EUROPEAN
COMMISSION

Brussels, 28.11.2012
COM(2012) 750 final

ANNEX

MACRO-ECONOMIC REPORT

to the

COMMUNICATION FROM THE COMMISSION

Annual Growth Survey 2013

INTRODUCTION

The EU economy continues to struggle with the post-financial crisis correction. Financial tensions have continued in the euro area before the summer, while the global economy has decelerated reducing the potential contribution of exports to recovery. Therefore, the short-term outlook for the EU economy remains weak, but a gradual return to growth is projected for 2013 and a further strengthening in 2014. This outlook creates additional challenges for the necessary adjustment in many EU Member States. In particular, low growth prospects hold back investment, job creation and accelerate labour shedding, as the margins to use flexibility in work patterns are now reduced.

The challenges facing the EU economy continue to be daunting. In particular, several Member States' economies continue to face large deleveraging of the private and public sectors. This deleveraging reflects the unwinding of accumulated financial imbalances linked to previous unsustainable expenditure levels financed by credit, in some cases promoted by asset price bubbles in the private sector and in others by the lack of fiscal rigour in the public sector. This is now weighing on growth, as spending is reduced and income directed to debt repayment.

On the positive side, there are signs that the adjustment in the EU economies is progressing. Financial market situation has improved after the summer on the back of the steady implementation of the reform agenda, including the advancements in the EMU architecture, and by the important policy decisions in the euro area, including by the ECB. The significant reform efforts in the vulnerable Member States are also bearing fruit: leveraging has decreased in the private and public sectors and competitiveness is improving in countries with large competitiveness gaps creating conditions for further adjustment going forward. Exports are contributing increasingly to improvements in large current account deficits, which bodes well for the lasting nature of the correction. The large growth differences among the EU countries are also a reflection of the ongoing adjustment: temporarily lower or negative growth is often a feature of deep adjustments, but they open the way for more sustainable growth and convergence, which should be visible already in 2014.

The deleveraging and adjustment process is inevitable and the main task of policy makers is to manage it and alleviate the associated economic and social consequences.

Fiscal adjustment has to continue along the path of a differentiated growth-friendly consolidation strategy in view of the high debt levels and long-term challenges to public finances. However, as fiscal consolidation can have negative growth effects in the short term, it should be conducted in a growth-friendly manner, that is:

– the speed of consolidation has to be differentiated across countries according to their fiscal space, to strike the right balance between potential negative growth effects and the risks to debt sustainability. The Stability and Growth Pact and the central role of structural budget balances therein offer the appropriate framework to guide the differentiated speed of adjustment;

– while focusing the consolidation on the expenditure side, there is a need to devise an overall growth-friendly mix of revenue and expenditure, with targeted measures within available fiscal space to protect key growth drivers while ensuring efficiency of expenditure.

Additionally, credibility of consolidation and its positive effects are enhanced if it is anchored in a credible medium-term fiscal framework and accompanied by reforms addressing the long-term sustainability issues stemming from an ageing population.

Orderly deleveraging in the private sector requires a robust and efficient financial sector. Therefore, financial repair and restructuring has to continue in particular in the banking sector in view of its important role in the EU economy, but also new sources of funding have to be promoted. A coherent and effective micro- and macro-prudential policy framework is crucial to restore confidence in the stability of the banking sector, foster a sustainable flow of capital into productive activities and to ensure stable financing of the economy.

Structural reforms are necessary to facilitate adjustment and improve the framework conditions for growth. Structural reforms, which improve competitiveness, wage responsiveness and price flexibility are key to improving adjustment capabilities and to stimulating the transfer of resources from declining to growing sectors. Reforms promoting job creation, investment in innovation, skills and inclusive growth are necessary to tackle the risk of hysteresis and alleviate the negative impact of the crisis on social conditions. A fair distribution of the adjustment burden across society is important for sustained growth. Ultimately, however, a coherent policy mix encompassing both macro-financial and structural policies is indispensable for growth to resume. Hence a determined policy action on all these fronts is necessary to counter the negative dynamics and improve the economic situation in a sustainable manner.

The countries of the euro area are in a specific situation due to their stronger financial and economic interlinkages and the resulting spillovers.

Private capital flows within the euro area have turned around abruptly, flowing away from vulnerable countries. The external financing gap that emerged as a result was bridged through the provision of liquidity by the official sector, which prevented a disorderly adjustment. However, as a result of an increasing home bias, financing conditions for both the public and private sectors have been diverging increasingly within the euro area. This has led to a very tight policy mix in the vulnerable euro-area Member States, as tight financing conditions add to the necessary fiscal consolidation. This is hampering adjustment, contributing further to divergent economic outcomes between euro-area countries and undermining the stability of the whole currency area.

The main priority for the euro area is to continue on the path of structural reform and to reverse financial fragmentation, improve financing conditions in the vulnerable countries and to encourage the inflow and efficient allocation of capital to support adjustment. This is indispensable for growth and adjustment. Also, the need to reduce macroeconomic imbalances highlights the need for a differentiated pace of public deleveraging between the surplus and the deficit countries. Finally, in view of the single monetary policy, structural reforms to increase wage and price flexibility and facilitate adjustment play an even greater role in the euro area.

Continuous perseverance in reforms is of the utmost importance to meeting the challenges. The European Stability Mechanism has become operational on 8 October 2012 and the ECB has decided to introduce the Outright Monetary Transactions in September 2012. These are important contributions to tackling the most immediate challenge of stabilising the financial situation and restoring confidence. Restructuring and rebalancing of the economies will be materialising over the medium term, as the structural reforms usually take time to have full effect. Finally, the vision of genuine EMU is being developed as a long-term goal, for which tangible steps are already being taken to support reform momentum. As a result, financial market tensions have eased somewhat recently, but markets remain fragile and have become dependent on the continuation of supportive policies. Therefore, any stalling in reform efforts could immediately lead to a re-emergence of tensions and undo the recent improvements.

1. GROWTH-FRIENDLY FISCAL CONSOLIDATION

Sound and sustainable public finances are an essential prerequisite for macroeconomic stability and hence for growth. This is particularly the case in the euro area, where the single monetary policy cannot react to country-specific circumstances, and national budgets need to regain their ability to assume a stabilisation function in the event of country-specific shocks. At the same time, euro-area Member States share much stronger spillovers from unsustainable fiscal policies, chiefly through the financial channel, as clearly demonstrated by the current crisis. This calls for greater responsibility in terms of budgetary developments at national level. This is at the root of the rules-based fiscal governance provided for in the Treaty and the Stability and Growth Pact (SGP). The respect of these rules is essential for a smooth functioning of EMU.

Fiscal consolidation has negative effects on growth in the short term as fiscal retrenchment reduces aggregate spending, but benefits accrue in the medium-term. During financial crises, the impact of fiscal policy on growth can be larger than usual, as the so-called fiscal multipliers are thought to be larger than in normal economic conditions[1]. In the short-term, this could also entail adverse effects on debt-to-GDP ratios from consolidation if initial debt ratios, and hence consolidation needs, are high.

Nevertheless, in some Member States there is no viable alternative to consolidation, as its absence could lead to even more negative consequences. In the presence of high and rising debt levels, it is necessary to look at debt sustainability, which is a medium-term concept. The Commission's analysis[2] shows that only under rather implausible assumptions (very high degree of myopia in the markets, very unusual reactions of risk premia) would consolidation lead to adverse debt effects in the medium term. Moreover, creating conditions for, and expectations of, a permanent consolidation is an important part of avoiding adverse debt effects, as expectations of a reversal in consolidation can cancel out its potential positive effects on risk premia. At the same time, for Member States with reduced market access, the assessment of the costs of consolidation, also in the short term, depends on the alternative scenario considered. When fiscal sustainability is at risk, the lack of consolidation can result in higher risk premia or the loss of any market access, which could prompt a much more dramatic adjustment, with consequences for growth that are far worse than in the case of consolidation and improved fiscal sustainability.

While some EU countries enjoy more room for manoeuvre, the risks stemming from slowing fiscal consolidation should be carefully assessed. Some EU Member States currently enjoy record-low interest rates on their public debt and hence could seemingly increase their borrowing without running into risks of unsustainable dynamics. However, also in those countries debt is at peacetime highs. Moreover, in almost all of them, public expenditure is projected to increase due to ageing, and in some cases, low growth prospects. Therefore, it cannot be excluded that a loosening of the commitment to sustainable fiscal policies would lead to a switch in market sentiment. This would have serious repercussions not only for the countries concerned but also for the crisis-management capacity of the euro area as a whole, which relies on the creditworthiness of these countries.

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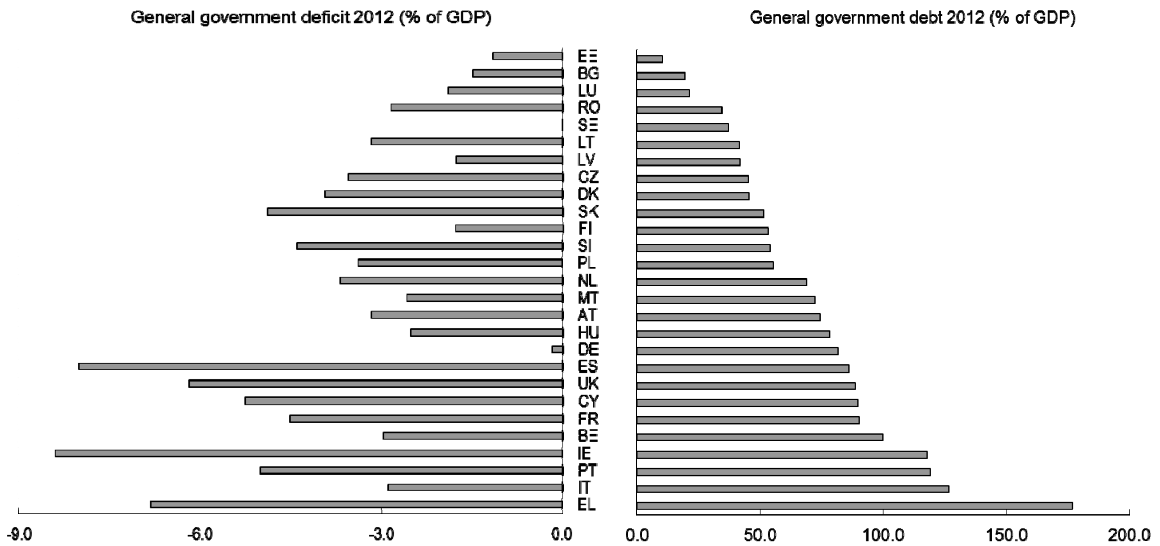
1 Although, there is no evidence supporting some recent propositions about very large size of the multipliers, see e.g. Box I.5 "Forecast errors and multiplier uncertainty" in European Economic Forecast, Autumn 2012, European Economy 7/2012

2 See European Commission (2012) Report on Public finances in EMU 2012, European Economy 4/2012 DG Economic and Financial Affairs.

Graph 1. Government debt and deficit in EU Member States (forecast for 2012, % of GDP)



Source: *Commission Services, European Economic Forecast, Autumn 2012*

EU public finances face great challenges, and fiscal stability must be restored in a permanent manner (Graph 1)**.** The challenges stem from the need to reduce high debt levels in an environment of low growth prospects, long-term spending pressures and an already relatively high tax burden. Thus, the overarching principle of growth-friendly fiscal consolidation remains valid. The strategy advocated by the Commission in the previous Annual Growth Survey, has proved successful, even if short-term negative consequences could not be avoided, as argued above, and the full benefits can become visible only in the medium term.

The effect of consolidation on growth can be influenced by its composition. Additionally, to guarantee the permanent nature of consolidation and improve expectations of fiscal sustainability, consolidation should be accompanied by reforms strengthening the long-term sustainability of public finances and supported by a robust institutional framework.

The pace of consolidation

The pace of consolidation should continue to be differentiated across countries according to fiscal space. In particular, in view of the persistent market pressure on the high-debt countries, countries which have lost access to financial markets or are under severe market pressure must continue to implement the agreed fiscal commitments. Other Member States should continue to respect their commitments under the SGP, which allows automatic stabilisers to work around the agreed path of structural fiscal adjustment while ensuring the long-term sustainability of public finances.

The Stability and Growth Pact offers a flexible and efficient framework to guide the differentiated pace of consolidation. The rules of the SGP allow for the pace of consolidation to vary according to the particular characteristics of the Member States. Within the SGP countries are assigned nominal targets, for the benefit of transparency and anchoring budgetary policies. However, the Council recommendations also specify the necessary structural effort, which should capture the underlying budgetary positions without taking into account cyclical effects and one-off measures. If a country had delivered the agreed structural effort, but fails to achieve its targets only as a result of worse-than-expected growth, the deadline for correction of the excessive deficit can be extended. This option has been taken up on several occasions in the past, most recently for Spain and Portugal.

The composition of consolidation

While expenditure-led consolidations should be favoured, the focus should be on an overall efficient and growth-friendly mix of expenditure and revenue measures. Analysis of past episodes of consolidation suggests that expenditure-based consolidations are more likely to succeed. Also, given the relatively high tax burden in the EU, further tax increases could impact negatively on future growth and should therefore be introduced with caution. Overall, in order to limit the short-term negative effects on growth, the composition of consolidations should find the right mix of growth-friendly measures on the expenditure side and the revenue side.

The efficiency of spending and the quality of public finance in general is becoming increasingly important in view of the long-term challenges to public finance. In the light of historically high debt levels and the long-term impact of ageing populations, pressure on public expenditure is likely to remain beyond the current fiscal adjustment. Therefore reviewing expenditure efficiency becomes increasingly important in reconciling the need for sustainable public finances and the provision of public services at a satisfactory level. International best practices show that in many EU countries there is significant room for savings of public resources for unchanged levels of services.

The pursuit of government sector reforms and the introduction of best practices in performance-oriented budgeting could be instrumental in increasing the efficiency of public spending. There is significant cross-fertilisation between public administration reforms spurred by spending reviews and performance-based budgeting, in terms of objectives and timeframes. While performance-oriented budgeting favours a holistic approach and requires long-term vision for both introduction and delivery of results, public administration reforms can generate fast and significant results in terms of efficiency of public spending and savings, provided that they are prepared by rigorous spending reviews and included in longer-term strategies. Public administration reforms could usefully focus on extracting savings where indicators, including cross-country and within-country comparisons, suggest the largest scope for saving (see also Section 3). Other measures relevant for spending efficiency may reflect the variety of socio-economic goals of different spending items, including distributional concerns, such as improved design and targeting of social transfers and state aid or other subsidies, identification of most productive public investment projects or improved efficiency in the provision of public goods and services. However, whatever the instrument chosen to strengthen public spending efficiency, it has to be accompanied by performance management at all levels of public administration.

Expenditure savings should avoid items, which have a positive impact on growth and growth potential. Where cuts are envisaged, they should be minimised in areas related to the development of human capital and technological advances. For public investments in fixed assets the situation is less clear-cut. Such investment contributes to potential growth only as far as the new infrastructures are inputs to private investment, which applies mainly to investment in transport, communication and certain public utilities. Secondly, public investment in fixed assets is beneficial only up to a certain level, and for Member States with an already satisfactory level of infrastructure, the focus should rather be on maintenance and possibly upgrading.

On the revenue side of the budgets, despite recent reforms, many Member States still face substantial tax policy challenges. Some EU Member States could benefit, albeit to varying degrees, from revenue-side measures to consolidate their public finances and ensure sustainability. Such measures must, however, aim at improving the efficiency of tax systems while ensuring a fair distribution of the consolidation burden across all parts of society. Additional revenue would preferably be raised by broadening tax bases rather than increasing rates or creating new taxes. This may involve a need actively to review tax expenditure and other loopholes in personal and corporate income taxation, while cutting the scope for VAT reduced rates or exemptions or raising reduced rates to a level closer to the standard rate. Excise duty exemptions could also be reviewed with a view both to raising revenue and contributing effectively to other public policies (e.g. health and environment policy).

Improved tax governance could also usefully complement revenue-raising measures. Some measures to address tax evasion, such as lifting the banking secrecy, seems to have brought significant additional tax revenue already in the short term. However, the gain in revenue from better tax governance is often difficult to estimate ex-ante and should therefore not be overestimated in the context of prudent fiscal policy, especially in the short term. Enhancing tax compliance could take various forms, such as reducing the shadow economy, combating potential VAT fraud and evasion, or promoting the efficiency of the tax administration. Improving the tax administration is a challenge many Member States face to raise additional revenue, reduce the high cost per net revenue collected and lighten the heavy administrative burden for small and medium-size companies.

With respect to increasing the growth and jobs potential of European economies, revenue-neutral reforms could be considered. This is the case especially for Member States that have both the margin and the need for a shift from labour taxes to less distortionary taxes (consumption taxes, recurrent property taxes, environmental taxes). A tax composition with a high share of direct taxes and social security contributions alongside a low share of indirect taxes might indicate scope for such a tax shift. Revenue-neutral reform could also involve reducing high corporate income tax rates.

The designing of the consolidation and tax reforms strategy should take account of other issues relating to the design of specific taxes. First, corporate taxation is often biased toward debt financing instead of equity funding. Secondly, housing taxation is based too much on transaction taxes rather than less harmful recurrent taxes on immovable property, while tax-deductibility of mortgage interest generates a debt bias and a risk of overinvestment in housing. Finally, environmental taxes could play an important role in meeting agreed environmental objectives and should over time provide appropriate incentives to reduce harmful emissions, in particular of greenhouse gasses. Tax reforms will have to reflect both economic efficiency and social equity, according to collective preferences. Distributional effects will have to be taken into account when designing tax reforms.

Addressing long-term sustainability

The need for consolidation is heightened by the challenges posed to public finances by an ageing population. The Fiscal Sustainability Report 2012[3] shows debt in the EU remaining stable until 2020, thanks to recent fiscal consolidation efforts and reform progress that nearly stabilize age-related spending. However, from 2021 onwards, the ageing costs take hold more firmly and debt in the EU starts to rise again, coming close to 90% of GDP by 2030. This dynamic can be reversed only through sustained efforts by Member States. If the improvement of the structural balance by 0.5% of GDP per year until the medium-term

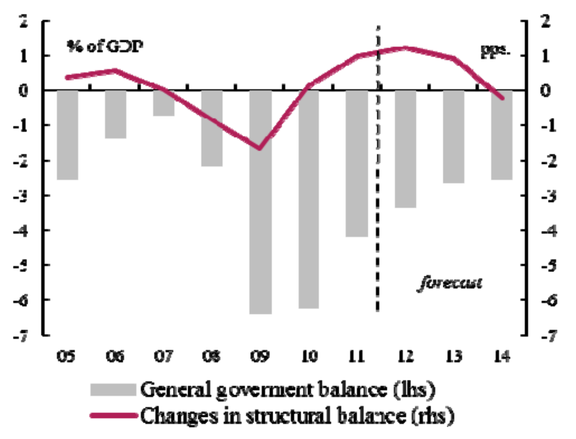
[3] See European Commission (2012) "Fiscal Sustainability Report 2012", European Economy 8/2012.

objective were to be achieved and maintained over the long-term, in line with the SGP, the debt level would be brought close to 60% of GDP by 2030.

While some countries are already addressing age-related pressure on spending, more remains to be done, in addition to delivering on current plans. Substantial efforts to reform pension systems have already been made in many Member States in the last decade, with visible positive budgetary impact. In the long run, however, a further increase in public pension expenditures in the long run is still to be expected at aggregate EU level[4] (+1.5 p.p. of GDP by 2060). This calls for enhanced efforts to reform pension systems, especially in countries where increases in pension expenditure are projected to be far above the EU average and where the reform process has not yet started in earnest. In 2012, a majority of Member States were given recommendations to adapt pension policy in 2012. While good progress has been made in a number of countries, including through restricting access to early retirement and harmonising the retirement age between men and women, in other Member States the reform agenda needs to be either intensified or activated.

Linking the retirement age to life expectancy would help stabilise the balance between working years and years in retirement. To avoid recurrent difficult negotiations, the link should preferably follow automatic rules. This measure is an effective way of reducing longevity risk, addressing sustainability and adequacy concerns at the same time, by giving incentives to work longer and thus to accrue higher pension entitlements. To contribute successfully to higher effective retirement ages, reforms in pension systems need to be underpinned by policies that develop employment opportunities for older workers and support active and healthy ageing, complemented by tax and benefit policies giving incentives to stay longer at work and giving access to life-long learning.

Graph 2. Budgetary developments – euro area



Source: *Commission Services*

Member States have shown determination in pursuing fiscal consolidation and have reduced deficits significantly. According to the 2012 Commission Autumn Forecast, average general government deficit in the EU is expected to decline by 0.8 p.p. in 2012 and reach 3.6% of GDP. For the euro area, the picture is broadly similar with the deficit falling to 3.3% of GDP. With continuing fiscal consolidation in 2013, general government deficit in the euro area is expected to fall below 3% of GDP for the first time since 2008 (Graph 2). In a majority of Member States, the composition of consolidation can be assessed as overall growth friendly and broadly balanced between revenue and expenditure. Between 2007 and 2012 the main expenditure savings have been recorded in investment spending, intermediate consumption and the public wage bill. At the same time the share of social transfers has generally increased, particularly so in countries more strongly hit by the economic crisis.

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4 See European Commission and Economic Policy Committee (2012) "2012 Ageing Report: Economic and budgetary projections for the 27 EU Member States (2010-2060)", European Commission, European Economy, No 2.

Fiscal consolidation appears to have been even stronger in structural than in nominal terms. The structural adjustments for 2012 are forecast to exceed 1 p.p. both in the EU and in the euro area. To reach such an outcome, Member States have on average stuck to their nominal targets, undertaking corrective measures in the course of the year in the context of a deteriorating macroeconomic background. The consolidation path is expected to remain steady in 2013, since Member States either have to implement the fiscal effort required under their Excessive Deficit Procedure (EDP) or have still to converge towards their medium-term objectives. This is expected to bring structural deficit down by more than 0.5 p.p. in the EU in 2013.

Fiscal governance and budgetary institutions

Solid national budgetary frameworks are central for sound fiscal decision-making. Under the Treaties, final budgetary decisions remain with national authorities. It is thus key that Member States take action at national level to enhance predictability and the credibility of their commitments to prudent fiscal policy. The Directive on national budgetary frameworks and the Treaty on Stability, Convergence and Governance (TSCG) improve national fiscal frameworks considerably. Proper transposition of the Directive by the end of 2013 should ensure robust budgetary frameworks across EU Member States, including timely and comprehensive statistics, medium-term planning, reliance on realistic forecasts and definition of national fiscal rules promoting compliance with budgetary obligations under the Treaty. In addition, through the TSCG, 25 Member States have committed themselves to enshrining in binding national law the objective of a budget in balanced or in surplus, thus anchoring a founding principle of the SGP at the heart of national frameworks. Compliance should be further enhanced by national automatic correction mechanisms, to be designed in line with common principles and activated in well-defined circumstances, should enhance compliance.

Fiscal governance at European level has been strengthened and the Commission has submitted more improvements to the co-legislators. The Six-Pack[5] has reinforced the preventive arm of EU fiscal surveillance and the ability to spot and correct fiscal imbalances at an early stage. It has introduced new tools such as an expenditure benchmark and a numerical debt rule. As the fiscal policies of the Member States sharing the same currency share increased budgetary spillovers, the financial sanctions for non-compliant euro-area Member States have been strengthened, but are now also applied more gradually and at an earlier stage. The Commission has proposed further improvements in fiscal surveillance for euro-area Member States in the two Regulations that form the Two-Pack. The Regulation on enhanced surveillance streamlines and reinforces the fiscal surveillance applicable to Member States threatened with or experiencing financial difficulties, while the Regulation on enhanced monitoring of budgetary policies creates a closer monitoring of Member States in EDP to ensure a timely correction of excessive deficits. It also reinforces preventive action at EU level by laying cornerstones for genuine budgetary policy coordination in the EMU, e.g. a common budgetary timeline, a coordinated submission of annual national budgetary plans to the Commission ahead of their parliamentary adoption.

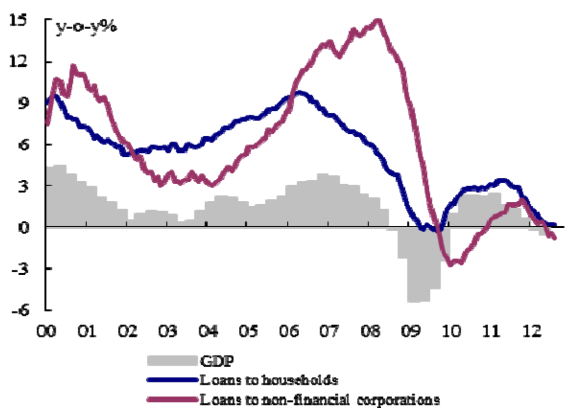
[5] A legislative package of five regulations and a directive, which entered into force on 13th December 2011. The legislation reinforced the Stability and Growth Pact and introduced a new set of rules for the surveillance of macroeconomic imbalances. See also: http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

2. RESTORING FINANCIAL STABILITY

Over the past year, financial tensions in the EU financial markets have continued, but there are signs of an improvement recently. The negative feedback loops between euro-area sovereigns, banks and growth continued to fuel financial stress and weighed on confidence. Strong policy actions by EU and national policy makers have recently led to improvements, but the sovereign spreads in vulnerable countries remain high and volatile. At the same time, some other EU countries have enjoyed large inflows of private capital and witnessed record-low, including negative, interest rates on their sovereign bonds. The tight interlinkages between sovereign markets and the EU banking sector continue to pose major risks to financial stability in the EU and the euro area in particular.

Liquidity and structural funding problems have persisted in the EU banking sector. Particularly in the vulnerable Member States, access to market funding for a number of banks has remained hampered. Downgrades of sovereign ratings have reduced collateral available for banks' operations with the Eurosystem and triggered downgrades of banks' own credit rating, leading to an increase in banks' funding costs. In the first half of 2012, funding pressures in the vulnerable euro-area Member States have been compounded by deposit outflows, while higher-rated Member States have witnessed deposit inflows. Also, banks' internal funding has come under pressure due to reduced growth prospects and thus lesser earnings potential. The response of banks to funding pressure was to turn from unsecured to secured lending and to the issuing of covered bonds. This has resulted in a significant increase in the amount of encumbered assets in banks' balance sheets, which represents an additional source of concern.

Graph 3. Bank lending to households and non-financial corporations – euro area



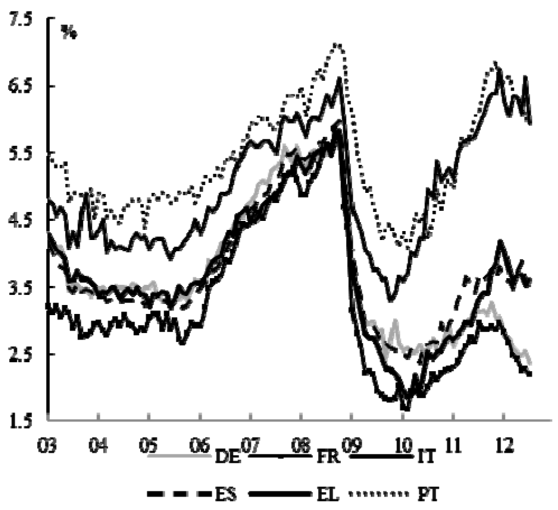
Source: *Commission Services*

The scarcity of market-based funding and rising credit risks due to stagnant growth hamper the capacity of banks to lend to the real economy. Financing constraints are particularly high for small and medium-sized enterprises, which are the backbone of the EU economy and provide the bulk of employment. The lending difficulties are greatest in the vulnerable countries where distressed banks have been reducing lending, although weak growth prospects and the need to reduce corporate and household debt also reduce the demand for credit (Graph 3). At the same time, while banks have continued the necessary adjustments of their balance sheets, there have been no signs of a disorderly or excessive deleveraging. The capital flows from public sources, which have mitigated the outflow of private capital, as well as the coordinated recapitalisation exercise led by the European Banking Authority have played a key role in this regard. Still, the need of deleveraging has varied across countries, with banks in vulnerable Member States adjusting their balance sheets faster than elsewhere. In view of these factors, it is a positive sign that in the euro area as a whole bank lending to the private sector has stabilised in 2012 and the latest ECB Lending Survey has shown some easing in funding concerns.

The re-emergence of sovereign risks has reversed the process of financial integration in the euro area. The introduction of the euro, but also the global pricing of credit risk before the crisis, have spurred financial market integration in the euro area and facilitated credit flows between euro-area countries. With the bursting of the asset bubbles in some countries and the eruption of the sovereign debt crisis, cross-border flows diminished dramatically and capital retrenched behind national borders. In particular, private capital flowing over the previous decade from the Northern to the Southern euro-area Member States has been falling dramatically, as banks have been reduced their cross-border exposure vis-à-vis both governments and the private sector in vulnerable countries. The external financing gap that emerged as a result was bridged through liquidity drawn from the Eurosystem and in the later stages through EU/IMF loans under financial assistance programmes. Also, the home bias in sovereign debt holdings increased, strengthening the negative feedback loop between weak sovereigns and weak banks.

Financing conditions across the euro-area countries have diverged. Higher risk premia in cross-border lending have led to growing financial fragmentation and thereby to widening gaps in interest rates on loans to enterprises and households across euro-area countries. The private sector now faces significantly higher interest rates in vulnerable countries than in other Member States, in particular in those, which have been perceived as "safe haven" markets (Graphs 4 and 5).

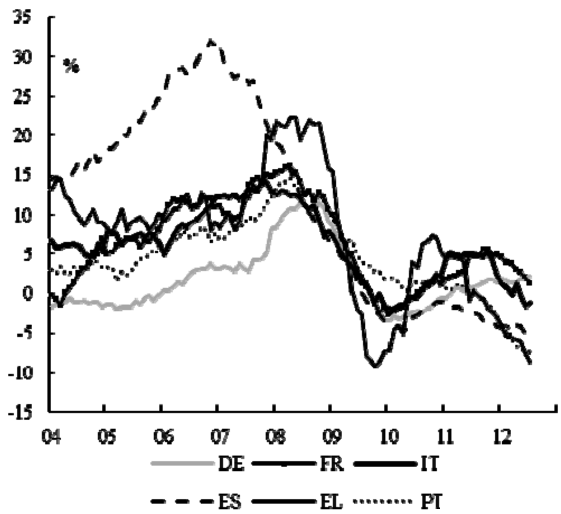
Graph 4. Interest rates on loans to enterprises



Note: *New businesses, maturity up to 1 year*

Source: *Commission Services*

Graph 5. Loans to enterprises



Note: *Index of national stocks y-o-y growth rate*

Source: *Commission Services*

The dysfunctionality of credit markets across the euro area poses significant challenges for the functioning of monetary union. The ongoing adjustment and restructuring in the vulnerable euro-area Member States weighs heavily on growth. Their adjustment process depends on the restoration of normal lending conditions by the banking system, which presently does not play its proper intermediation role in the single market. Micro- and macro-prudential supervision with a cross-border dimension, should contribute to the integrated banking system to restore its function as financial intermediary.

Restoring the conditions for a normal lending to the economy requires addressing the underlying root of banks' distress. Bold policy responses have been adopted at the EU level to break the vicious cycle between weak banks and their sovereigns, address the funding difficulties, financial fragmentation and broken monetary transmission mechanisms in the euro area.

As part of a road towards genuine EMU, the EU Heads of State agreed in June 2012 to move towards a Banking Union, with the Single Supervisory Mechanism (SSM) as a first tangible step. Following the agreement, the Commission presented proposals to establish the SSM and grant the European Central Bank supervisory powers. At the same time, the European Banking Authority would be aligned to the new framework for banking supervision in order to ensure consistency at EU level. The SSM aims at removing the differences in supervisory practices, which contributed to the trend towards fragmentation of the European financial market and put the banking sector at risk. The SSM will ensure that all participating Member States have full confidence in the quality and impartiality of banking supervision. This is important to guarantee that capital flows will support rebalancing in the short term and will not lead to new imbalances in the future (See also Section 3).

With the establishment of the European Stability Mechanism (ESM), the euro area has been equipped with a strong permanent firewall. The large funding capacity (EUR 500 bn) and a set of flexible instruments make the ESM well equipped for breaking the negative feedback loop between banks and sovereigns and helping to restore confidence. In addition to disbursing loans and credit lines for liquidity-constrained euro-area Member States, the ESM has an extensive set of instruments and can, if certain pre-conditions are met, intervene on primary and secondary bond markets, under conditionality that do not necessarily imply the request for a fully-fledged macroeconomic adjustment programme.

The possibility of using the ESM to recapitalise banks directly will be a powerful tool for ultimately breaking the vicious circle between banks and sovereigns in the euro area. The ESM can also provide loans specifically targeted at bank recapitalisation. Until now, however, these loans could be granted to Member States only, which would in turn use them for recapitalisations of their distressed banks. Although bringing some relief to liquidity-constrained governments, this approach has been a second-best solution to the problem of interconnection between banks and sovereigns. In particular, such loans would be recorded in Member States' fiscal accounts and increase their public debt. To overcome this problem, the Euro Area Summit decided in June 2012 to allow the ESM to recapitalise banks directly, once the SSM has been effectively established. This will go a long way towards de-linking the risks of banks and sovereigns in the euro area and will be a major step towards successful resolution of the euro area-crisis.

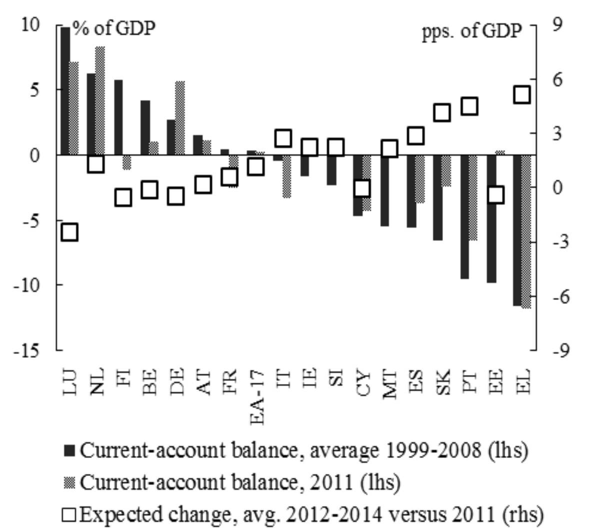
The European Central Bank has taken effective measures to alleviate banks' funding constraints and repair the monetary transmission mechanism. The two 3-year Long-Term Refinancing Operations carried out by the ECB in December 2011 and February 2012 filled acute refinancing gaps for euro-area banks by guaranteeing banks' access to low cost medium-term funding. However, as funding pressure persisted and in some euro area Member States signs of severe disruptions in the monetary transmission mechanism became apparent, the ECB has introduced a new tool - Outright Monetary Transactions (OMTs) - to safeguard the proper transmission of monetary policy in the euro area. OMTs are outright transactions in secondary sovereign bond markets subject to strict and effective conditionality in connection with an ESM-financed adjustment programme. While the tool has not yet been used, its announcement has already led to improvements in the euro-area sovereign bond markets and, together with the plans to implement the Banking Union, it has great potential to mitigate financial tensions in the euro area and restore conditions for healthy lending to the economy.

While strong policy actions have eased market tensions, markets remain very dependent on the continuation of supportive policies and the implementation of commitments. Underlying vulnerabilities are still present in the EU and particularly the euro-area financial system. At the same time, the duration of the crisis in the euro area has led to high dependence of market developments on policy measures. Therefore, certainty on policy actions and forceful implementation of the agreed measures and national reform policies is crucial to containing market volatility. The commitment to build genuine EMU, and a full Banking Union in particular, will restore financial stability on a permanent basis.

3. STRUCTURAL REFORMS TO SUPPORT GROWTH AND CORRECT IMBALANCES

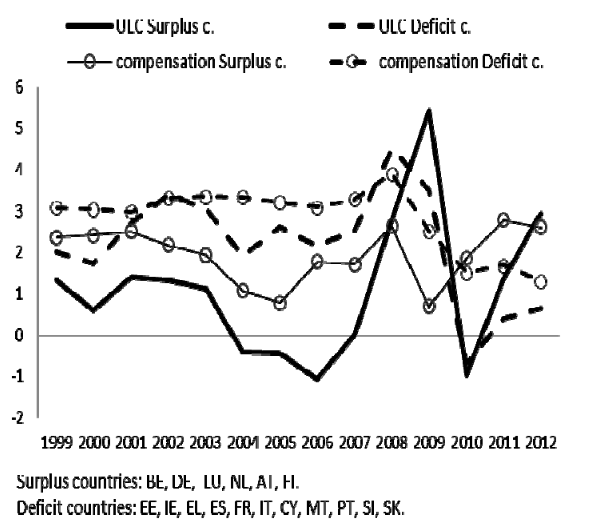
Improving confidence and reviving growth in the short run while creating conditions for sustainable growth in the future is the main challenge at the current juncture. In a context of constrained macroeconomic policies, structural reforms are a crucial element of the growth and rebalancing strategy, aimed at tapping the potential of EU economies. Significant reform efforts have been made in the vulnerable countries as the crisis progressed. Although the need for action in these Member States is more pressing, growth in both the short and medium-to-long term is an EU-wide problem which requires a collective response. Despite significant differences in the economic situation across Member States, a co-ordinated approach to reforms across the Member States and at the EU level would trigger political momentum, relax political economy constraints and so facilitate the reform process.

Graph 6. Current-account balances – euro area and Member States



Source: *Commission Services*

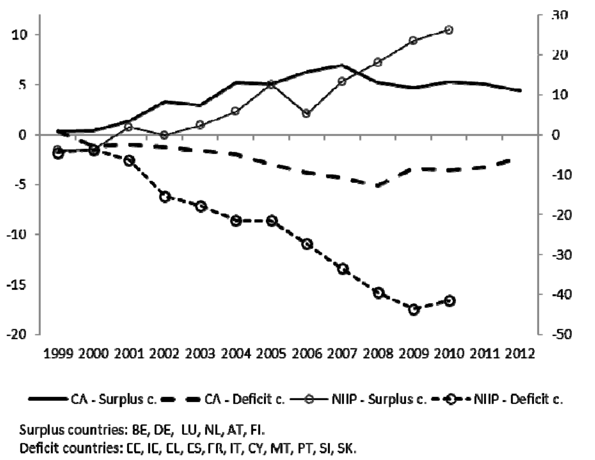
Graph 7. Unit labour costs and nominal compensation per employee – euro-area



Source: *Commission Services*

Growth in the EU economy is currently constrained by persisting macroeconomic imbalances and the need to adjust past excesses in borrowing and consumption. Temporarily lower growth is an inherent feature of deep adjustment, as economies undergo restructuring, resources are transferred from non-tradable to tradable sectors and balance sheets in all sectors of the economy have to adjust. The required adjustment has continued over the last year, in spite of the difficult economic context, and is bearing fruit. Headline figures for current account balances, trade data and domestic demand show that adjustment is on-going in the EU, including among the euro-area countries, but further progress is needed (Graph 6). Adjustment is also currently underway in programme and other vulnerable countries, including those where progress appeared limited until recently. Not only are current-account imbalances narrowing, but also unit labour cost developments are supportive of more rebalancing in the future (Graph 7). In some deficit countries, nominal wages are adjusting in both the public and private sectors.

Graph 8. Current-account and net international investment position (NIIP) surplus and deficit countries



Source: *Commission Services*

The ongoing adjustment in external positions appears to be largely structural. Deficit countries have experienced a large compression in imports and some expansion in exports. While the import compression has been dominant so far, the gains in competitiveness prepare the ground for future export expansion and – according to the Commission Autumn Economic Forecast – export contribution to rebalancing is expected to rise over the forecast horizon. Provided that the competitiveness gains are sustained, the increase in exports should lead to development of the export-oriented industries and to the permanent nature of the adjustment. Nonetheless, the external rebalancing in current account flows is not yet sufficient to change unsustainable trends in stocks (net international investment position and external debt) (Graph 8). In most deficit countries, the external debt-to-GDP ratios keep on increasing; if they are declining, this is mainly due to large revaluation of liabilities. Sizeable adjustment will be needed, the cost of which – particularly in employment terms – will depend on the Member State's adjustment capacity. The progress in reducing bilateral current-account imbalances between surplus and deficit countries has been much more visible. For the surplus countries, there are also signs of rebalancing towards domestic demand, though the adjustment of current-account surpluses also reflects that the current account of the whole euro area has moved into surplus.

While the full effect of structural reforms on growth and rebalancing is likely to materialise in the medium-to-long run, gains can also emerge in the short term. Reform processes are usually associated with adjustment and transition costs in the short term, partly because of their generally uneven distribution across firms and individuals. However, structural reforms might also have immediate expansionary effects, insofar as they improve confidence and expectations across economic actors. Priority should be given to reforms entailing the lowest impact on budgetary costs (such as competitiveness and competition-enhancing reforms in product markets or reduction in regulatory and administrative burden for enterprises), while emphasis should also be placed on achieving the best framework conditions (e.g. enhanced social dialogue) to support action in policy areas which are traditionally more difficult to reform, such as the labour market. Furthermore, synergies across different reform areas need to be considered. For instance, labour market reforms aimed at moderating unit labour costs might be more effective in driving competitiveness if coupled with product-market reforms aimed at increasing competition and squeezing margins. In general, interactions among different reform areas and the appropriate timing should be studied carefully, taking into account specific conditions in each Member State.

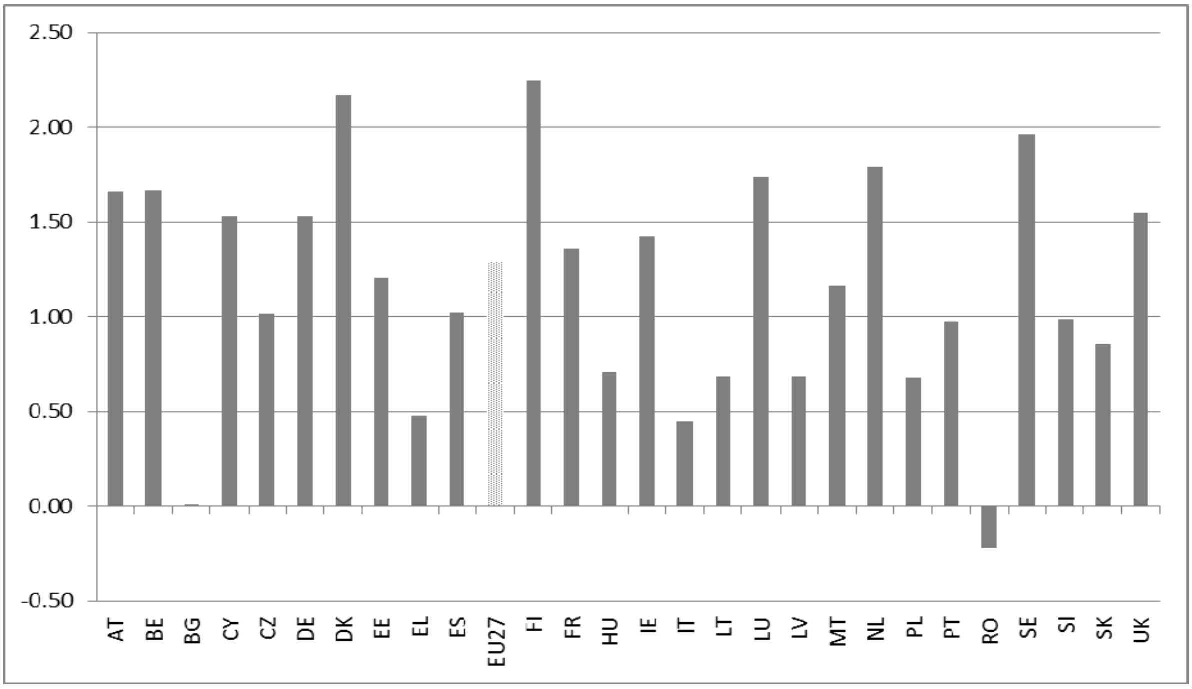
Financial regulation and supervision have an important role to play in ensuring orderly rebalancing and preventing damaging boom-and-busts cycles. The necessary deleveraging process taking place in the private sector in some EU countries, also linked with the tight financial conditions described in Section 2, might negatively affect growth in the short run. However, it is a pre-condition for the correction of excessive internal and external imbalances. In parallel, excessive credit growth and leverage in the financial sector, as witnessed before the crisis, leads to a build-up of vulnerabilities in the sector that bear a high risk of a disorderly correction, with massive negative consequences for economic growth. In this context, the development of effective macro and micro prudential tools is crucial to guarantee that, once financing conditions across the EU normalise, rebalancing will continue on the basis of sustainable capital flows towards the most productive activities and long-term investment needs of the EU economy, and that that excessive imbalances will not build up again.

Productivity-enhancing structural reforms remain a priority to foster medium-term growth prospects and ensure a lasting rebalancing of the EU economy. Empirical evidence shows that reforms aimed at increasing efficiency in product, service and labour markets can spur productivity, innovation and increase output and employment levels. Structural reforms oriented specifically at supporting innovation, investment in, and the use of, ICT and further increasing trade liberalisation also can have a direct impact on productivity. Such reforms also favour the reallocation of labour and capital, allowing for shifts towards sectors with high growth potential (including green growth sectors and digital economy). Moreover, this type of structural reform can play a key role in reducing internal and external imbalances, e.g. through improving competitiveness and export performance. Structural reforms are particularly relevant in the euro area, where relative prices cannot be influenced by nominal exchange-rate movements.

Fostering the opportunities for green growth could translate into better performance at both macro-economic and micro-economic levels. A shift to low-carbon and resource-efficient production patterns will alleviate the pressure of commodity price shocks on cost levels and inflationary expectations. It will reduce resource and energy dependence and thus also the energy trade deficit and enhance the competitiveness of the EU economy over the long term. The EU has developed policies to improve efficiency in the use of resources, including ambitious targets which will have implications for all Member States. The full rewards of these policies will be reaped only if they are accompanied by a stable and predictable regulatory framework to steer investment, tax shifts away from labour towards environmental and consumption taxes, a phasing-out of environmentally-harmful subsidies, measures to promote the emergence of new green markets and technologies, and the greening of existing production and consumption patterns.

The momentum of product and service market liberalisation should be maintained. Further action is needed to remove unjustified restrictions and improve competition in product and service markets, including in the areas of retail trade, regulated professions, construction, tourism and business services as well as network industries. This also requires action at EU level, where a well-functioning Single Market can both improve growth potential and contribute to the unwinding of imbalances. In order to realise its full potential, the development of the Single Market requires ambitious improvements, both by strengthening enforcement and by increasing reform efforts at country level, as laid down in Single Market Acts I and II. In this context, Member States are called upon in particular, to take ambitious measures to implement the Services Directive, given its growth and adjustment capacity potential.[6]

Graph 9. Government Effectiveness Index, EU Member States, 2011



Note: *The World Bank's Government Effectiveness Index shows the population's perception of the quality of public and civil services and their degree of independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The index attains values in the range -2.5 to 2.5.*

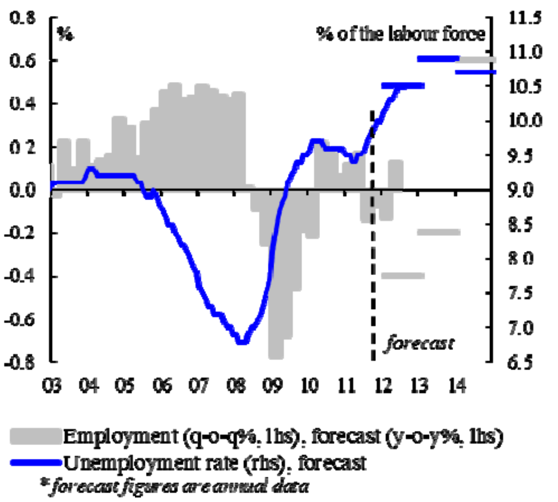
Source: *World Bank*

Improving the business environment, *inter alia* by seeking ways to increase public sector efficiency, is a key priority. An open and effective business environment is a catalyst for growth, as it promotes business activity and reduces unnecessary costs for enterprises. Evidence shows that administrative complexity or 'red tape' has a significant negative impact on the level of entrepreneurship, innovation and competitiveness, and the inward FDI flows which could play a significant role in addressing imbalances. Moreover, an excessive regulatory burden tends to stimulate the shadow economy. An efficient public administration should deliver services to the whole economy without imposing disproportionate bureaucratic burdens on economic operators (Graph 9). Addressing problems in the public administration would contribute both to fiscal consolidation and to competitiveness and growth prospects. In particular, reforms of the judicial system would reduce the risks and uncertainty of starting and doing business, leading to investment and contributing to reduce transaction costs and strengthen competition. To this end, several Member States have already adopted measures to shape a more streamlined and effective public service. Key reform areas include judicial systems and enhanced use of e-government and e-procurement.

[6] Commission services estimate that gains associated with the current implementation of the Services Directive in Member States are of the order of 0.8% of EU GDP, while a slightly more ambitious implementation, with each country achieving EU-average level of barriers to the cross-border provision and establishment of service activities, would bring additional gains worth 0.4 percentage points of GDP. Under an extremely ambitious scenario, where each Member State would reach the average of the five best-performing countries, an additional 1.8% growth of GDP could be achieved at EU level.

Unemployment has become a very serious issue in a number of EU countries, **with increasing economic, social and political implications** (Graph 10). Rising unemployment is accompanied by a major increase in the degree of divergence across EU labour markets. While unemployment has increased in most countries, reaching record-high levels in some cases, in some Member States it has been falling. Longer periods out of work and worse matching between labour demand and supply in many EU countries, also due to sectoral shifts in some countries, imply that unemployment may become increasingly structural with a negative effect on long-term growth potential.

Graph 10. Employment growth and unemployment rate – EU

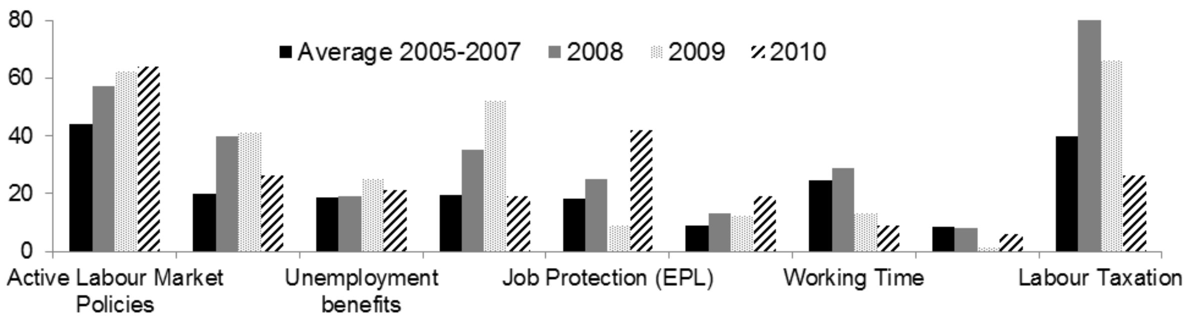


Source: *Commission Services*

Structural reforms play a key role in tackling unemployment while improving growth and promoting adjustment. If unemployment rates are to be reduced significantly, the conditions must be created for renewed confidence and stable labour demand. At the same time, reducing joblessness will be key to strengthening confidence and ensuring the social and political sustainability of current reforms. Nonetheless, the immediate challenge is to manage high and persistent jobless rates under subdued growth conditions and, in some countries, against the background of ongoing deleveraging and external rebalancing. In the light of the different labour market conditions across the EU, the policy response needs to be coordinated but adapted to the specific circumstances of each country.

Since the start of the crisis, several EU countries have taken an active approach to labour reform. In some cases, ambitious reform plans have been adopted, with the aim of creating more favourable conditions for employment (Graph 11). Recent reform activity appears to be largely in line with the priorities set at European level, notably with measures that help to make labour markets more dynamic, reducing precariousness and improving competitiveness. Some countries with high unemployment and large external imbalances have taken up the challenge of improving the responsiveness of wages and their labour market adjustment capacity, notably by reforming employment protection legislation (EPL) and the wage-setting system. Income protection, activation and job search assistance policies have been adapted to the growing labour market challenges. However, not all countries have so far taken the necessary steps to rise to the policy challenges they are facing.

Graph 11. Number of labour market measures by domain, total EU



Note: *ALMPs exclude training.*

Source: *Commission services, DG ECFIN LABREF database.*

Tackling unemployment and support for job creation should be high on the policy agenda. The momentum in labour market reform should be maintained, particularly in countries characterised by major labour market challenges. The extent to which potential growth can sustainably resume to a large extent depends on how successfully labour market bottlenecks are addressed and the risk of unemployment hysteresis is tackled. Appropriate policy responses are urgently needed in order to address structural and institutional labour market challenges (labour market segmentation, deterioration in the job matching process and persistent structural unemployment). Efforts aimed at ambitious structural reform favouring adjustment (EPL, wage setting) and the proper implementation of enacted measures need to be maintained in countries with major labour-market challenges. Specific measures can also be considered to boost labour demand by reducing taxation on labour – notably on low-paid groups – when fiscal conditions allow, and supporting entrepreneurship and the social economy. In addition, there is a need for targeted measures to promote the hiring of specific groups of workers at risk of dropping out from the labour force (such as the long-term unemployed or young workers with no previous experience), including by means of cost-effective active labour market policies and by exploiting the potential of job-rich sectors.

Annex. Selected macro-economic indicators

	Growth and jobs						Competitiveness							Public Finances						Financial Stability			
	GDP per capita in PPS	GDP growth projec-tion	Employ-ment rate	Long-term unemplo-yment*	Youth unemp-loyment (<25)*	Labour-force partici-pation rate*	Nominal Unit Labour Costs*			Nominal Compensation per employee*		Current Account Balance*	Market share of exports (goods + services)*	General Government Debt*	General Government budget position*	Overall tax burden	Sustainability Indicator (S2)*	Average exit age from the labour force*	Life expectancy*	Private debt*	Non performing loans	Long-term interest rate spreads vis-à-vis Germany	Return on equity
							Whole economy	Services	Manufac-turing	Public sector	Private Sector												
	Level ompared to EU27=100	Annual rate of change	Age group 15-64	% of active population	% of active population	%	Annual rate of change	Annual rate of change	Annual rate of change	Annual rate of change	Annual rate of change	% of GDP	% change	% of GDP	% of GDP	Total taxes as % of GDP	High level means weak sustain-ability	2010 or latest available	At 60 years	% of GDP	%	Percentage points	%
	2011	2012	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011	2011		2011 or latest available	March 2012	2011 or latest available	September 2012	2011 or latest available
BE	118	-0.2	61.9	3.5	18.7	66.7	2.7	2.6	-0.9	3.5	2.9	1.0	5.0	97.8	-3.7	45.6	7.4	61.6	23.6	238.4	4.2	1.1	1.4
BG	45	0.8	58.5	6.3	25.0	66.0	1.1	-1.0	:	4.8	8.1	1.7	5.6	16.3	-2.0	27.1	2.8	64.1	19.4	:	19.7	2.3	4.6
CZ	80	-1.3	65.7	2.7	18.1	70.5	1.1	0.4	-1.3	1.4	2.6	-3.9	5.9	40.8	-3.3	34.4	5.5	60.5	21.4	78.1	7.1	0.9	13.7
DK	125	0.6	73.1	1.8	14.2	79.3	0.5	0.1	0.0	0.9	2.2	6.6	5.4	46.6	-1.8	49.0	3.3	62.3	22.8	241.5	3.0	-0.2	0.6
DE	120	0.8	72.5	2.8	8.6	77.2	1.4	2.3	-2.2	3.0	3.1	5.6	5.2	80.5	-0.8	39.8	1.4	62.4	23.8	128.3	1.6	0.0	2.2
EE	67	2.5	65.1	7.1	22.3	74.7	-1.4	1.6	-10.1	3.5	-2.0	0.3	7.4	6.1	1.1	33.0	1.2	62.6	21.5	141.0	4.5	:	25.5
IE	127	0.4	59.2	8.6	29.4	69.4	-3.2	:	:	0.1	:	1.1	4.6	106.4	-13.4	29.9	4.1	64.1	23.5	332.0	:	3.8	-11.1
EL	82	-6.0	55.6	8.8	44.4	67.7	-1.8	-2.3	-0.2	-1.7	-5.5	-11.7	4.9	170.6	-9.4	34.8	-2.4	61.5	23.8	124.6	12.1	19.4	43.5
ES	99	-1.4	57.7	9.0	46.4	73.7	-1.5	-0.1	-4.1	-1.1	1.4	-3.7	4.2	69.3	-9.4	32.9	4.8	62.3	25.1	214.2	5.2	4.4	0.1
FR	107	0.2	63.9	4.0	22.9	70.4	1.6	1.6	2.3	2.5	3.2	-2.6	4.9	86.0	-5.2	45.6	1.6	60.2	25.4	141.1	4.6	0.8	5.6
IT	101	-2.3	56.9	4.4	29.1	62.2	0.9	1.4	2.1	-0.1	2.4	-3.3	5.4	120.7	-3.9	42.4	-2.3	60.4	24.6	126.0	9.5	3.8	-13.0
CY	92	-2.3	68.1	1.6	22.4	74.0	3.3	1.9	0.7	3.2	2.7	-4.2	7.4	71.1	-6.3	34.7	8.2	62.8	23.6	:		5.5	-86.0
LV	58	4.3	61.8	8.8	31,0	73.3	3,0	3.4	3.5	5.1	:	-2.4	10.4	42.2	-3.4	27.7	-0.7	62.7	20.0	123.1	10.1	2.4	5.1
LT	62	2.9	60.7	8.0	32.9	72.0	-0.1	0.2	-2.9	2.6	4.7	-3.7	9.8	38.5	-5.5	26.4	4.7	59.9	20.3	69.4	16,0	3.0	17.0
LU	274	0.4	64.6	1.4	16.4	67.9	3.3	3.1	2.0	1.9	2,0	7.1	10.1	18.3	-0.3	38.1	9.7	59.4	23.8	:	:	0.2	6.2
HU	66	-1.2	55.8	5.2	26.1	62.7	1.8	2.5	5.7	1.6	3.3	1.0	6.1	81.4	4.3	36.6	0.5	59.7	20.0	154.9	14.9	5.8	-7.9
MT	83	1.0	57.6	3.0	13.8	61.6	1.3	:	:	2.3	0.7	-0.3	4.4	70.9	-2.7	34.8	5.8	60.5	24.1	212.3	1.5	2.5	4.2
NL	131	-0.3	74.9	1.5	7.6	78.4	1.2	2.0	-1.8	0.9	1.8	8.3	5.2	65.5	-4.5	38.8	5.9	63.5	23.9	:	2.4	0.4	6.2
AT	129	0.8	72.1	1.1	8.3	75.3	0.9	2.9	-3.9	1.9	2.5	1.1	5.9	72.4	-2.5	43.7	4.1	60.9	24.1	161.9	4.1	0.6	1.5
PL	65	2.4	59.7	3.6	25.8	66.1	0.7	4.3	-7.9	4.8	4.2	-4.5	6.2	56.4	-5.0	32.5	1.6	59.3	21.5	79.0	6.0	3.4	12.3
PT	77	3.0	64.2	6.2	30.1	74.1	-0.7	:	:	:	:	-6.6	3.9	108.1	-4.4	36.1	-1.8	62.6	24.2	247.9	5.3	7.1	-4.1
RO	49	0.8	58.5	3.1	23.7	63.3	1.7	:	:	-8.5	7.2	-4.1	5.4	33.4	-5.0	27.5	3.7	64.3	19.7	:	11.4	5.1	1.3
SI	84	-2.3	64.4	3.6	15.7	70.3	-0.6	-0.3	-1.0	-0.1	1.5	0.1	5.5	46.9	-6.4	37.6	7.6	59.8	23.3	130.3	:	4.8	-11.1
SK	73	2.6	59.5	9.2	33.5	68.9	-0.4	2.7	0.0	-0.6	2.8	-2.5	6.2	43.3	-4.9	28.8	6.9	58.8	20.4	74.8	4.0	2.7	11.1
FI	116	0.1	69.0	1.7	20.1	74.9	1.8	2.6	1.9	2.8	3.8	-1.1	7.7	49.0	-0.6	43.4	5.8	61.7	23.9	179.9	0.8	0.3	8.1
SE	126	1.1	74.1	1.4	22.9	80.2	-0.8	-1.0	-4.1	0.6	1.3	6.5	5,0	38.4	0.4	44.9	2.0	64.4	24.2	234.7	:	0.0	10.7
UK	108	-0.3	69.5	2.7	21.1	75.7	1.5	:	:	:	:	-1.9	5.2	85.0	-7.8	37.6	5.2	63.0	23.8	:	2.2	0.0	4.2
EA	108	-0.4	64.3	4.6	20.8	71.5	0.9	:	:	:	:	0.3	5.1	88.1	-4.1	40.6	2.7	61.5	24.0	:	:	2.3	:
EU	100	-0.3	64.3	4.1	21.4	71.2	0.9	:	:	:	:	0.0	5.2	83.0	-4.4	39.9	2.1	61.5	23.2	:	:	2.0	:

* Variables mentioned in the text on the Euro Plus Pact in the European Council conclusions of March 2011

Sources: Commission services, Eurostat, ECB