary. Regulatory measures reducing the pro-cyclicality of credit supply appear to be particularly relevant in this context and more work is needed. Without prejudice to the internal market, this could mean to ensure that bank capital requirements duly reflect regional differences in asset price overvaluation. Structural features of the housing market that increase the likelihood of bubble building including tax incentives for mortgages need to be reviewed. Moreover, improved flexibility and adjustment capacities of the economies through product markets and will render them more resilient and facilitate the necessary adjustments in case of major shocks.

Policy priorities

In order to address the challenges that were outlined above, action is needed in particular in the following areas in 2011-2012:

- **EU-level growth drivers must be mobilised.** Agreements should be sought on key legislative proposals in the context of the Single Market Act (for more detail, see the progress report on Europe 2020).

- **In Member States with large current account deficits or high levels of indebtedness, reforms affecting wage-setting systems and services markets are important to improve price and wage responsiveness.** Improvements in the business environment through enhancing competition (e.g. via the Services Directive) and reductions in administrative burdens will also help in this respect.

- **Measures supporting the reallocation of resources across firms and sectors are strongly needed.** They include an employment protection legislation which does not hinder reallocation of resources across sectors, better financial incentives to work and active labour market policies better targeted to the most vulnerable. Measures that eliminate hindrances to entry and exit (start-up conditions) and investment (such as the harmonisation of corporate tax bases) will also be important in facilitating sectoral reallocation towards higher value added and faster growth activities.

- **Member States with large current account surpluses need to identify and tackle the sources of weak domestic demand.** Such policies could include further liberalisation of the services sector and improving the conditions for investment.

- **All Member States should frontload structural reform efforts that remove their most important bottlenecks to growth in the medium-term.** Based on the draft National Reform Programmes (NRPs) submitted by Member States, the planned measures appear to be insufficient in terms of ambition, and thus are unlikely to have a material impact on growth and jobs in the medium run. Member States, in their final NRPs, need to be much more precise on their reform plans, to frontload key actions and to step up their overall level of ambition.

Annex : Table 1. Some country-specific indicators on growth and jobs, fiscal position, financial market conditions and macro imbalances

	Growth and Jobs						Public Finance				Macroeconomic Imbalances					Financial Markets			
	GDP per capita	**GDP growth**	**Employ - ment rate**	**Employ - ment growth**	**Unemploy - ment rate**	**Labour productivity**	**Fiscal position**	**Gross public debt**	**Fiscal sustaina - bility (S2)**	**Overall tax burden**	**Current account as a share of GDP**	**Net foreign assets**	**REER (UCL defl.)**	**Private sector debt as a share of GDP**	**HICP**	**LT interest rate spreads vis-à-vis Germany**	**Capital adequacy ratio**	**Non perfor- ming loans**	**Return on equity**
	Level compared to EU27 =100	Annual rate of change	Age group 20-64	annual rate of change		Level compared to EU27 =100	Net lending, % GDP	%GDP	High level means weak sustainability	Total taxes as % GDP	3 y. back. average of Current transaction balance, % GDP	% GDP	% difference from LT average. High value means lower competitive -ness	levels	annual rate of change				
	09	11-12	09	11-12	09	08	09	09	09	09	09	09	09	09	09	2010-Q3	09	09	09
BE	128	1.9	67.1	0.5	7.9	125.1	-6.1	96.2	6.5	45.7	2.3	35	7.8	223	0.0	0.7	17.3	4.1	-2.4
DE	129	2.1	74.8	0.5	7.5	104.7	-3.0	73.4	4.5	41.1	6.5	30	-5.8	154	0.3	0.0	14.3	3.2	-1.8
IE	148	1.4	66.7	-0.1	11.9	132.1	-14.4	65.5	14.8	29.6	-4.7	.	20.2	387	-1.9	3.2	12.8	9	-36.1
EL	78	-0.9	65.8	0.6	9.5	98.0	-15.5	126.8	20.3	33.0	-15.4	-110	12.8	139	1.5	8.4	11.7	5.2	2.1
ES	82	1.2	63.7	-1.3	18.0	111.0	-11.1	53.2	15.3	32.3	-8.4	-90	12.4	289	-0.3	1.8	12.2	3.6	8.8
FR	121	1.7	69.6	0.9	9.5	120.6	-7.6	78.1	7.1	43.8	-2.6	-2	5.1	224	0.1	0.4	12.2	4.3	0
IT	97	1.3	61.7	0.2	7.8	109.8	-5.2	116.0	2.6	43.4	-2.7	.	14.6	176	0.8	1.5	11.7	6.9	4
CY	80	1.9	75.7	0.5	5.3	88.9	-6.0	58.0	12.5	34.2	-12.7	.	10.3	.	0.2	2.2	12.1	4.3	10
LU	281	3.0	70.4	1.8	5.1	169.9	-0.7	14.5	12.7	38.0	6.9	.	12.7	.	0.0	0.3	18.1	1.3	8
MT	57	2.1	58.8	1.3	7.0	88.1	-3.8	68.6	6.4	36.1	-6.0	.	11.5	.	2.0	1.6	24.2	1.7	17.6
NL	138	1.6	78.8	0.3	3.7	111.0	-5.4	60.8	8.5	39.0	5.5	63	8.7	251	1.0	0.2	15	0.4	-0.2
AT	138	1.9	74.7	0.7	4.8	111.6	-3.5	67.5	4.6	44.4	3.4	-4	-1.9	156	0.4	0.5	12.7	2.7	2.8
PT	61	-0.1	71.2	-0.5	9.6	74.1	-9.4	76.1	8.9	33.9	-11.0	-106	8.7	332	-1.0	3.2	10.5	2.7	5.4
SI	66	2.3	71.9	0.2	5.9	81.8	-5.8	35.4	12.2	38.0	-4.2	-35	9.2	178	1.0	1.3	11.7	2.3	1.1
SK	30	3.4	66.4	0.6	12.0	78.7	-7.9	35.4	8.5	28.9	-5.0	-43	54.2	140	1.0	1.3	12.7	3.5	5.6
FI	140	2.6	73.5	0.5	8.2	107.2	-2.7	43.8	4.3	43.2	3.0	-1	8.7	213	1.7	0.3	14.6	1.1	7.1
BG	13	3.2	68.8	0.9	6.8	38.6	-4.7	14.7	2.8	30.2	-16.4	.	50.0	.	3.2	3.6	17	11.5	8
CZ	38	2.7	70.9	0.2	6.7	71.8	-5.8	35.3	9.8	34.5	-1.5	.	41.5	.	0.7	1.2	14	-	17.1
DK	160	1.8	77.8	0.3	6.0	100.4	-2.8	41.4	-1.4	49.2	2.5	4	18.9	278	1.1	0.1	16.1	2.8	-3.8
EE	32	4.0	69.9	2.4	13.8	64.5	-1.8	7.2	1.2	36.0	4.5	-80	48.0	244	0.2	2.9	12.6	8.9	-48.5
LV	26	3.7	67.1	0.5	17.1	50.0	-10.2	36.7	9.0	27.0	-8.9	.	51.8	184	4.4	7.6	13.7	13.6	-52.4
LT	27	3.0	67.2	1.6	13.7	55.5	-9.2	29.5	10.4	30.0	-8.5	-66	29.4	132	5.1	2.7	12.9	15.4	-70.1
HU	30	3.0	60.5	0.5	10.0	70.2	-4.4	78.4	-1.3	39.6	-4.8	-120	13.0	209	4.8	4.7	14.4	7.7	22.5
PL	33	4.0	64.9	1.3	8.2	65.4	-7.2	50.9	5.6	31.9	-3.9	-64	-7.0	110	4.3	3.2	13.5	6.4	7
RO	14	2.6	63.5	0.4	6.9	47.2	-8.6	23.9	9.7	28.2	-9.8	-51	56.0	211	6.7	4.7	15.8	5.7	5.9
SE	162	2.8	78.3	0.8	8.3	111.2	-1.0	41.9	0.5	46.9	8.2	-7	-12.2	277	2.1	0.1	12.7	2	5.4
UK	143	2.4	73.9	0.4	7.6	110.3	-11.3	68.2	13.5	36.7	-1.8	.	-12.3	243	2.3	0.4	14.9	3.5	0.4
EA (17)	110	1.6	69.0	0.4	9.5	109	-6.3	79.2	6.8	40.5	-0.6	-19.1	6.1	205	0.3	1.0	13.2	4	0.4
EU (27)	100	1.9	69.1	0.5	8.9	100	-6.8	74	7.5	39.8	-1.1	-3.5	4.8	208	1.0	1.2	13.6	3.9	0.6