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COMMISSION STAFF WORKING DOCUMENT

Analysis of the Euro Area economy

Accompanying the document

Recommendation

for a Council Recommendation on the economic policy of the Euro Area

{COM(2019) 652 final}

Executive summary

The euro area is continuing its expansion, though growth is moderating and interconnected risks to the outlook have increased along with uncertainty. Risks to the outlook and uncertainty have heightened, notably given trade risks which are also contributing to the growth slowdown. The euro area's current account surplus is projected to narrow but remains sizeable and country divergences continue to be significant. Real convergence among euro area countries appears to be resuming slowly with rising disposable income and declining poverty and social exclusion in virtually all Member States. However, the share of income held by the highest income levels has slowly increased in the past decade. The euro area economy is facing short-term challenges stemming from the uncertain outlook and interconnected risk factors as well as long-term challenges stemming from the emerging risk of a prolonged period of low potential growth driven by anaemic productivity, and aging populations.

Decisions on the macroeconomic policy stance need to be taken against the background of low inflation and a weakening outlook which might be persistent. The ECB is maintaining an accommodative monetary policy. The euro area fiscal stance is expected to be broadly neutral between 2019 and 2021 (see section 4). While the euro area debt to GDP ratio is projected to continue decreasing, the aggregate deficit is expected to increase from the historical low recorded in 2018, mainly due to the impact of expansionary discretionary measures and automatic stabilisers, which more than offset the projected decline in interest expenditure. Meanwhile, national fiscal policies are insufficiently differentiated according to available fiscal space. A key question in a downside scenario is what would be the most effective fiscal response across member states taking into account the respective fiscal space and severity of the downturn. The aggregate fiscal policy stance might need to become more supportive should negative risks materialise.

Acting on the composition of fiscal policy represents a powerful policy lever. Member States have been slow in improving the quality and composition of public finances. Improving Member States' public investment strategies and green budgeting analyses are essential to support growth and face long-term challenges such as the climate transition and technological transformation. Addressing aggressive tax planning, engaging in spending reviews and improving the functioning of fiscal frameworks at large would be essential measures for more growth friendly and greener fiscal policies.

Structural reforms are needed to complement macroeconomic policies. Reform progress remains low despite efforts to improve implementation within the European Semester, and productivity growth in the euro area has been declining in line with what is happening across advanced economies. Structural reforms could contribute to bridging the productivity gap while strengthening institutional quality would be key in improving the delivery of structural reforms, namely on product and services market regulations where reform effort is slowing.

Labour market indicators continue to improve but challenges in terms of job quality, and skills, as well as labour market integration of under-represented groups, remain. Employment figures are improving but the materialisation of risks can negatively impact labour market developments, especially for more vulnerable Member States and workers and

while wage growth accelerated, it is unclear how far this dynamic will be sustained beyond the forecast horizon. In the long-term, technological change and the digital revolution can be expected to create new jobs, while destroying others, raising challenges in particular for less qualified workers and increasing the need for investment in skills.

Risk reduction in the banking sector broadly continues but completing the financial union would be key to further strengthening the sector's resilience. Measures have been taken to strengthen banks' resilience but bank competitiveness is still an issue as the sector continues to face challenges from the economic environment and business-model transformation. Going forward, important areas for financial integration remain to be completed, notably the backstop to the Single Resolution Fund and a European Deposit Insurance Scheme. The share of non-bank finance in the euro area's financial system has continued to grow as the Commission delivered on all of the actions announced in the Capital Markets Union action plan. However, barriers for an integrated capital market remain, including regulatory, legal and tax divergences.

Progress remains slow in deepening the EMU. There has been some progress on the economic union, with political agreement on a euro area budgetary instrument for convergence and competitiveness and on improving the ESM toolkit. However, there was no progress towards a euro area-wide fiscal stabilisation function or on euro area governance proposals. Stronger progress on the measures proposed in the Commission Communications of December 2017 and of June 2019 would result in better macroeconomic outcomes.

This Staff Working Document provides an analytical underpinning for the Euro Area Recommendation which outlines an overall orientation for the collective challenges ahead, focusing on the years 2020 and 2021. The recommendation is adopted at the beginning of the European Semester, to precede and inform the package of country-specific recommendations which is adopted in the spring. For the first time this year, the SWD includes an overall assessment of progress in implementing the euro area recommendation (see Box 3). Since the euro area recommendation for 2019 and 2020 was published last year, some progress was made on structural reforms for growth, competitiveness and productivity and there was also some progress in implementing financial sector reforms. However, progress remained limited on the other recommendations, namely fiscal reforms, labour market reforms and deepening the Economic and Monetary Union.

1. Macroeconomic context and developments

The euro area is continuing its expansion, though growth is moderating and interconnected risks to the outlook have increased along with uncertainty. The economy has been expanding at rates above potential, also as a result of the dynamics of euro area consumption and investment, and the positive output gap is expected to hover around ¼-½% of potential GDP in 2020-21 (Graphs 1 and 2). Though growth is being sustained, the forecast has been revised down to 1.1% for 2019 and 1.2% for both 2020 and 2021. The expansion is still supported by steady – though slower - domestic demand, with a contribution of private

consumption to growth of 0.8%, of GDP for 2019, 2020 and 2021.¹ Nonetheless, uncertainty remains elevated further as the outlook is subject to a number of downside risks, some of which have started to materialise, such as the impact on confidence of trade tensions and Brexit. Though headline inflation was accelerating, driven mainly by energy prices and services inflation, it is now projected to slow to around 1¼% both for 2019-21 down from 1.8% in 2018. Core inflation (excluding energy and unprocessed food prices) is forecast to remain even lower than previously expected from the 1-1½% range in 2018 to around 1½% in 2019-20. This is despite the fact that real wages per employee have slowly increased – following several years of stagnation – at some 1% in 2018 and 2019. Wage growth is nevertheless projected to slow again to around ¾% in 2020-21.

Notwithstanding the positive output gap, potential GDP growth is set to remain below pre-crisis levels over the forecast horizon. Potential GDP growth is projected at below 1½% for 2019-21, significantly below its pre-crisis level of some 2 percent (Graph 2). Structural unemployment, as measured by the non-accelerating-wage rate of unemployment (NAWRU), has been declining since 2013 from 9.4% and is projected to reach 7.7% in 2021 but is still far above levels of best performers in the euro area, at around 4%.

While supporting GDP growth and the climate transition requires further investment, the uncertain outlook could weigh on investment growth, which is still in a recovery phase in the euro area (Graph 3). Given the EU’s commitments to reducing greenhouse gas emissions², increasing the use of renewable energy and improving energy efficiency, substantial investment is needed to support GDP growth that remains reliant on greenhouse gas emissions³. Supporting potential GDP growth, during the environmental transition and given its weak levels, will require further investment. Though total investment growth is forecast to spike up to 4.3% in 2019 from 2.3% in 2018, it is predicted to ebb to 2.0% in 2020 and 1.9% in 2021. Public investment as a percentage of GDP also remains low – around ¼-½ percentage points below the 2007-08 level - and is recovering only slowly in certain Member States. Importantly, net public investment has declined significantly, turning zero or slightly negative between 2013 and 2018, and is projected to recover only slowly to around ¼ of a percentage point of GDP by 2020-21. Overall, private investment has recovered faster than public investment and is forecast to reach pre-crisis levels (Graph 3) by 2019-20. Beyond the crowding-in effect of public investment, an essential factor for the private sector to participate in increasing potential growth is the financial sector and financial markets’ ability to finance investment, and the credibility of the institutional and policy framework.

With additional significant medium and long-term factors weighing on growth and inflation – and in the absence of policies to address them – the risk of a prolonged secular stagnation in the euro area economy is emerging. The low potential growth and

¹ All forecast figures in this document are from the European Commission Autumn 2019 forecast.

² European Council Conclusions, 24 October 2014, EUCO 169/14, https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/145397.pdf

³ NBER working paper 26167 “Long term macro effects of climate change Khan Mohades Ng Pesaran”, IPCC reports.

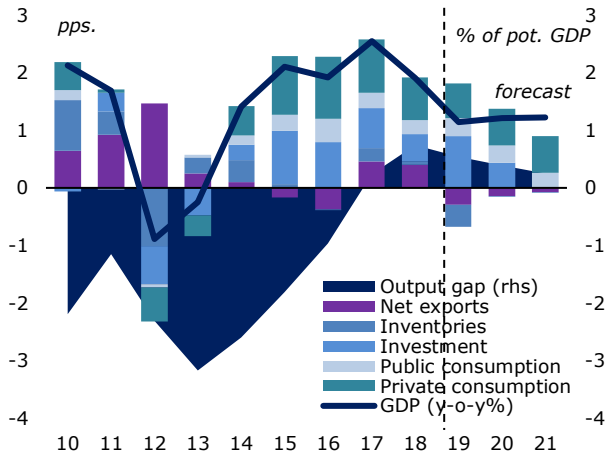
productivity, low inflation, and rising inequality coupled with deteriorating demographics are a reminder of the Japanese economy since the early 1990s (Box 1) and call for policy action.

The slowdown in growth may also be attributed in part to the slowdown in trade, and further trade risks loom on the outlook. For 2017 and 2018 each, net exports contributed nearly ½ percentage point of GDP growth, or around one fifth and one fourth of growth respectively. This contribution is expected to become zero or negative in 2019 and 2020. Given the EU's position as a highly open economy with large export-dependent economies, the evolution of trade disputes will have an important bearing on the growth projection. Empirical analysis suggests that a substantial increase in tariff rates on US imports of cars from the EU would have a significant and disruptive impact on economic activity⁴. FDI flows between the EU and the rest of the world also declined in 2018. In this context of failing multilateralism and free trade, it is uncertain whether the impact of trade on growth will be transitory or permanent.

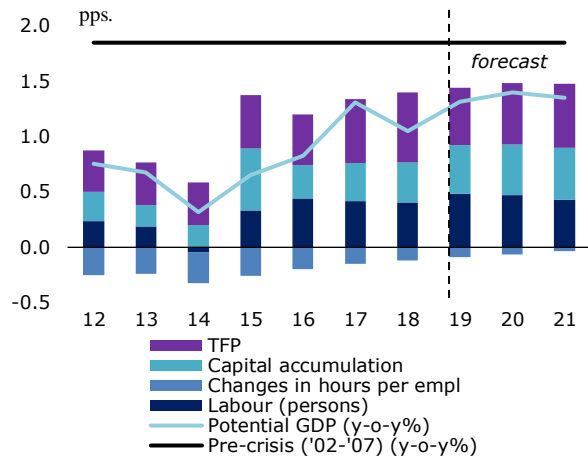
The euro area's large current account surplus is projected to decrease in 2019 and 2020 but country divergences continue to be significant on the external side. The euro area current account surplus is forecast to narrow from some 3¾ % of GDP in 2018 to 3-3¼ % in 2019-21. At country level, the correction of large deficits is not matched by a comparable adjustment of large surpluses, which are expected to decrease but to a smaller extent in some Member States. Those countries in a net creditor position therefore continue to increase their net international investment positions (NIIP). Moreover, the reductions in current account surpluses are explained by lower contributions of net exports to growth rather than an increase in domestic demand. The NIIP to GDP ratios of the most indebted Member States have improved only recently, supported by improving nominal growth and external surpluses, although sustained rebalancing efforts are still needed. Countries that recorded large deficits for a long time still have large negative NIIPs that represent vulnerabilities, and are often mirrored by large stocks of private and/or government debt.

⁴ A CESifo study concluded that permanent US tariffs of 25% on German car exports would lower German car exports to the US by almost 50% and total German car exports by 7.7%; without retaliation, US tariffs are estimated to lower real incomes in the EU by 9 bn. EUR (0.06% of GDP) with the largest impact among the large Member States such as Germany (0.16% of GDP). See G. Felbermayer and M Steininger (2019). 'Effects of new US auto tariffs on German exports, and on industry value added around the world'. Working Paper (ifo Institute), February. See also V. Gunnella (2019). 'Assessing the impact of the threat of auto tariffs on the global economy and the euro area'. *ECB Economic Bulletin* 3, pp. 59-61.

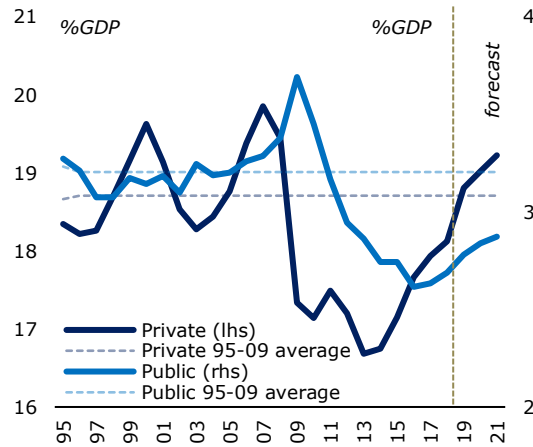
Graph 1: GDP and its components, euro area



Graph 2: Contributions to potential growth, euro area



Graph 3: Public and private investment, euro area



Source: European Commission 2018 autumn forecast, Ameco.

Box 1: Is secular stagnation a risk for the euro area?

Japanification – a variant of secular stagnation

The persistence of low real GDP growth and inflation in the euro area, despite very accommodative monetary policy and low unemployment, have raised concerns that this phenomenon is not primarily the result of the legacy of the Great Recession, but reflects a long-term trend. The main explanations for this trend are the secular stagnation hypothesis⁵ and a variant of it known as “Japanification”.

The secular stagnation hypothesis argues that a structural (or secular) reduction in aggregate demand in advanced economies has led to a decline in the equilibrium (or natural) real interest rate, potentially even below the effective lower bound on monetary policy interest rates, resulting in chronically lower economic growth and inflation. Japan is often presented as the most striking example of a country experiencing such a structural shortfall in aggregate demand, with low inflation and growth since the early 1990s. While a number of factors driving such a structural fall in aggregate demand have been posited⁶, the most prominent in Japan are: (i) a declining working-age population; (ii) rising inequality resulting in a larger share of income going to those with a lower propensity to spend; (iii) increasing friction in financial intermediation, initially due to impaired bank balance sheets in the wake of the financial crisis and subsequently increased regulatory burdens; (iv) declining productivity growth and by extension potential growth. The broader concern, as the multi-decade long duration of this low-growth/low-inflation phenomenon in Japan suggests, is that these dynamics can create a self-perpetuating trap, with lower consumption, and lower investment feeding each other and reducing long-term productivity and potential growth.

Is it relevant for the euro area?

While not all the aspects of secular stagnation are relevant for the euro area,⁷ there is an increasingly widespread view that, following the Great Recession, the euro area shares some of the features of Japanification.⁸ The similarities between the euro area and Japan include not only very low inflation and real GDP growth despite very low interest rates and ample liquidity but also low productivity and potential GDP growth, a shrinking working age population, a troubled banking sector that constrains credit to the private sector and a persistent current account surplus reflecting an excess of savings.⁹

At the same time, there are important differences: first, the deleveraging required in Japan following its financial crisis in the 1990’s was significantly greater than that in the euro area: total credit to the non-financial private sector in Japan peaked at 218% of GDP in the mid-1990s (and since fallen to 161% in 2018), while the equivalent peak in the euro area was 169% (in 2012). Secondly, the problems in the banking sector were treated relatively quickly

⁵ Summers, L. (2014). “Reflections on the new ‘Secular Stagnation hypothesis’”, Vox article.

⁶ Summers, L. (2014) “Ibid.

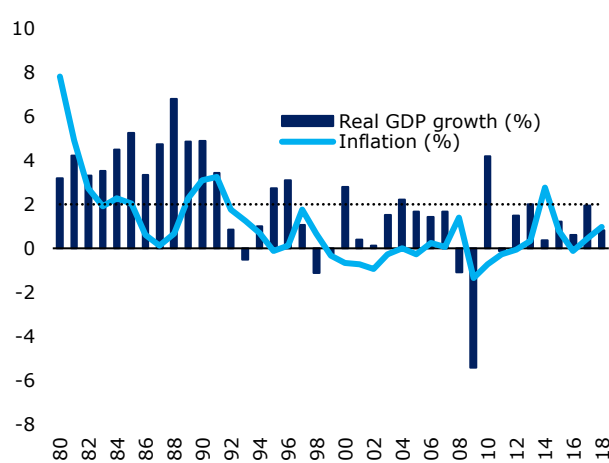
⁷ Roeger, W. (2014). “ECFIN’s medium term projections: the risk of ‘secular stagnation’”. Quarterly Report on the Euro Area 13:4, pp. 23-29.

⁸ See e.g. El-Erian, M. (2019). “How Western economies can avoid the Japan trap”. Project Syndicate, April 8; Donisau, P. (2019). ‘Is the Eurozone fated to Japanification?’ Global Perspectives (Wells Fargo), June 11; Brzeski, C. and I. Fechner (2019). ‘The eurozone’s Japanification – more to come’. Economic and Financial Analysis (ING), June 24.

⁹ Kirkegaard, J. (2019) “Yes, We Are Probably All Japanese Now”, Monetary Dialogue, September 2019.

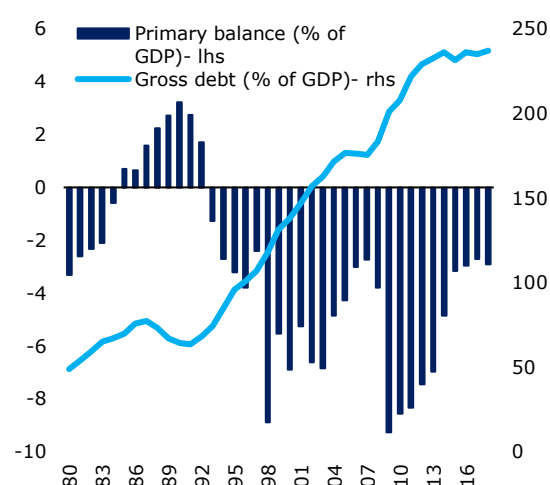
in the euro area, with the peak in non-performing loans reached three years after the crisis, while in Japan the level of non-performing loans peaked a decade after their crisis.¹⁰ Thirdly, the demographic drag thus far in the euro area is much slower than that in Japan: the euro area's working age population since 2009 has fallen by around 0.1% per year, while in Japan the average annual decline between 1993-2018 was 0.6% (and in the last decade reached 1% per year). Fourthly, while disinflationary pressures in Japan – at least in the first decades – were driven primarily by depressed demand, there is increasing recognition of the disinflationary impact that supply side factors, namely globalization, technology and global value chains, are now having on inflation in the euro area and other advanced economies.¹¹ Finally, there are indications that the negative interest rates in the euro area may not simply be due to secular stagnation, but also financial markets fragmentation, including a relative scarcity of safe assets.¹²

Graph 4: Japan - persistently low growth and inflation



Source: IMF World Economic Outlook database

Graph 5: ...despite significant fiscal expansion



What are the policy implications?

In the short-term, an appropriate policy mix in the euro area would combine accommodative monetary policy with a supportive fiscal stance focused on public investment and accelerated implementation of structural reforms.¹³ Structural reforms at both national and EU level can counter disinflationary pressures through a number of channels: reducing structural unemployment can help increase the activity rate and help decreasing inequality, while strengthening the conditions that support wage growth in surplus countries can help increase propensity to spend. Investment which remains low, can contribute both to increasing internal demand and potential growth in the long-run.

¹⁰ Fujii, M. and Kawai, M. (2010), “Lessons from Japan’s Banking Crisis, 1991–2005.” Asian Development Bank Institute Working Paper 222/2010.

¹¹ Auer, R, C Borio and A Filardo (2017): “The globalisation of inflation: the growing importance of global value chains”, BIS Working Papers, no 602, January and Baldwin, R (2016):” *The Great Convergence: information technology and the new globalization,*” Belknap Press.

¹² Borio C. and P. Disyatat (2011), “Global imbalances and the financial crisis: Link or no link?”, BIS Working Papers, No 346, Monetary and Economic Department, May; Giudice G. (2019), “Completing the Economic and Monetary Union with a European Safe Asset”, in *European Financial Infrastructure in the Face of New Challenges*, Allen F., Carletti E., Gulati M. and J. Zettelmeyer (eds.), European University Institute.

¹³ See Draghi, M. (2019), Introductory Statement, ECB press conference, 12th September 2019.

Over the medium to long-term however, it is possible the euro area will experience stronger demographic pressures that will require a stronger policy response. In particular, according to Eurostat's latest baseline long-term population projections, the decline in the euro area's working-age population will accelerate sharply between 2020-40¹⁴, resulting in the working-age cohort falling to 57.8% of the total population by 2040 (from 64.5% in 2018), below the share in Japan in 2018 (59.7%). If these projections materialise, they would call for policies that will offset this negative shock to potential growth, by increasing the working-age population and productivity. One policy could be a broad-based shift in public expenditure in the euro area towards productive investment that can boost long-term productivity (i.e., environmental transition and digital infrastructure, as well as investment in up-skilling and re-skilling of the workforce).¹⁵ However, a growing dependency ratio and the related expenditure in healthcare and pensions can reduce the share of public resources available for investment or current expenditure in younger generations. Fiscal and structural policies could also create incentives for greater workforce participation, in particular of women, and higher fertility rates.¹⁶ However, the experience of Japan shows fiscal policy alone, even if focused on higher expenditure and productive investment, is insufficient and may even be counter-productive (in terms of raising debt ratios without raising growth significantly – see charts above) if not accompanied by macro-structural reforms that directly tackle the root causes of a declining population and low productivity.¹⁷ The structural reforms required will vary across the euro area countries according to their situation (i.e., demographic pressures are projected to be particularly acute in Germany and Italy but in France the working age population is expected to rise). Action to complete EMU, in particular to improve the integration of its capital markets, could also contribute to reducing the risk of Japanification for the euro area by raising potential growth through greater financing for investment and innovation.¹⁸

2. Convergence and inequalities

Real convergence among euro area countries was deeply impacted by the economic and financial crisis but appears to be resuming again. On the back of the continued economic expansion, convergence in living standards in the euro area has resumed, albeit at a lower pace compared to the pre-crisis period. Real convergence in GDP per capita and in unemployment has been stronger overall for Member States that have adopted the euro more recently as the difference between euro area-12 and euro area-19 countries reveals (Graph 6)¹⁹. Considerable disparities are also present within countries, often with stark divisions between capital city regions and the other regions.²⁰

¹⁴ The average annual decline in the working age population is projected to rise to 0.45% (from 0.1% over the last decade) according to Eurostat's EUROPOP 2018 projections.

¹⁵ Kirkegaard, J. (2019) "Yes, We Are Probably All Japanese Now", Monetary Dialogue, September 2019.

¹⁶ Blanchard, O. and Tashiro, T. "Fiscal Policy Options for Japan", Policy Brief 19-7, May 2019.

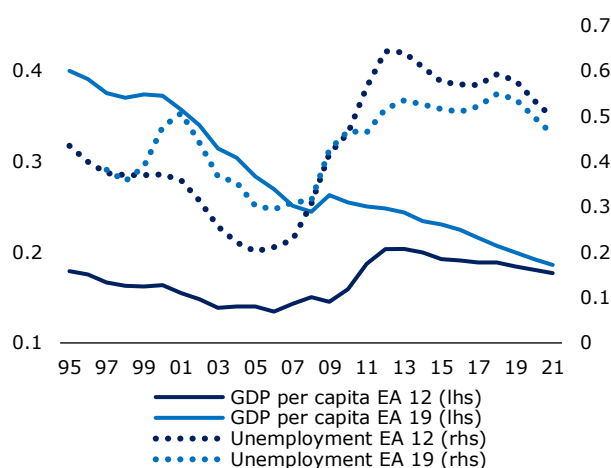
¹⁷ Japan: Staff Report for the IMF Article IV consultation, November 2018.

¹⁸ Villeroy de Galhau, F., and J. Weidmann (2019), "Towards a genuine capital markets union".

¹⁹ Euro area 12 corresponds to all Member States that had adopted the euro by 2001. Euro area 19 are all euro area Member States today. The difference in euro area 12 and 19 corresponds mostly to Central and Eastern European Member States).

²⁰ Eurostat, (2019), Eurostat regional yearbook.

Graph 6: Coefficient of variation of real GDP per capita and unemployment



Note: EA 12 are euro area Member States that joined the euro before 2007. EA 19 are all current euro area Member States.
Source: AMECO, Eurostat. Unemployment for EA 19 starts in 1998 due to data availability.

While the euro area has seen several years of economic expansion, within countries, the effects of this expansion have not been felt evenly throughout society. Net disposable income growth has increased from 1% in 2010 in the midst of the crisis to 3.2% in 2018 and a large majority of Member States have seen declining poverty and social exclusion. This has been accompanied by convergence towards the best performers in GDP-per-capita for some countries over the past few years following a period of increased divergences. The income of the 20% highest income households as a share of the income of the 20% lowest income households²¹ which had increased since the crisis from 4.7 in 2006 to 5.2 in 2016, subsequently marginally declined to 5.04 in 2017: these levels vary from 3.4 to 7.3 across euro area countries. At the same time, though increasing, the growth of disposable income has not yet reached pre-crisis levels and in some Member States, the shares of people at risk of poverty and social exclusion remains above 2010 levels. Inequality at high levels limited intergenerational mobility, increasing precariousness in labour market relations, and the uneven impact of globalisation, climate and technological change on people’s lives are creating a sense of vulnerability in certain parts of society.

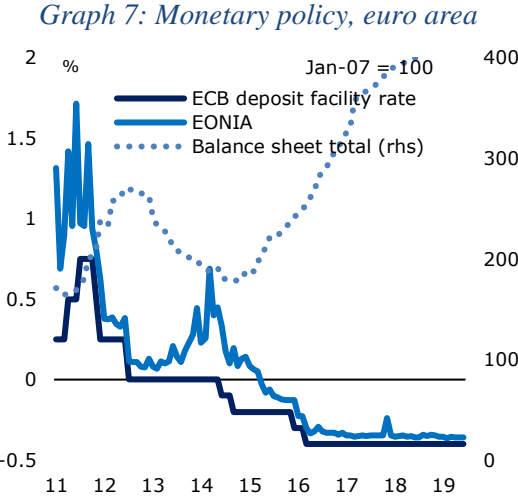
3. The macroeconomic policy stance

Decisions on the macroeconomic policy stance need to be taken against the background of persistent low inflation and a weakening and uncertain macroeconomic outlook. As signs of slower growth become more visible also the risks to the outlook increase, the macroeconomic policy will need to respond not only to the baseline scenario of slightly slower growth but also to a scenario where risks materialise and where there is a significant slowdown in economic activity. This would notably require stepping up structural policies and standing ready to use fiscal policy to support monetary policy taking into account

²¹ The income quintile ratio measures the ratio of the equivalised disposable income of the 20% highest income households to the income of the 20% lowest income, S80/S20.

country-specific circumstances. Even if the risks do not materialise, high and increasingly entrenched uncertainty is sufficient to slow growth and investment. This is particularly relevant in a context where it is uncertain if the slowdown is of a cyclical nature or if it is a more long-term structural change. Persistently low euro area headline and core inflation and growth rates – that rebounded only shortly following a deep economic crisis – are worrying signs for the long-term growth prospects.

The ECB is maintaining an accommodative monetary policy (Graph 7). In September 2019, the ECB lowered the deposit facility rate and introduced a two-tier system for reserve remuneration, in which part of banks’ holdings of excess liquidity will be exempt from the negative deposit facility rate. It also modified its rate forward guidance to become purely outlook-based. The ECB now expects to keep interest rates at the current or lower levels until inflation converges robustly to a level sufficiently close to, but below 2% over its projection horizon and this convergence has also been consistently reflected in the dynamics of underlying inflation. It furthermore announced an open-ended restart of net asset purchases under its asset purchase programme as from November 2019 and the intention to continue reinvesting the principal payments from maturing securities purchased under the asset purchase programme until after interest rates start rising. Finally, it announced lower rates and longer maturities for the new series of quarterly targeted longer-term refinancing operations.



Source: ECB

Better fiscal policy coordination among euro area Member States would result in stronger macroeconomic outcomes. Lack of buffers and only moderate fiscal support in Member States with more favourable positions, coupled with little reform effort at euro area and national level, would put the burden to counteract the deflationary effects of a possible marked slowdown once again on the monetary policy. Pursuing prudent policies in high debt countries to put public debt credibly on a sustainable downward path, while further boosting high-quality investments in Member States with favourable fiscal positions could reduce the burden on monetary policy, help overcome the low-inflation, low-interest-rate environment, and support nominal growth, thereby favouring deleveraging and rebalancing within the euro

area. Any policy package should combine short-term measures to sustain demand with long-term ones to increase potential growth. The Eurogroup can play a useful role in coordinating ex ante this work.

The currently-expected policy mix might not be sufficiently accommodative should negative risks materialise. The outlook appears contingent on several important downside risks that share a high degree of uncertainty and interconnectedness. In the event of a broad based economic downturn, the full use of automatic stabilisers could provide for an effective response. This could be accompanied by selective discretionary counter-cyclical fiscal policy measures in case extra fiscal support is needed, especially by Member States that have a favourable fiscal position.

A key question in a downside scenario is what would be the most effective fiscal response across Member States taking into account the respective fiscal space and severity of the downturn. The key principles of discretionary fiscal expansion in response to an economic shock are “timely, targeted, and temporary”.²² While public investment is considered to have the highest positive fiscal multipliers and is thus the most appropriate response to an economic shock, in practice it is difficult to scale-up significantly given implementation lags (see box 2).

Structural reforms are needed to complement macroeconomic policies. As lower technology adoption results in slower productivity (see section 5.2) and the demographic change further takes a toll on growth potential looming risks of secular stagnation ask for appropriate policy responses (see section 1 and box 1). To cater for the possibility that the slowdown is not just a temporary one but rather a more extended period of low growth, fiscal and monetary policies need to be combined with an ambitious package of national structural policies to foster economic resilience, growth potential and a sustainable economy (see section 5). Also, as there is little room for manoeuvre particularly in highly-indebted Member States, improving the quality and composition of public finances can contribute to build fiscal buffers while improving the growth outlook. Policies that favour education, employment and investment can increase growth potential in a budget neutral way. At the same time, the use of available fiscal space to support investment and disposable income would make growth prospects less dependent on foreign demand.

At the euro area level, completing the EMU would reduce uncertainty and support better macroeconomic outcomes. An incomplete EMU perpetuates financial fragmentation hindering the smooth transmission of monetary policy across the euro area. This limits financing opportunities for much-needed investment and undermines the potential for a stronger international role of the euro.

²² Commission Communication, COM(2008) 800 final, 26/11/2008, 'A European Economic Recovery Plan'.

Box 2: Effectiveness of fiscal policies in a downturn

A key policy question relates to the appropriate design of an effective discretionary fiscal response in case of a broad-based downturn in the euro area. In the case of large economic shocks, automatic stabilisers alone may not be sufficient to stabilise output, but need to be complemented with discretionary fiscal policy. While public investment is widely considered the first-best fiscal policy response to downturns given its high positive multiplier, in practice it is difficult to scale-up significantly given implementation lags. As a consequence, policy-makers often resort to other stimulus measures with varying macroeconomic stabilization impact.

The most recent instance of a coordinated discretionary fiscal stimulus was the European Economic Recovery Plan (EERP)²³ of December 2008 in response to the Global Financial Crisis (GFC). The plan's main objective was to stimulate aggregate demand over 2009-10 through a gross discretionary fiscal impulse of around 1.5% of GDP per year in the EU27 based on common principles of timely, temporary and targeted measures.²⁴ Given the implementation lags cited above, public investment spending accounted for only around one-fifth of the total discretionary fiscal stimulus in the EU27 between 2009-10 (i.e., 0.6% of GDP cumulatively).²⁵ A larger share of the stimulus was aimed at households' purchasing power (1% of GDP cumulatively or one-third of the total), and businesses (0.8% of GDP cumulatively or 30% of the total), with the remainder aimed at labour markets (0.5% of GDP cumulatively or around a sixth of the total). Support to households came mainly via reductions in consumption, labour income taxes and employees' social security contributions, as well as higher government transfers via expanded coverage of the unemployment benefit and social assistance system (beyond automatic stabilisers). Measures targeting labour markets included higher spending on short-time working (STW) schemes and job placement and life-long learning services, while those targeting businesses focused mainly on cuts in employers' social security contributions.

Table 1: European Economic Recovery Plan: Size and composition of discretionary fiscal stimulus

Policy Area	2009	2010	Total	% of total	Type of measure
Households	0,5	0,5	1,0	34%	Transfers, consumption taxes, SSC employees, labour income taxes
Labour market	0,2	0,3	0,5	17%	Government consumption
Business	0,4	0,4	0,8	28%	Reduction in employers' social security contributions (SSC)
Investment	0,3	0,3	0,6	21%	Public investment
Total	1,5	1,4	2,9	100%	

Source: Report of Public Finances in EMU – 2010

Measures were timely, temporary, well targeted and overall effective. The Commission's monitoring of the Member States' recovery plans found that they were implemented in a timely manner, were mostly of a temporary nature (around three-fifths expired by 2011), and generally well-targeted in that they focused on the policy areas highlighted by the EERP,

²³ Commission Communication, COM(2008) 800 final, 26/11/2008, 'A European Economic Recovery Plan'.

²⁴ The net discretionary fiscal impulse was equal to 1.1% of GDP in 2009 and 0.8% of GDP in 2010 because some Member States also implemented consolidation measures during this period.

²⁵ Report of Public Finances in EMU - 2010

although a quantitative assessment of their impact on output – the multipliers – was not undertaken.²⁶ An external quantitative assessment²⁷ of the EERP using the ECB’s New Area-Wide DSGE Model found the maximum fiscal multipliers for government spending on labour markets (classified as consumption) and investment were above one but those for all other measures (labour income and consumption taxes, transfers, social contributions) were below 0.3. As a result, the overall multiplier of the EERP was estimated at 0.57 by end 2009 and 0.6 by end-2010, with an effect on output of 0.59% and 0.49% of GDP respectively.

The literature on the impact of temporary fiscal stimulus on output broadly confirms the findings related to the EERP. The size of multipliers depends on the composition of the temporary stimulus as well as the degree of monetary policy accommodation.²⁸ If there is no monetary accommodation, the first-year multipliers from a temporary two-year EU-wide increase in government consumption for the first year range between 0.8 to 0.9 in the EU and then drop to zero as soon as the stimulus ends. The multiplier is slightly below unity due to modest crowding out of private domestic demand and reduction in net exports resulting from a rise in interest rates that depresses private domestic demand and drives real exchange rate appreciation. With monetary accommodation, the instantaneous multiplier from a temporary two-year rise in government consumption is above unity in the first year and grows marginally over the medium-term because output remains above trend following the expiration of the stimulus, reflecting the persistent reduction of real interest rates. Moreover, while the literature focuses mostly on government consumption, there is significant variation in the size of multipliers depending on the type of temporary fiscal measures. Table 2 summarizes the average first-year multiplier on real GDP of a two-year fiscal stimulus accompanied by two years of monetary accommodation, depending on the type of stimulus measures undertaken.

Table 2: First year multiplier by type of stimulus

Type of fiscal stimulus	Multiplier
Government Consumption	1.52
Government Investment	1.48
Targeted transfers	1.12
Consumption taxes	0.66
Labour income taxes	0.53
General transfers	0.29
Corporate income taxes	0.15

In summary, it would be prudent for Member States to prepare contingency plans that could be activated in case a broad based downturn materialises, focusing on productive yet temporary spending. In addition to investment, productive spending could include government consumption and social transfers targeted specifically at low-income, cash-constrained households that could

be quickly rolled out. These measures should be temporary given the known difficulties to phase them out after the economic conditions improve. Tax cuts, as mentioned above, tend to have much lower multipliers than spending, but may be effective if targeted rather than broad-based. If countries with relatively high debt would embark on spending reviews that identify savings to create room for productive spending, and seek to complement expansionary fiscal

²⁶ "Progress report on the implementation of the European Economic Recovery Plan" June and December 2009.

²⁷ Coenen, Günter & Straub, Roland & Trabandt, Mathias, (2013). "Gauging the effects of fiscal stimulus packages in the euro area," *Journal of Economic Dynamics and Control*, Elsevier, vol. 37(2), pages 367-386.

²⁸ This paragraph and table 2 draw on the review of seven structural dynamic stochastic general equilibrium models used heavily by policymaking institutions and two academic DSGE models in Coenen et al. (2012), "Effects of Fiscal Stimulus in Structural Models." *American Economic Journal: Macroeconomics*, 4 (1): 22-68.

policies with well-designed medium-term fiscal strategies and productivity-enhancing structural reforms they would be better prepared should a downturn materialize.²⁹

Moreover, beyond discretionary fiscal measures, there is scope in several Member States to increase the efficiency of automatic stabilisers. The share of consumption absorbed by the tax and benefit system following a shock to market income ranges from 64% to 75% across Member States and is around 70% in the EU as a whole.³⁰ Options to increase the stabilization impact would be to adjust the features of selected revenue/expenditure categories in order to increase their response to economic activity, for example the replacement rate or duration of unemployment benefits. Alternatively, automatic changes to revenue (tax) and expenditure parameters could be introduced as a response to macroeconomic developments, but concrete cases have been rare so far. Nevertheless, enhancing automatic stabilisers is not a panacea, since they can have a negative impact on the allocative efficiency such as prolonging unemployment spells, especially if these measures are not rescinded in good times.

4. Budgetary policy

4.1 Fiscal policy

The euro area fiscal stance is expected to remain broadly neutral to slightly expansionary in 2019 to 2021 but national fiscal policies are not expected to be appropriately differentiated. The change in the structural balance, points to a broadly neutral fiscal stance in 2019, 2020 and 2021 by around 0.1 or 0.2 percentage points each year in a no-policy change scenario (Graph 8). Overall, the structural budget deficit is expected to widen from -0.8% of GDP in 2018 to -1.2% in 2021. A more expansionary fiscal stance, by around ½ percentage points of GDP each year, is forecast when looking at the fiscal effort based on the structural primary balance and the expenditure benchmark³¹ which are not affected by ongoing savings in interest rate expenditure. While Member States with fiscal space are forecast to use part of it in 2020 to support economic growth prospects, broadly in line with the recommendations addressed to them, a number of highly-indebted Member States are not expected to reduce their structural deficits.

²⁹ "World Economic Outlook," International Monetary Fund (2016).

³⁰ Mohl, Moure and Stovicek (2019), "Automatic Fiscal Stabilisers in the EU: Size & Effectiveness" European Commission, Economic Brief 045.

³¹ Compared with the change in the structural primary balance, this indicator uses a (lower) medium-term potential growth as a reference and does not benefit from some revenue windfalls projected in 2019.

Table 1: General Government budgetary position

	2014	2015	2016	2017	2018	2019	2020	2021
Total receipts (1)	46.8	46.4	46.2	46.2	46.5	46.3	46.2	45.9
Total expenditure (2)	49.3	48.4	47.7	47.2	47.0	47.1	47.1	47.0
Actual balance (3) = (1)-(2)	-2.5	-2.0	-1.4	-0.9	-0.5	-0.8	-0.9	-1.0
Interest expenditure (4)	2.6	2.3	2.1	1.9	1.8	1.7	1.5	1.4
Primary balance (5) = (3)+(4)	0.1	0.3	0.7	1.0	1.3	0.9	0.6	0.4
One-offs (6)	-0.2	-0.2	0.1	-0.1	-0.1	-0.2	0.0	0.0
Cyclically-adjusted budget balance (7)	-1.0	-1.0	-0.9	-1.1	-0.9	-1.1	-1.1	-1.2
Cyclically-adjusted primary balance (8) = (7)+(4)	1.6	1.4	1.2	0.9	0.9	0.6	0.4	0.2
Structural budget balance (9) = (7)-(6)	-0.8	-0.8	-1.0	-1.0	-0.8	-0.9	-1.1	-1.2
Structural primary balance (10) = (7)-(6)+(4)	1.8	1.5	1.2	1.0	1.0	0.7	0.4	0.2
Change in actual balance:								
of which change in:								
- Cycle		0.4	0.5	0.7	0.3	-0.1	-0.1	-0.1
- Interest (inverse)		0.3	0.2	0.2	0.1	0.2	0.1	0.1
- One-Offs		0.1	0.2	-0.1	-0.1	0.0	0.2	0.0
- Structural primary balance		-0.3	-0.3	-0.2	0.1	-0.3	-0.4	-0.2
Change in structural budget balance		0.0	-0.1	0.0	0.2	-0.1	-0.2	-0.1
Public debt (% GDP)	95.1	93.0	92.2	89.8	87.9	86.4	85.1	84.1

Source: European Commission 2019 Autumn forecast, Ameco.

Note: contributions to change in actual balance may not add up to total due to rounding.

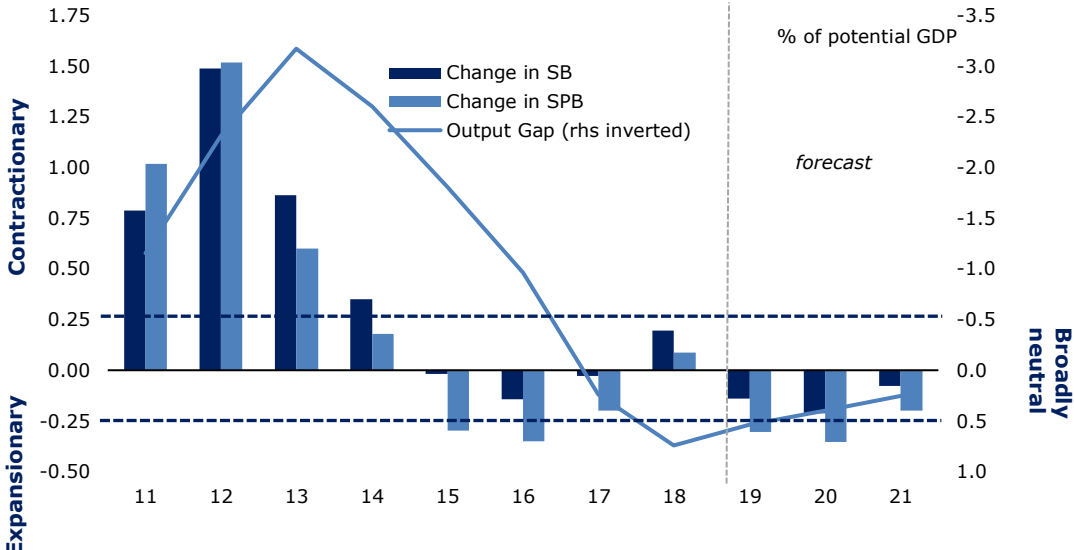
The euro area debt-to-GDP ratio is gradually decreasing. The aggregate debt-to-GDP ratio has been on a declining path since 2014 (Table 1 and Graph 10), when it reached a peak of 95%. In 2018, the debt ratio fell to 87.9% and it is projected to fall further over the forecast period to reach around 84% in 2021, under a no-policy-change assumption, thanks to favourable interest-growth differentials and primary surpluses. However, public debts are not projected to decline in some highly-indebted Member States and a sharp downturn could compromise further debt reduction in the euro area aggregate (Graph 11).

Headline deficit improvements seen since 2011 seem to have halted. The euro area aggregate deficit has declined by 5.7 percentage points of GDP since 2010, to 0.5% of GDP in 2018, the lowest level since 2000 (Table 1, Graph 9). To this reduction contributed the sizeable consolidation packages adopted in 2011-2013 and the working of automatic stabilisers afterwards, with actual economic growth outpacing potential growth. Between 2014 and 2018, the reduction in the headline budget deficit was supported by the cyclical upswing and the low interest rate environment. The expenditure ratio decreased by some 2pp since 2014 to around 47% of GDP (Table 1) while revenues declined by less than half a percentage point of GDP over the same period. Lower growth expected in 2019 seems to be reversing the trend. With the euro area economy moderating in the coming quarters and with risks to the downside this improvement in the fiscal position may be put at risk. The aggregate deficit is forecast to increase in 2019, 2020 and 2021 to 0.8%, 0.9%, and 1% respectively given the less favourable cyclical conditions and discretionary expansionary measures planned in the 2020 Draft Budgetary Plans which more than offset the expected decline in interest expenditure.

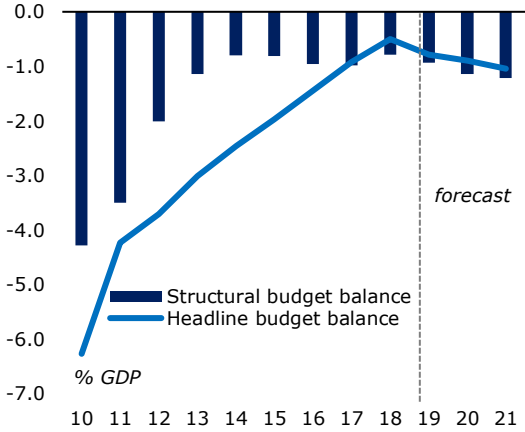
Member States have been slow in improving the quality of public finances. Euro area Member States took only limited measures to implement 2018 CSRs related to public finances and taxation. While fiscal frameworks in Member States generally conform to the minimum EU requirements in this area, ensuring that national fiscal rules and institutions operate

smoothly and guide fiscal policy over the short- and medium-term requires continuous monitoring and effort. In return, effective and efficient fiscal frameworks can improve the quality of fiscal policy, both in terms of its macroeconomic stance and composition of budgets and in this way mitigate the tension between stabilisation and sustainability goals. The improvement of the quality of public finances should go hand in hand with the development of green budgeting practices and benchmarks.

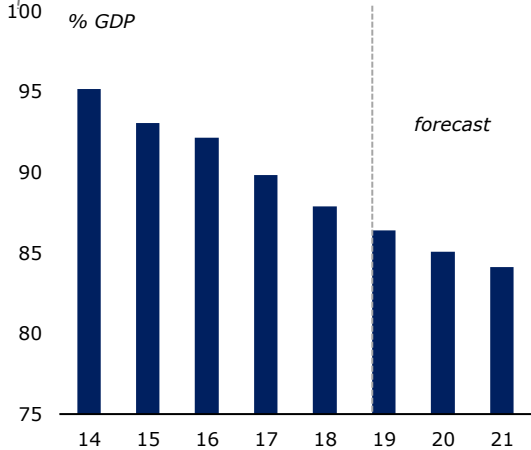
Graph 8: Change in the structural balance (SB) and structural primary balance (SPB), euro area



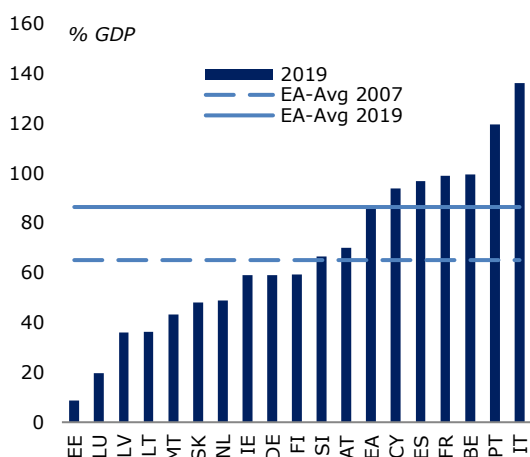
Graph 9: Government budget balance, euro area



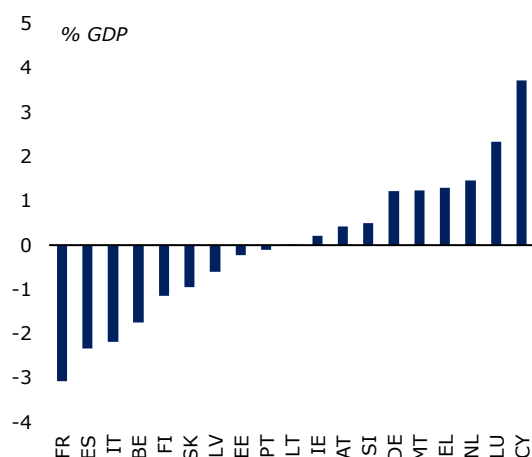
Graph 10: Government debt, euro area



Graph 11: Government gross debt, 2019



Graph 12: Government headline balance, 2019



Sources: European Commission 2019 [spring] forecast (Graphs 4, 5, 6), ECB (Graph 3).

4.2. Expenditure policy

While spending reviews are critical in improving the quality of public finances, they are seldom incorporated into budget decisions. By keeping expenditure in check and addressing its efficiency, spending reviews help creating room to build fiscal buffers (see section 4), improve fiscal sustainability and are also a fitting tool to boost high-quality public spending. Focused reviews on spending reprioritisation could make room to increase productive spending in priority areas and help preserve the public investment envelope in cyclical downswings, when investment is most vulnerable³². Engaging in spending reviews in large areas of expenditure such as pensions or health can improve the long-term sustainability of public finances. But while political commitment with spending reviews in the euro area is increasing, only a minority of Member States incorporates decisions from spending reviews into their budget planning.³³ Public procurement – the buying of works, goods or services by public bodies – is one of the largest expenditure items accounting for over 14 % of EU GDP³⁴. However, according to the Single Market Scoreboard, there are still large differences within the euro area in terms of public authorities’ performance in getting the best value for money in their purchases. In 2018, some Member States still had unsatisfactory performance in terms of applying public procurement best practices.

Public investment – which is key for increasing productivity and potential growth – remains at historically low levels. Public investment declined by almost 1% GDP since the beginning of the crisis and barely increased since 2014 while social benefits and compensation of employees remained broadly stable as a share of GDP (Graph 13). It is projected to increase only marginally over the forecast horizon (close to 2.9% in 2021, from 2.7% in 2018) and thus remain below its pre-crisis average (3.2% of GDP over 2000-2005).

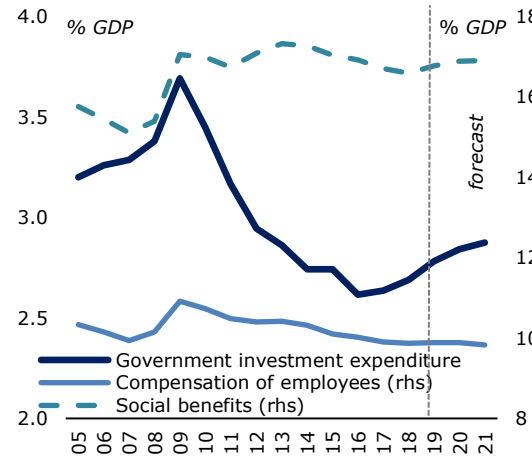
³² European Commission, “Spending reviews as a key tool to enhance public investment in the Euro Area.”, Technical note for the Eurogroup, September 2019.

³³ “Spending reviews for smarter expenditure allocation in the Euro Area.”, Note for the EPC, 19 June 2019.

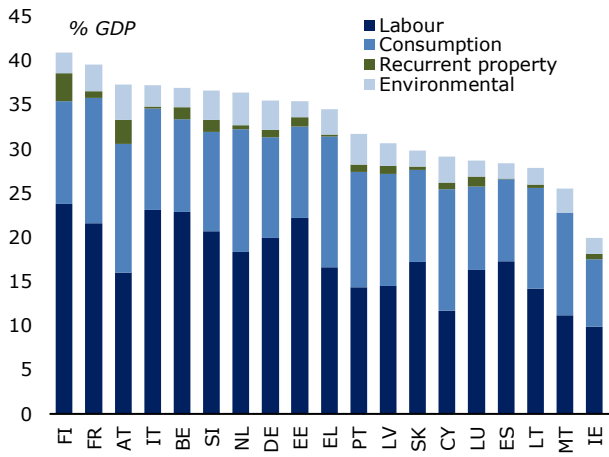
³⁴ Making Public Procurement work in and for Europe COM(2017) 572.

Increasing public investment levels and investment quality could play a role in fostering long-term growth (see section 1) given the positive effect of public investment on potential growth and labour productivity³⁵. Increasing public investment can be achieved in a budgetary-neutral way in those countries that lack fiscal space by improving the efficiency of current spending. High-quality investments, particularly in research and development, network industries (provided there is no overprovision) and education could boost these countries competitiveness. In surplus countries additional investment spending would boost potential growth while also contributing to rebalancing in the euro area. There is increasing coordination within the EU to identify the priority areas for investment (see section 4.2).

Graph 13: Government expenditure, euro area



Graph 14: Composition of tax revenues*



* Consumption taxes often include environmental taxes, thereby total tax revenues presented in Graph 10 may be inflated. Data for 2017. “Other taxes”: all taxes that are not labour, value added, corporate income, environmental, or recurrent property taxes (e.g capital taxes such as on capital gains or inheritances and some consumption taxes such as on imports or alcohol and tobacco). Labour taxes includes employers’ and employees’ social contributions. Source: European Commission 2019 autumn forecast, Ameco (Graphs 7, 8, 9), European Commission, Taxation trends in the European Union, 2019 (Graph 10).

Improving Member States’ public investment strategies is essential to face long-term challenges. Investment now, would benefit future generations if used to tackle long-term changes in technology, climate and skills needs. Investment in infrastructure, education and innovative activities adds to a country’s capital stock, which enhances the economy’s long-run productivity growth.³⁶ Coordinated investments among Member States, and between private and public sector, will be essential to achieve the Paris Agreement objectives of emission reduction, energy efficiency, and renewables targets. An additional EUR 260 billion³⁷ in annual investment compared with the baseline for the EU as a whole would be needed to reach the 2030 climate and energy targets. Interventions to replace dirty technologies with their clean counterparts are expected to play a significant role in the reallocation of capital and labour between sectors within countries³⁸. The same can be said for the need to upgrade skills to face the upcoming challenges. New ways of working and rapid

³⁵ Fournier, J. (2016), The positive effect of public investment on potential growth, OECD.
³⁶ Johansson, A. (2016), “Public Finance, Economic Growth and Inequality: A Survey of the Evidence”, OECD Economic Department Working Papers, No. 1346, OECD Publishing.
³⁷ “United in delivering the Energy Union and Climate Action - Setting the foundations for a successful clean energy transition” COM(2019) 285, European Commission.
³⁸ Ardagna (2019), “Growing Green”, European Economic Analyst, Economics Research, Goldman Sachs.

technological change are affecting the types of skills needed. High skills enable people to adapt to unforeseen changes. Similarly, the transition to a low carbon and circular economy means creating and adapting to business models and job profiles.³⁹ If public investment is coupled with structural reforms, more regulatory certainty is given to businesses. The BICC can be key in this strategy since it will combine investment and structural reforms at member state level coordinated at euro area level.

Green budgeting practices, which can enable fiscal policy to address directly climate challenges, remain underdeveloped in most Member States. Presenting transparently the extent to which national budgets contribute to the achievement of environmental objectives, conducting environmental impact assessments, assessing greenness of taxes, freeing up fiscal space for green investments and incentive schemes for private investments in a budget-neutral approach are measures that can be taken in the framework of green budgeting. The framework for assessing debt sustainability would also need to consider impacts of extreme weather events and gradual temperature rises on fiscal outcomes and growth, public finance and economic costs of Member States emission reduction commitments as well as impacts and costs of macro-relevant adaptation measures. Only a few Member States explicitly identify environmental measures within budgetary documents in a way that can track effort and progress towards environmental goals. In those cases where such practice exists, a consistent and coherent approach for the presentation of environmentally-friendly measures is missing. A coherent link between Climate Action plans and expenditure policies would improve the quality and impact of public spending on climate challenges.

4.3 Tax Policies

Rethinking the overall tax mix, including labour taxation would support inclusive and sustainable growth. A level-playing field on taxation and shifting taxes towards more growth friendly tax basis would contribute to a more resilient euro area. In times of transition towards a greener and digital economy, tax systems need to be designed to deliver on the objectives of green investment and environmental sustainability, better employment opportunities, a fair burden-sharing, and fiscal responsibility. The overall tax burden in the euro area is skewed towards labour (including social contributions) with property or environmental taxes representing a very small share of tax revenues (Graph 14). To finance its reduction, the tax burden could be shifted towards tax bases that are less detrimental to growth. At the same time, a high tax burden on labour, particularly for low-income and second earners, can be an impediment for job creation and labour market participation. Targeted tax cuts for those groups can thus be an important instrument as part of a broader policy package for a just transition to a greener economy.⁴⁰

³⁹ Commission Communication, COM(2016) 381 final, ‘A new skills agenda for Europe’.

⁴⁰ Brys, B., et al. (2016), "Tax Design for Inclusive Economic Growth", OECD Taxation Working Papers, No. 26, OECD Publishing, Paris, <https://doi.org/10.1787/5jlv74ggk0g7-en>.

Environmental taxation can contribute to sustainable growth by incentivising “greener” behaviour by producers, users and consumers. Energy, transport, as well as resource and pollution taxes differ significantly across countries, in particular in how carbon and energy content are taken into account when taxing energy products⁴¹. At EU level a review of the Energy Taxation Directive could be helpful in this regard since it has not kept pace with the developments in the field of energy efficiency and climate change. A first evaluation of the current Directive was already undertaken by the Commission services. It provided a first technical assessment on the need for restructuring the framework for the taxation of energy products and electricity given the significant changes which took place in technologies, national taxes and energy markets since 2003⁴². However, as environmental taxes often hit low-income earners particularly hard, it is important to accompany their increased use with measures mitigating the impact on the vulnerable groups. Also, a Carbon Border Tax would contribute to avoid carbon leakage and by this to reduce total CO₂ emissions in the world.

There has been a race to the bottom in recent decades in corporate taxation and the international corporate tax system is out of step with the realities of the modern economy. Corporate income tax rates have fallen significantly over the past three decades worldwide.⁴³ The euro area is no exception, at least in the last decade where the average statutory tax rate has fallen from 32% in the year 2000 to 24% in 2019⁴⁴. While this reduction in rates has not so far resulted in a corresponding decrease in revenue, scope for further broadening the corporate tax base may be limited. The ease with which mobile resources can move within the euro area increases the scope for tax competition between euro area economies. Excessive tax competition risks distorting businesses’ investment decisions and leading to tax policies aimed at short-term tax collection rather than at long-term economic growth, jobs and social fairness. Together with the occurrence of tax avoidance, it also risks undermining faith in the fairness of the overall tax system. Corporate taxation systems currently do not ensure that profits are taxed where they are generated, particularly given the increasing weight of the digital economy. Coordination among Member States is essential to address profit-shifting and tax competition and to ensure a lasting, efficient and fair approach for international taxation. An EU agreement for a Common Consolidated Corporate Tax Base would contribute to this and in the long-run increase growth in the EU by up to 1.2%⁴⁵. Positive impacts would also come from reviewing profit allocation among countries at global level and ensuring minimum effective taxation. The need to finance investments in climate change adaptation and decarbonisation of the euro area economies should bring new impetus to the EU proposals in this area. From this perspective, improving tax collection would reduce the recourse to debt.

⁴¹ Economic Policy Committee note 2019: “The quality of public administration”.

⁴² Commission Staff Working Document, SWD (2019) 329 final, evaluation of the Council Directive 2003/96/EC of October 2003 restructuring the Community framework for the taxation of energy products and electricity.

⁴³ IMF (2018), “Tax Policy Measures in Advanced and Emerging Economies: A Novel Database”, Working Paper No. 18/110.

⁴⁴ European Commission (2019), “Taxation Trends in the European Union”.

⁴⁵ COM(2019) 8, “Towards a more efficient and democratic decision making in EU tax policy”.

Addressing tax fraud, evasion and aggressive tax planning (ATP⁴⁶) are essential to make tax systems more efficient and fairer. These are essential to secure government revenues, impede distortions of competition between firms, provide tax certainty for businesses, preserve social cohesion and fight increasing inequalities. Recent studies⁴⁷ find that corporate tax avoidance in the EU-28 entails more than EUR 35 billion of corporate tax revenues losses annually.⁴⁸ In particular, a study commissioned by the European Parliament finds that the revenue loss from profit shifting within the EU amounts to about EUR 50-70 billion. These revenue losses are very sizeable, including when compared to the investment needs to address climate change. The mobility of capital, which has increased with the introduction of the euro and the ensuing suppression of currency risks, facilitates tax arbitrage by multinational enterprises operating within the euro area, which make the adoption of measures to address ATP particularly urgent for euro area Member States. ATP has clear spillover effects within the euro area as it creates a tax-induced redistribution of tax revenues across euro area Member States on top of an overall loss due to lower effective taxation.

Tax simplification and addressing the debt bias in corporate taxation would contribute to improving tax systems. This could improve the resilience of tax systems, provide certainty for businesses and contribute to investment and innovation, as well as improving tax compliance. Most euro area Member States' corporate tax systems still favour debt over equity financing. Reducing or eliminating this debt bias would contribute to reducing financial stability risks. Continued efforts should be made to simplify tax systems by decreasing loopholes, duplications and improving the rules transparency while considering well-designed tax incentives to boost real investment, including in the green economy. Improving the capacity of the tax administration could contribute to decrease tax avoidance and ensure tax collection from the entire tax base thereby creating space to reduce/reorient the tax burden.

5. Structural issues

Reform progress by euro area countries remains moderate despite efforts to strengthen implementation in the context of the European Semester. Country Specific Recommendations (CSR) provide economic policy guidance to Member States on what should be their reform priorities. From an annual perspective, Member States' progress in CSR implementation has been decreasing steadily since 2013 (European Commission calculations).⁴⁹ This shows some reform fatigue after a stronger reform effort in the post-crisis

⁴⁶ ATP consists in taxpayers' reducing their tax liabilities through arrangements that may be legal but are in contradiction with the intent of the law. It occurs through three main channels: debt shifting, strategic location of intellectual property rights and intangibles assets and misuse of transfer pricing.

⁴⁷ Álvarez-Martínez, M., Barrios, S., d'Andria, D., Gesualdo, M., Nicodème, G., & Pycroft, J. (2018). *How Large is the Corporate Tax Base Erosion and Profit Shifting? A General Equilibrium Approach*. CEPR Discussion Papers 12637.

⁴⁸ Tørsløv, T., Wier, L., & Zucman, G. (2018). *The Missing Profits of Nations*. NBER Working Paper 24701.

⁴⁹ In 2013, the progress in CSR implementation by euro area countries accounted for 39%, while in 2018 the progress was of 33%. Each CSR is assessed qualitatively every year on implementation progress from "no

period. In terms of average annual assessment of progress in implementing CSRs by broad policy areas between 2013 and 2018, progress in the financial sector was the highest (see section 6), followed by the progress in public administration & business environment (section 5.2), labour market, education & social policies (section 5.1) and public finances (section 4). However, the area of structural policies, which together with public administration are crucial for institutional quality (see below and section 5), saw the lowest implementation ratio. In terms of individual policy areas, the average annual progress in CSR implementation between 2013 and 2018 was below 50%⁵⁰ on all of them apart from financial services, access to finance and insolvency frameworks (Graph 15). Areas where reform effort stayed below 30% were the debt bias, broadening the tax base, and competition in services and telecoms.

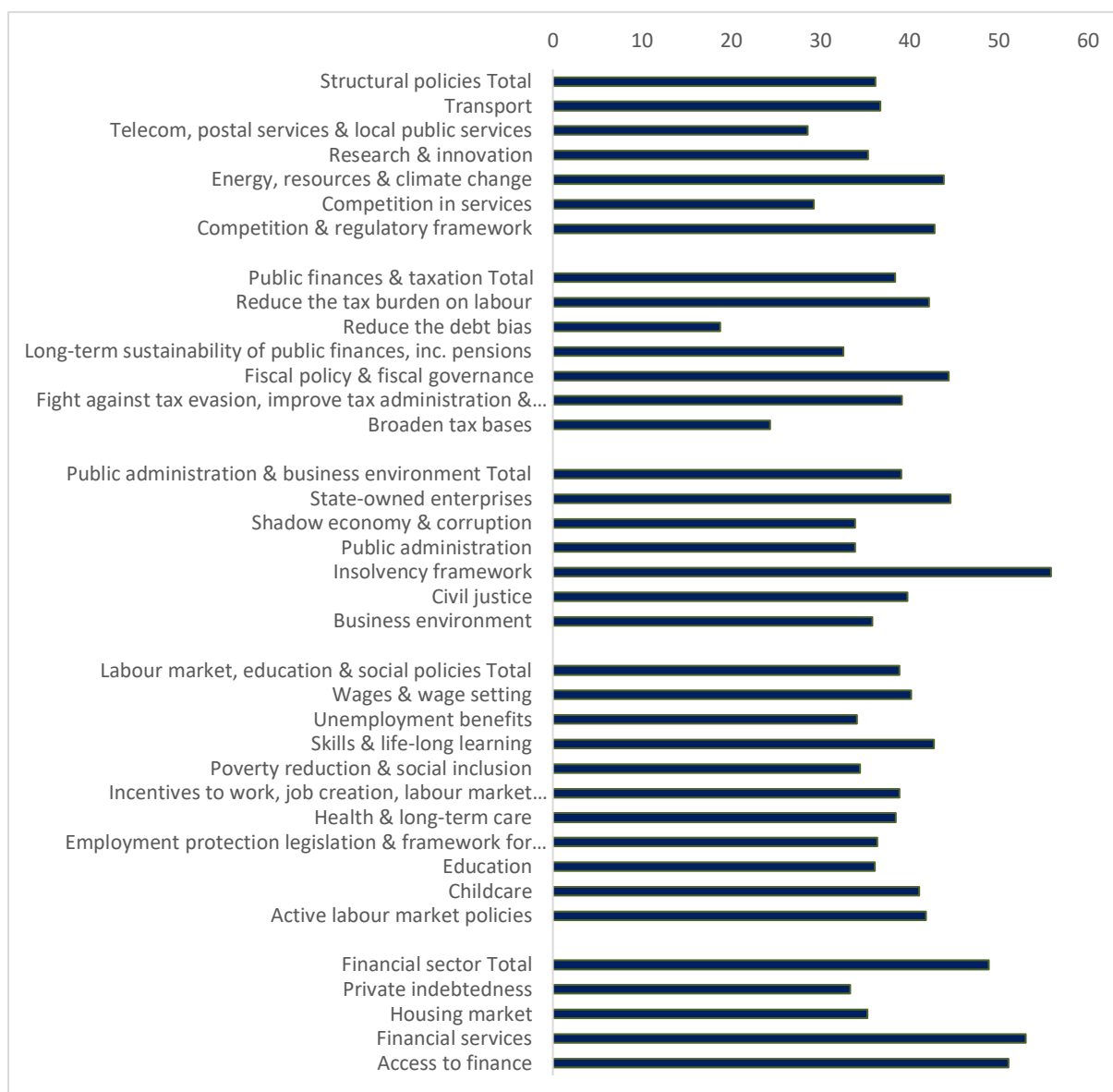
The Commission has made concrete efforts to make the European Semester more effective and increase the ownership by Member States.⁵¹ The number of recommendations has been reduced and their content made more focused, while leaving room for Member States to act in line with their national practices and situations. Social considerations have been prioritised and mainstreamed in line with the European Pillar of Social Rights and through the use of the Social Scoreboard. The Commission took several initiatives to promote dialogue, reach out to stakeholders, increase national ownership of reforms and consult Member States on the analytical parts of their country reports prior to the publication. The Commission's Structural Reform Support Service also provides targeted reform assistance to Member States, at their request, to support them in design and implementation of reforms.

progress” to “full implementation”. In order to be able to make aggregate analysis across countries and over time, a quantification is given to each assessment level: no progress = 0; limited progress = 25; some progress = 50; substantial progress = 75; full implementation = 100.

⁵⁰ Idem.

⁵¹ European Commission press-release IP-19-2813

Graph 15: Average of annual assessment of implementation of CSRs for euro area countries (2013-2018)



Source: European Commission CSR database.

Note: This graph shows the average of the annual implementation scores of country-specific recommendations per policy area. The scores attributed are 25 for 'limited progress', 50 for 'some progress', 75 for 'substantial progress', and 100 for 'fully implemented'. Data has been collected since 2011, but 2013 saw a major break in series. Comparison is thus more reliable as of 2013.

Box 3: Progress in addressing the 2019 EARs

This box makes a first assessment of the implementation of the euro area recommendations (EARs). A more complete review of progress in implementing the euro area recommendation will be published in next year's SWD, based on a methodology to be elaborated and discussed with euro area Member States and institutions in the relevant committees.

Going forward, the goal will be to provide an overview of progress for the euro area as a whole in implementing previous year's EARs. First, the assessment takes into account reforms that were undertaken at national level or at European level where relevant. Second, it takes into account policy outcomes, including at the euro area level and available assessments at country level. In the cases where a recommendation is addressed to a specific group of

Member States (such as member states with high debt levels or external surpluses) only those are considered for assessing progress. *Overall, following the euro area recommendation published last year, the following qualitative assessment can be made.*

Some reform progress was achieved to increase potential growth, competitiveness and productivity (EAR 1, see sections 1, 2, 5 and 5.2). The rate of Single Market integration has slowed down and the level of integration remains low in services with significant remaining gaps. National reforms in the areas of research and innovation, competition and services have been progressing but reforms in the areas of network industries and sustainability progressed only slowly. Most Member States improved their business environment scores but large differences remain and there was no significant improvement in many aspects pertaining to the quality of national public administrations. Most Member States with persistent current account deficits have reduced their deficits or turned them into surpluses but productivity decreased or remained broadly unchanged in particular in some Member States with large deficits. There was some progress in promoting wage growth, among the Member States with current account surpluses though wage gains were overall modest and in some cases below inflation. Investment in these same countries has been sustained and increased in some cases though investment levels are projected to weaken for some countries over 2019-20.

On the fiscal recommendation (EAR 2), progress has stalled. There continues to be lack of differentiation in Member States' fiscal policies (see section 3). The expected fiscal effort for 2019-20 by Member States with high debt levels is negative or neutral, in contrast with the recommendation to rebuild fiscal buffers while Member States with fiscal space are forecast to use only part of it to support economic growth prospects. Public investment and the share of growth-enhancing expenditure remain low with only a few Member States incorporating spending reviews decisions into their budget planning. Private investment is forecast to reach pre-crisis levels in 2019-2020. Progress is also limited in tackling Aggressive Tax Planning (ATP) where there remains scope for further action through the coordination of national tax policies. Furthermore, discussion at the Council have stalled on proposals such as the CCCTB, which would contribute to fighting ATP (see section 4.3).

Following years of economic expansion and job creation, the labour market and social situation continues to improve, but challenges remain. The unemployment rate continued to decrease, with significant differences persisting across Member States. Member States adopted reforms to increase the number of people active on the labour market but labour market segmentation remains a source of concern, as well as in-work poverty. In some countries, efforts are ongoing to promote open-end hiring and to reinforce labour inspectorates. Moreover, in a context of rising skills shortages and mismatches, policy action was taken to better link the education and training system to labour market needs. Some countries are making efforts to adapt social protection systems to a changing world of work, including by ensuring adequate coverage to non-standard workers and self-employed. A few Member States are taking action to reinforce their income support schemes, while targeting carefully support to those most in need and by promoting activation of beneficiaries. Finally, several Member States supported employment and labour income by reducing the tax wedge.

The euro area and its Member States took several actions to improve the resilience of the financial sector (EAR 4, see section 6). The revision of the ESM Treaty providing the common backstop to the Single Resolution Fund is under discussion and a High Level Working Group (HLWG) was established concerning the European Deposit Insurance Scheme (EDIS). Though the Commission delivered on all of the actions announced in the Capital Markets Union (CMU) and the co-legislators reached at least political agreement on

13 of the 16 Commission proposals, further steps are needed to build a genuine CMU. Non-performing loan levels have been substantially reduced with only a few exceptions, while private debt levels have decreased for households, though not for non-financial corporations.

On deepening the EMU, progress has been slow (EAR 5, see section 7). There has been some progress on the economic union, with a political agreement on a euro area Budgetary Instrument for Convergence and Competitiveness and on improving the ESM's toolkit. However, there was no progress towards a euro area-wide fiscal stabilisation function or on euro area governance proposals. Lack of progress in completing the EMU hinders the development of the global role of the euro.

5.1 Institutional aspects and public administration

Strengthening institutional quality at national level would be key in improving the delivery of structural reforms. Well-performing public institutions are a precondition for the successful delivery of structural reforms⁵² as successful reform depends on good governance, effective law making and implementation, independent and efficient justice systems and overall quality of public administration.⁵³ Public Administration and Business environment is another area crucial for institution quality, and there progress in CSR implementation was similar to other broad policy areas. Focusing on improving the effectiveness of the public administration, including justice systems, as well as the quality and stability of the regulatory environment could contribute to improve the reform pace and the appropriateness of the reforms undertaken to current and future challenges.

A well-functioning public administration requires action in several areas, from accountability, to management of financial and human resources as well as quality of service delivery. An efficient tax administration and low tax compliance costs, a regular and transparent budget cycle of planning, negotiation and implementation and efficient public procurement are essential for the quality of public financial management. An indicator-based assessment framework on public administration⁵⁴ has been developed by the European Commission to identify public administration reform priorities in Member States.⁵⁵ The framework considers that effective policymaking requires, among other things, strategic planning, coordination, parliamentary oversight of government policy making, public consultation, and ex-ante and ex-post evaluation of regulations. In terms of the quality of the civil service and human resource management the framework highlights that performance assessments, measures to promote integrity in the civil service and rules governing the recruitment of civil servants and of senior managers are key for a well performing administration. In order to ensure accountability, providing access to public data and well-functioning oversight institutions and a fair and effective system of administrative review

⁵² Commission Communication, COM(2018) 770 final, Annual Growth Survey 2019.

⁵³ OECD- SIGMA (2017), The Principles of Public Administration, OECD Publishing, Paris

⁵⁴ Guidelines for assessing public administration and governance in the European Semester, September 2019, Note to the Economic Policy Committee.

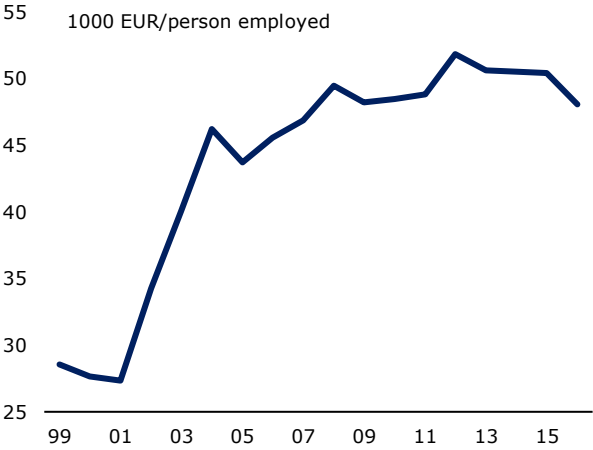
⁵⁵ It looks into five performance areas: i) policy planning, development and coordination; ii) civil service and human resource management, iii) accountability, iv) service delivery and v) public financial management.

along with effective justice systems are essential. Top performant service delivery by public administrations is characterised by user centricity and the existence of mechanisms to ensure the quality and access of services.

5.2 Product markets and the business environment

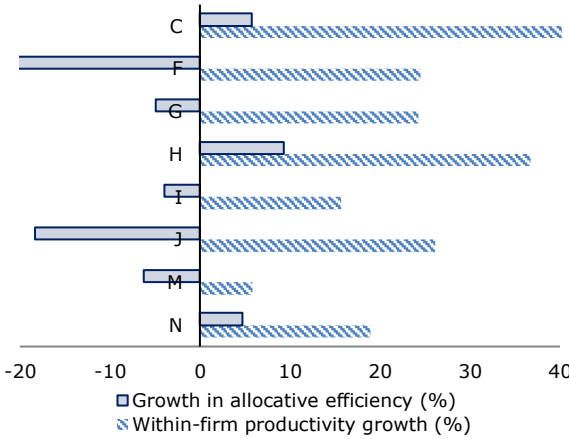
Despite the progress achieved in product and services market regulations in the past two decades, reforms are slowing down. Euro area Member States have been implementing competition-enhancing product market regulation at a steady pace since the introduction of the euro, as measured by the OECD’s product market regulation indicators which show a significant reduction in the restrictiveness of product market regulation between 1998 and 2013.⁵⁶ Moreover, the European Commission’s assessment of the implementation of structural reforms recommendation in the area of product markets⁵⁷ shows that, on average, Member States have made only some progress, since 2013. In effect, challenges remain, as almost no recommendations in the area of product and services markets reforms have been fully implemented. Most have seen, on average, only limited implementation. Also, progress in the OECD indicators was much faster in the period 1998 to 2008 than between 2008 and 2013. This might reflect the low hanging fruits of the initial sets of reforms, or some reform fatigue in member states.

Graph 16: Difference in productivity between top 10% and median firms, euro area



Source: COMPNET database and European Commission calculations

Graph 17: Productivity growth and allocative efficiency from 2005 to 2016, euro area



Note: these are NACE sectors.
Source: COMPNET database and European Commission calculations

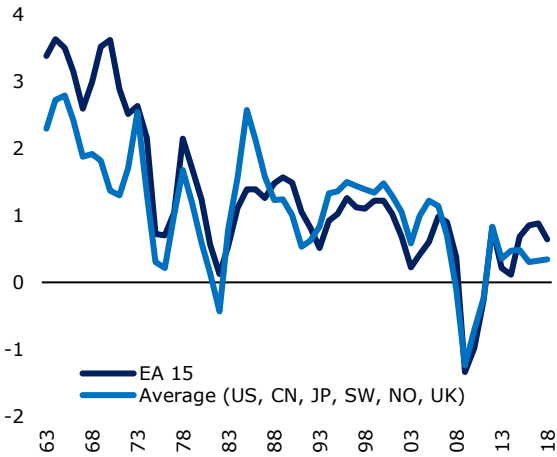
⁵⁶ The most recent figures, for 2018, cannot be compared with previous vintages of the data but show that the differences among countries increased somewhat.

⁵⁷ This refers to the policy areas “competition in services” and “competition & regulatory framework” and to an average annual assessment for the period 2013-2018.

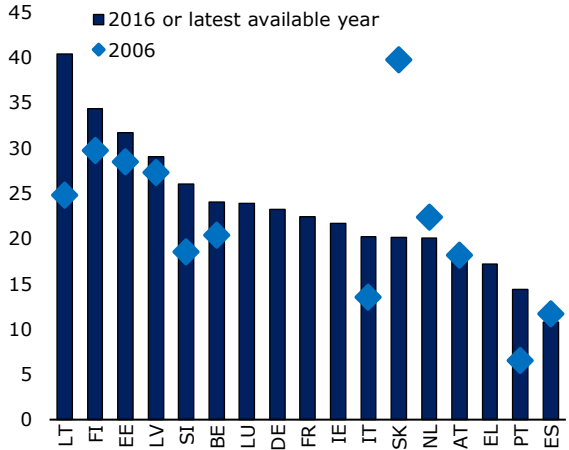
Productivity growth across advanced economies has been declining in the last few decades and the euro area is no exception. In addition, the gap in productivity between the most productive firms and all the rest has been increasing, including in the euro area.⁵⁸ (Graphs 20 to 25). This weighs on productivity growth because it implies that technological diffusion from the frontier firms to the rest of the economy is not working properly. Resource misallocation seems to have also worked as a drag on productivity growth (Graph 17). Factors inhibiting the reallocation of resources to more productive firms, are a barrier to aggregate productivity growth and decrease average productivity. Post-crisis employment gains in major euro area economies have been mainly in low productivity activities, dragging down overall productivity (Box 4). Increased productivity of frontier firms compared with laggards often goes hand in hand with higher mark-ups of top firms and lack of competition globally.⁵⁹ But this phenomenon seems to be much more pronounced in the US than in the EU thanks to a more effective competition policy.⁶⁰ Structural reforms play a role in improving allocative efficiency and diffusion of innovation from frontier firms to laggards (Box 4).

BOX 4: Productivity in the euro area: looking beyond aggregate trends.

Graph 18: Total factor productivity growth



Graph 19: Percentage of jobs created in sectors with above-median productivity



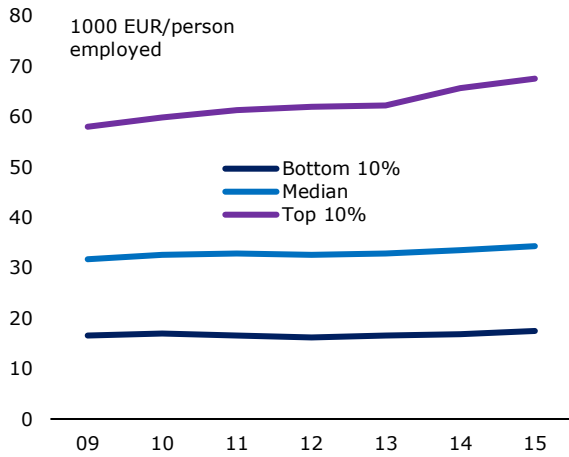
Like for other advanced economies, productivity growth in the euro area has been decreasing in the last decades. Total factor productivity growth is now less than half of what it was during the sixties and since the economic and financial crisis it never went sustainably above 1%. (Graph 18) For a better understanding of the origin of such a slowdown it is important to look at more disaggregate data to see what is happening at firm level.

⁵⁸ Andrews, D., Criscuolo, C. and P. Gal (2016) “The best versus the rest: the global productivity slowdown, divergence across firms and the role of public policy”, *OECD Productivity Working Papers* November 2016, No.5.

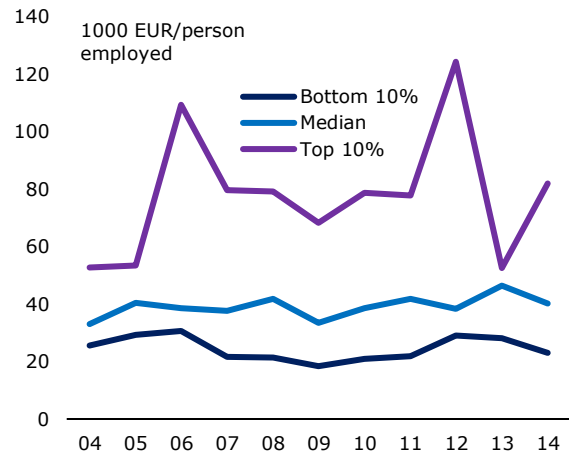
⁵⁹ Diez, F, F. Jiayue, C. Villegas-Sanchez (2019) “Global declining competition”, *Vox*, <https://voxeu.org/article/global-declining-competition>

⁶⁰ Gutierrez, G, and T Philippon (2018), "How EU Markets Became More Competitive Than US Markets: A Study of Institutional Drift", NBER working paper 24700.

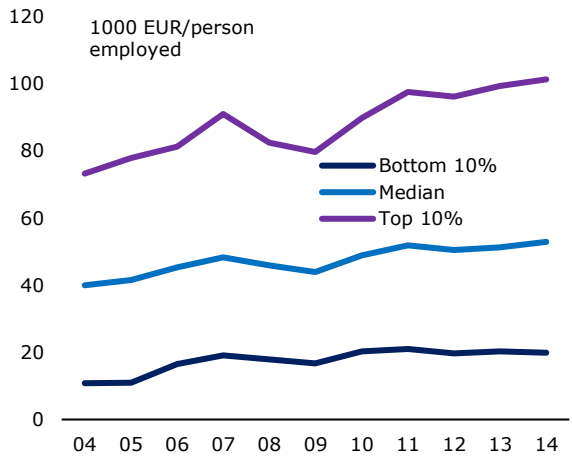
Graph 20: Labour productivity of the frontier firms and laggards - ES



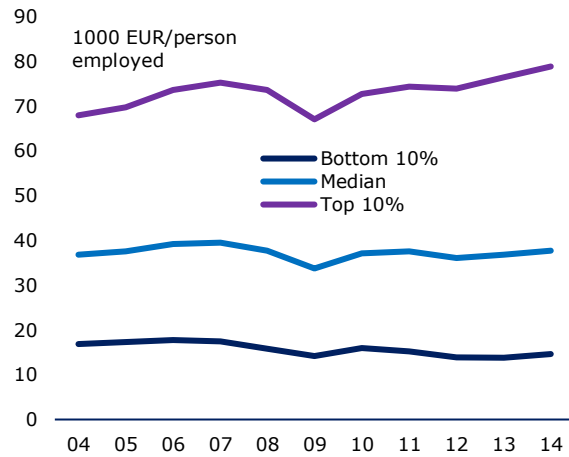
Graph 21: Labour productivity of the frontier firms and laggards - DE



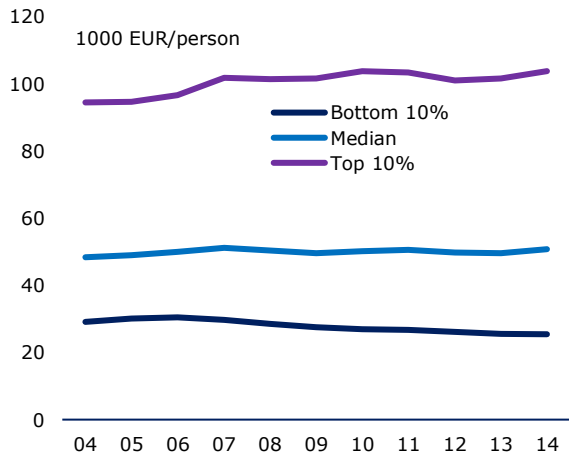
Graph 22: Labour productivity of the frontier firms and laggards - NL



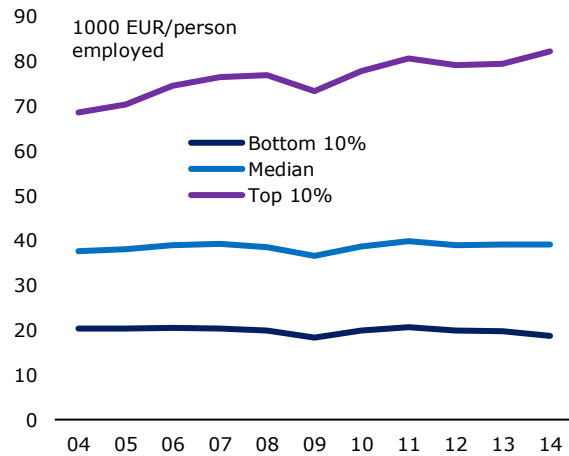
Graph 23: Labour productivity of the frontier firms and laggards - IT



Graph 24: Labour productivity of the frontier firms and laggards - BE



Graph 25: Labour productivity of the frontier firms and laggards - FR



Sources: (Graph 18) Ameco database 3-year rolling average. EA 15 are EA MS except EE, LV, LT and SK since for these MS figures are only available as of 1995; COMPNET. (Graph 19) OECD Structural and Demographic Business Statistics Database, 2018, figures for 2006 are not available for FR, LU, DE.

IE; (Graphs 20, 21, 22, 23, 24, 25) All MS: labour productivity of median firms as share of labour productivity of top 10% firms. Individual MS: labour productivity of firms per decile. DE is 3-year rolling average.

Splitting the firms by their productivity levels, we see that the labour productivity of frontier firms seems to be diverging compared with laggards (Graph 20 to 25). The labour productivity of frontier firms, here represented by the top 10% of firms in each MS in terms of their labour productivity, seems to be increasing in most euro area MS and in the euro area as a whole. The labour productivity of median and bottom firms seems to be decreasing or at least stabilising.

Even after the economic and financial crisis of 2008 the productivity of median and bottom firms seems not to have improved, or only very little (Graph 20 to 25). This could indicate that the crisis did not have the cleansing effect for productivity-enhancing reallocation and firm-restructuring it is expected from recessions⁶¹. Also, most jobs created in the euro area were in sectors with below median productivity.

In fact, between 2005 and 2016, growth in allocative efficiency in the euro area was negative for most sectors apart from Manufacturing, Transport and Storage as well as Administrative and Support Services⁶². Productivity growth came mainly from within-firm productivity growth. Employment is concentrating in sectors with below average productivity (Graph 19). The top three sectors generating the largest net employment gains over the period 2010 to 2016 had below average labour productivity, with restaurants, health and residential care activities featuring highly.⁶³ In recent years, the percentage of jobs created by enterprise births in sectors with above-median productivity were much below 50%, ranging from 40% in to 11% (Graph 19)

Reforms can contribute to close this gap between frontier firms and laggards. Engaging in vocational education programmes and closing the training gap to large firms must be strengthened in order to increase productivity of laggard firms. In some countries factors including weak banks and inefficient insolvency frameworks prevent distressed firms, too weak to survive in a competitive market, from exiting the market. Incentives to help small rather than young firms can also be a drag on productivity as smaller mature firms tend to be less productive than large ones but new small firms are often found to spur aggregate productivity growth as they enter with new technologies and stimulate productivity-enhancing changes by incumbents.

As product and services market reforms can have a positive impact on potential growth, incentivising these reforms remains essential. Improving the regulatory environment for product and service markets can contribute to more innovation, competition and productivity⁶⁴, essential to boost potential growth. There are potential synergies for increasing resilience in the euro area from an EU-coordinated push for reforms, including legislative action at EU level. This could contribute to speed up reform pace which has slowed down, but would not replace much needed action at Member State level.

Facilitating the adoption and diffusion of digital structural reforms can improve economic resilience, growth potential and relative convergence. Initial conditions in terms

⁶¹ Bartelsman et al. (2017).

⁶² COMPNET. European Commission calculations.

⁶³ OECD (2018), OECD Compendium of Productivity Indicators 2018, OECD Publishing, Paris.

⁶⁴ Égert, B. (2016), "Regulation, institutions and productivity: new macroeconomic evidence from OECD countries", American Economic Review Papers and Proceedings, 106(5), 109-113.

of digital infrastructure and skills vary greatly across euro area Member States. Most of the differentiation is in terms of human capital and integration of digital technology, while the ranking is more comparable in dimensions such as connectivity, digital public services and use of the internet.⁶⁵ This may worsen the relative comparative advantages within the euro area if it is not accompanied by adequate structural reforms and investments⁶⁶. In labour markets, the digital revolution could have an impact on employment composition, work organisation, wage setting and contract types creating risks of increased labour market polarisation, skills mismatch and a higher structural unemployment triggered by the skills-biased nature of digital technologies.⁶⁷ In financial markets, the increased role of data and technology requires constant regulatory upgrading and increased vigilance by supervisors. Reforms to face all these challenges include in addition to strengthening the regulatory framework, completing the Digital Single Market, investing in digital infrastructure and increase training in digital skills.

Single Market integration has slowed down, and there remain barriers for firms to grow and investment in the euro area. Though good progress has been achieved in the transposition of Single Market directives over the last 20 years, as shown by a significant decrease of the average transposition deficit (from 6.3% in 1997 to 0.9% in 2017), recent transposition rates have been weaker (25% transposition rate in June 2018 for 16 Directives adopted between 2016 and 2017) and infringement procedures had to be launched by the Commission against 21 Member States in 2016, 3 of which are still ongoing⁶⁸. Moreover, although the overall convergence of price levels has broadly resumed since 2014, it is now slower compared to the speed observed since the creation of the euro. New integration frontiers are in areas such as services which would provide a significant boost to productivity and growth, and taxation where divergences of applicable rules are perceived by many businesses as a major obstacle in the Single Market. The same applies to the social dimension of the Single Market where progress is essential to allow all citizens to benefit fully from integration.⁶⁹

Ensuring a well-integrated market for network industries can increase the capacity to withstand and recover from shocks as they supply general purpose goods and services. Secure supply from network industries at a correct pricing is key to absorb and recover from a shock as they are an underpinning of economic activity. However, progress in implementing CSRs from 2013 to 2018 on network industries as well as competition and regulatory framework (average annual assessment of the Structural Policies area) was low compared with other areas. Heterogeneity in cross-border regulation resulting in fragmented markets may weaken the effectiveness of common macro-economic policies and hence the resilience of economies. Also, quality and cost of products and services provided by network industries have an important economic impact as they are key production components of most industries, thus vitally contributing to the recovery from shocks. Further integrating networks

⁶⁵ Digital Economy and Society Index, European Commission Digital Scoreboard 2019.

⁶⁶ “The macro-economic implications of the digital economy” (2018), QREA vol 17, 2

⁶⁷ Petropolis (2019), “Digitalisation and European welfare states”, Bruegel, Blueprint series 30.

⁶⁸ Commission Communication, COM(2018) 772 final, ‘The Single Market in a changing world’.

⁶⁹ Ibid.

across the EU is therefore essential to foster more flexible prices and production in key areas such as energy, transport, telecommunication and digital infrastructure. The situation in most euro area Member States for which data are available, shows that product market regulation in network industries decreased between 2000 and 2013⁷⁰. Barriers nonetheless remain and they are typically identified as referring to entry, ownership, degree of vertical integration, market structure as well as political economy dynamics.⁷¹

Industry plays a vital role for prosperity and sustaining our social model. Currently, an industrial transformation is taking place, with an increasing role of digitalisation, the transition to a climate-neutral and circular economy and a fast-changing geopolitical context. A still fragmented Single Market and fragmented policies are barriers for European firms to scale up and to get the economy ready for the realities of the 21st century digital age and the challenges posed by the climate emergency. In order to respond to these challenges, as a follow-up to the EU industrial policy strategy, the Strategic Forum for Important Projects of Common European Interest recommends more pooling of resources and more coordinated action among Member States and coordinated investments along strategic industrial value chains.

5.3 Labour market and social protection systems

Labour market indicators have continued improving steadily, despite a deteriorating macroeconomic outlook. Unemployment and youth unemployment rates have been ebbing and have reached 7.5% and 15.8% respectively in Q3 2019 and long-term unemployment reached 3.3% in Q2 2019 (Graphs 26 and 27). Unemployment is forecast to decline further to 7.3% in 2021, more than 1 percentage point below pre-crisis levels, though the decline is decelerating. Total employment continued to grow by 1% in 2019 and is set to continue, albeit more slowly, at around ½% in 2020 and 2021. Divergences in labour market indicators remain wide in the euro area: in 2018, the unemployment rate ranged from 3.4% in Germany to 19.3% in Greece.

However, challenges in terms of job quality and in-work poverty remain, particularly among less-qualified workers. Involuntary part-time work⁷² and temporary employment have not seen a significant improvement over the past years, pointing to slower growth in quality employment (Graph 28). Involuntary part-time work as a percentage of total part-time employment has been on a decreasing trend since 2014 but is still 3 percentage points above its pre-crisis levels, while workers on temporary contracts have been increasing steadily from 12.7% in 2012 to 13.9% in 2018. At the same time, the in-work-at-risk-of-poverty rate has been steadily increasing from 8.1% in 2008 to 9.5% in 2016, to recede only marginally to 9.3% in 2018 (Graph 29). Moreover, the risk of poverty remains much higher among workers with a temporary job at 17.2% and part-time workers at 14%. The total number of hours

⁷⁰ European Commission (2013), Market Functioning in Network industries.

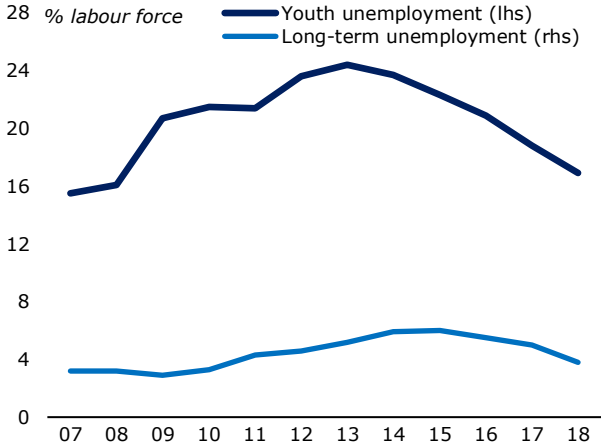
⁷¹ QREA, Vol. 17, No. 1 (2018).

⁷² Measured as under-employed workers, i.e., workers whose main job is part-time and who report either that they could not find a full-time job or that they would like to work more hours.

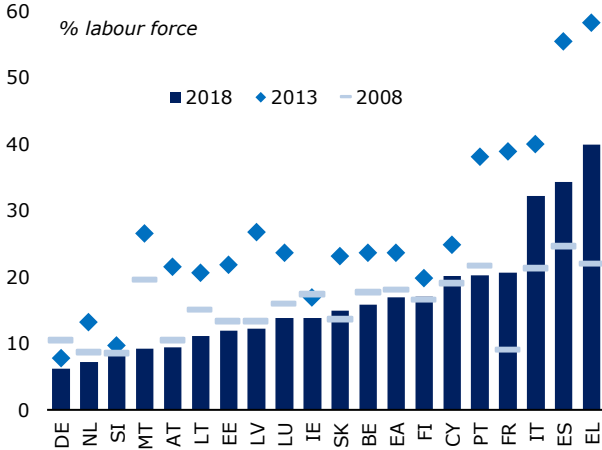
worked has also been slow to recover to its pre-crisis levels and, contrary to the EU as a whole, in 2018 was still 1% below its level in 2008 (Graph 30).

The materialisation of risks would negatively impact labour market developments, especially for more vulnerable Member States. While labour market indicators for the euro area have remained positive despite the deterioration of broader economic indicators, for some Member States, the unemployment rate is still significantly above 10%. In 2018, the proportion of temporary contracts ranged from 1.4% to 22.7% of total employment. Moreover, rates of involuntary temporary employment ranged from 0.9% to 21.3% of total employment in the same year. Differences are also large in terms of part-time contracts, ranging from 4.9% of total employment to 50.1%, as well as in the proportion of that is involuntary, from 5.8% to 70.1%.

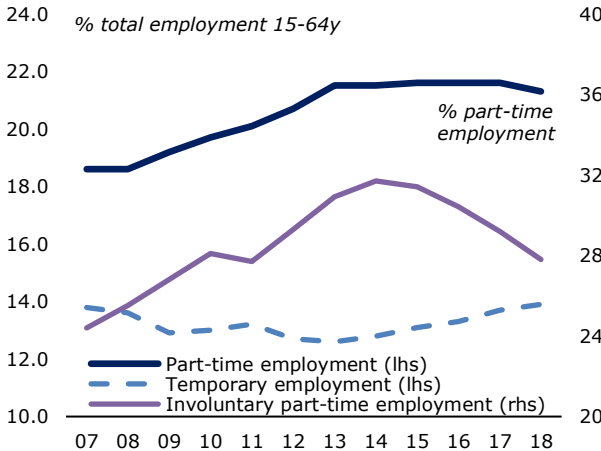
Graph 26: Youth unemployment and long-term unemployment, euro area



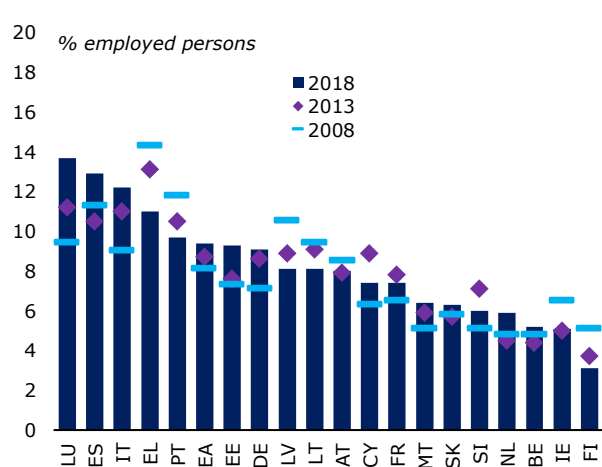
Graph 27: Youth unemployment, June 2019



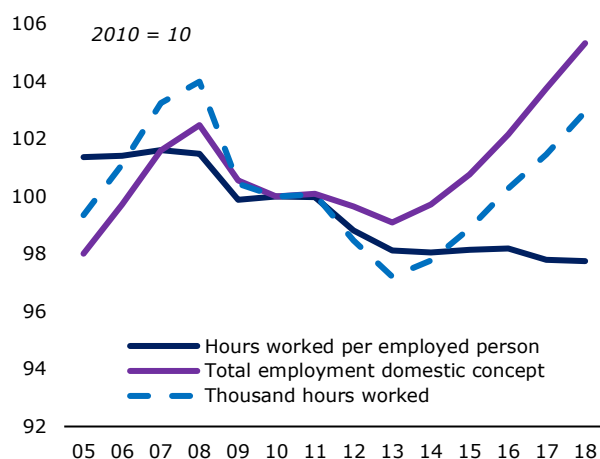
Graph 28: Part-time and temporary work, euro area



Graph 29: In-work at-risk-of-poverty rate

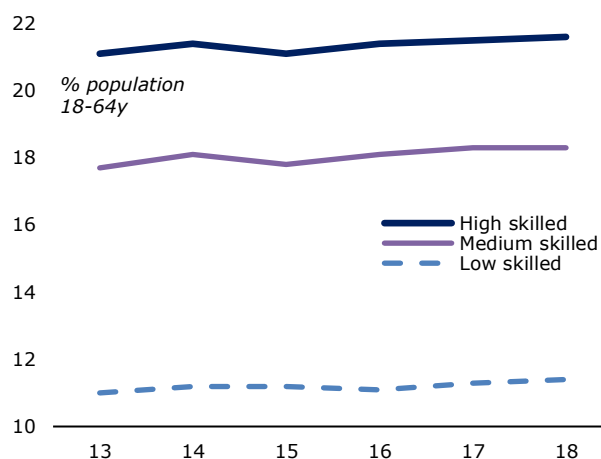


Graph 30: Employment and hours worked, euro area



Source: Eurostat

Graph 31: Participation in education and training (last 4 weeks), euro area



While wage growth has accelerated in 2018, it is unclear whether this dynamic will be sustained. Nominal wage growth had remained subdued in the past years but has started to accelerate registering year-on-year growth of 2.6% in 2019, and is projected to continue at 2.3% in 2019 and 2020. However, though wage increases are set to continue on the back of ongoing wage settlements, real wage growth is expected to remain low after an increase of 1% in 2019 at 0.7% and 0.8% in 2020 and 2021, despite slow inflation. Unit labour cost dynamics in the post-crisis period have contributed to reducing external imbalances, as net-debtor countries benefited from stronger cost competitiveness gains as compared with net-creditor countries. More recently, the advantage of net-debtor countries in terms of cost competitiveness dynamics has slowed in comparative terms due to tightening labour markets and a reduced pace of productivity improvements.⁷³

While technological change and the digital revolution create new job opportunities, they also raise challenges related to the loss of low-skill jobs and the increase in non-standard work. In this context, investment in skills is key to ensure that all citizens reap the benefits of technological transformation. Population ageing and rising old-age dependency ratios further reinforce the need for adequate and efficient investment in human capital. Significant differences across euro area Member States persist in terms of the share of early leavers from education and training and participation rates in adult learning, which has been recovering slowly.⁷⁴ Reducing labour market segmentation has positive effects in terms of higher investment in human capital as, employers tend to invest less in upgrading the skills and competencies of temporary employees. In turn, this may translate into higher productivity, stronger resilience and long-term growth.

On the back of the labour market recovery, poverty and social exclusion are declining in virtually all Member States. However, poverty and inequalities are still above pre-crisis

⁷³ European Commission (2018), Alert Mechanism Report 2019.

⁷⁴ For more details see DG Employment (2018), 'Chapter 1: Main Employment and Social Developments', in Employment and Social Developments in Europe 2018 Report.

levels in several countries. In 2018, the number of people at risk of poverty and social exclusion was still one million, above the 2008 level. Moreover, some categories, such as children, people with a migrant background and temporary workers, face persistently higher risks of poverty. As unemployment and social inequalities are seen by Europeans as the two main challenges looking ahead [Eurobarometer 467/2017], an increasing number of citizens express a sense of vulnerability. Drivers of this feeling include income inequality having stabilised at historically high levels, limited intergenerational mobility, increasing precariousness in labour market relations, and the uneven impact of globalisation and technological change on citizens' life. Social protection systems are being adapted in many Member States, but challenges persist in protecting all those in need, irrespective of their working status. Tax and benefit systems also play a key role in reducing inequalities: in the euro area, the impact of social transfers (excluding pensions) on poverty reduction remains high at 32%, though decreasing over time.

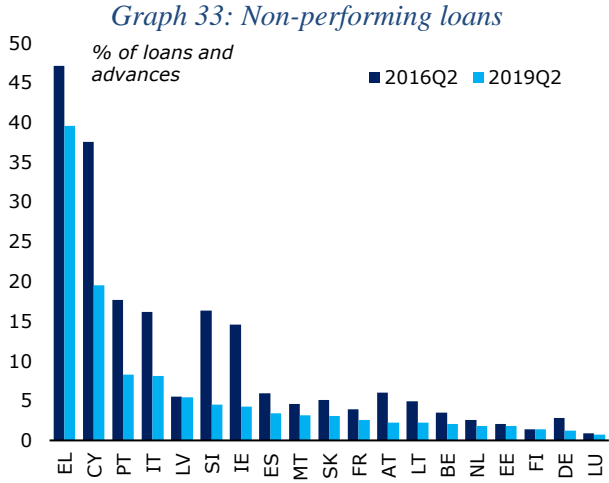
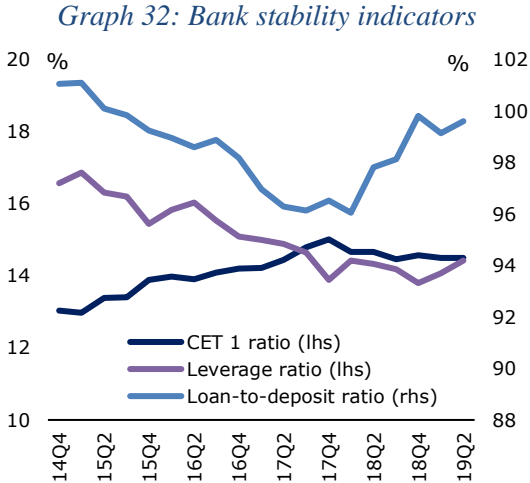
To address the challenges facing labour markets and their social and economic implications, national reforms should implement the principles of the European Pillar of Social Right. The Pillar aims at delivering effective rights for citizens in terms of equal opportunities and access to the labour market, fair working conditions as well as social protection and inclusion. Such reforms would help to strengthen inclusive growth and resilience across the euro area⁷⁵. Reforms at national level should promote quality job creation and reduce labour market segmentation and structural unemployment while promoting social cohesion. Key elements of such reforms include (i) high-quality, efficient and inclusive life-long education and training systems in combination with well-designed skills anticipation strategies that aim at better matching skills with labour market needs; (ii) employment legislation that provides fair working conditions for all workers, as well as flexibility and security for employees and employers; (iii) effective active labour market policies that support labour market transitions; (iv) sustainable and adequate social protection systems. The latter – which should be adapted to cover all workers as new forms of work emerge - provide automatic stabilization during economic downturns, support labour reallocation, and pave the way for higher living standards in the longer term. Adequate social protection systems, together with the portability of social rights and pension entitlements, promote a fair labour mobility, which also improves the resilience of the euro area. EU-level reforms, some currently under consideration, would also help ensure adequate social protection, inclusion and fair working conditions.

5.4. Financial markets and completing the Banking Union and Capital Markets Union

Risk reduction in the banking sector broadly continued in 2019. Banking sectors in nearly all Member States continued to increase the quantity and quality of their capital and reduce their leverage. While the loan-to-deposit ratio has increased again by 3 percentage points between Q1 2018 and Q1 2019, back to around the levels of 2015-2016 (Graph 32), the

⁷⁵ The Social Pillar sets out 20 key principles and rights to support fair and well-functioning labour markets and welfare systems. For more details see <http://ec.europa.eu/social/main.jsp?catId=1226&langId=en>

liquidity coverage ratio has continued its upward trend, from 142% in Q1 2017 to 147% in Q2 2019⁷⁶. Non-performing loans (NPLs) declined to 3.4% of total loans in Q2 2019 in the euro area, compared to 4.2% a year earlier, with the faster correction observed in Member States with the highest stock of such loans. Some national NPL ratios still remain far apart from the euro area average and continue to require attention (Graph 33) but these are exceptions from the large majority of Member States. At the same time, while households have seen their liabilities decrease from 69% of GDP in 2010 to below 61% in 2018, non-financial corporations have been increasing their debt from 203% of GDP in 2010 to 233% in 2017 and have only started deleveraging to 222% of GDP in 2018.



Note: Euro area changing composition, unless otherwise indicated. Domestic banking groups and stand-alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches, All institutions.
Source: ECB - CBD2 - Consolidated Banking data.

Additional measures have been put in place to further strengthen banks’ resilience, integration and financial sector integrity. Following a request from the Council, the Commission published a dedicated package of legislative and other measures to address legacy NPLs and avoid their build-up in the future, with actions at euro area and national level.⁷⁷ As part of the legislative measures on NPLs, a regulation was adopted in April 2019,⁷⁸ which introduces a ‘statutory prudential backstop’ in order to prevent the risk of underprovisioning of future NPLs. There has also been some progress in the negotiations on the Commission proposal for a directive that would enable banks to deal in a more efficient way with loans once they become non-performing by improving conditions to either: (1) sell the credit to third parties on a secondary market; or (2) enforce the collateral used to secure the credit. The recent adoption, in the Spring of 2019, of the November 2016 Banking Package, which further reduces risks by implementing internationally-agreed norms on loss absorbing

⁷⁶ In EU countries participating in the Single Supervisory Mechanism.
⁷⁷ European Commission, ‘Reducing risk in the Banking Union: Commission presents measures to accelerate the reduction of non-performing loans in the banking sector’, 2019, http://europa.eu/rapid/press-release_IP-18-1802_en.htm?locale=en
⁷⁸ Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures.

capacity, on capital requirements and liquidity requirements for banks, was a crucial step towards the completion of the Banking Union. The banking package also reinforced the anti-money laundering dimension in prudential supervision and the cooperation obligations between the various authorities in relation to anti-money laundering. As highlighted in the Commission reports on anti-money laundering issued in July 2019⁷⁹, a more comprehensive approach to fighting money laundering and the financing of terrorist activities is needed in the EU to address structural shortcomings identified. Separately from the banking package, measures have already been adopted to reinforce the European Banking Authority and supervisory cooperation and to address some of the shortcomings in the anti-money laundering framework as unveiled by several recent events.⁸⁰ Going forward, the Commission will further explore whether certain supervisory powers and responsibilities might be better allocated to a Union body and the possibility of creating a coordination and support mechanism to facilitate cross-border cooperation and exchanges among financial intelligence units. Moreover, the work of the Single Supervisory Mechanism and the Single Resolution Board also contributes to reducing risks by increasing the preparedness for orderly bank resolution and setting the targets for increasing loss absorption. Overall, the EU has adopted more than fifty legislative proposals since the crisis to increase the resilience of the financial sector.

However, other important areas remain to be completed, including notably the backstop to the Single Resolution Fund and a European Deposit Insurance Scheme (EDIS). In June 2018, the EU Heads of State and Government agreed that the backstop to the Single Resolution Fund will be provided by the European Stability Mechanism and that work should start on a roadmap for political negotiations on EDIS. Work has progressed on the backstop to the Single Resolution Fund and the Euro Summit of June 2019 mandated the Eurogroup to work towards an agreement in December 2019. Ambitious, even if gradual, progress is necessary for EDIS in light of its key stabilising properties and its importance for promoting financial integration. Achieving a financial union is crucial to ensure stability.

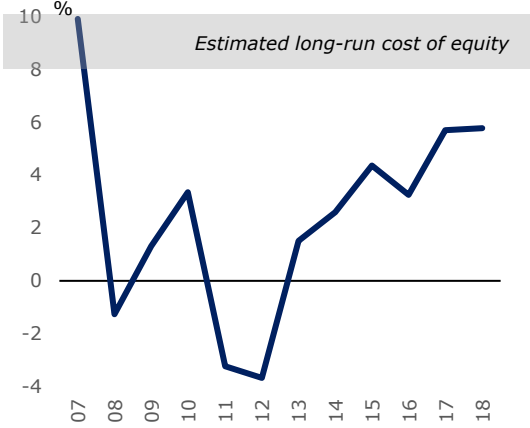
Bank profitability did not improve in 2017-2018, as the sector continues to face challenges from the economic environment and business-model transformation. Profitability remains low, below banks' estimated long-run cost of equity and though it has been recovering overall since the low of 2012 amidst improved asset quality and market conditions, return on equity stagnated in the following year. Some national banking sectors still post very low or even negative return on equity given tight interest margins, remaining legacy assets, market fragmentation and operational inefficiencies (Graphs 34 and 35). A number of challenges lie on the horizon, including considerable fragmentation across the euro area market, low yields and competition from fin-tech firms. Though several price-based banking market indicators show convergence has resumed, the level of integration remains

⁷⁹ Commission Communication, COM(2019) 360 final, from the Commission to the European Parliament and the Council of 24 July 2019 towards better implementation of the EU's anti-money laundering and countering the financing of terrorism framework.

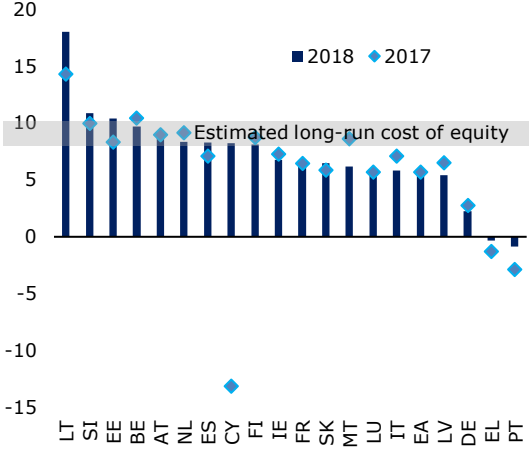
⁸⁰ Commission Communication, COM(2019) 373 final, from the Commission to the European Parliament and the Council of 24 July 2019 on the assessment of recent alleged money laundering cases involving EU credit institutions.

low, and the continued fragmentation of retail banking markets limits the ability of the sector to respond to profitability challenges and finance the investments needed to adapt to a changing competitive landscape and innovation. This is another reason to progress faster in the completion of the Banking Union.⁸¹

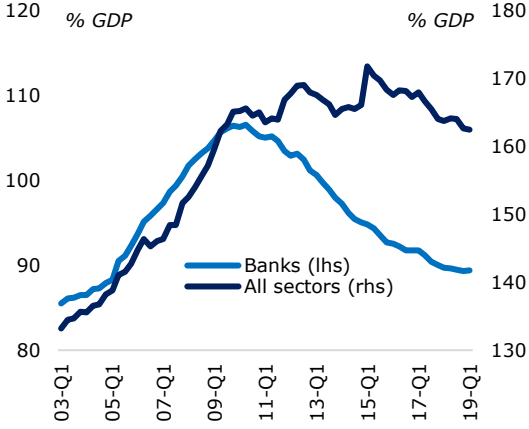
Graph 34: Banks' return on equity*, euro area



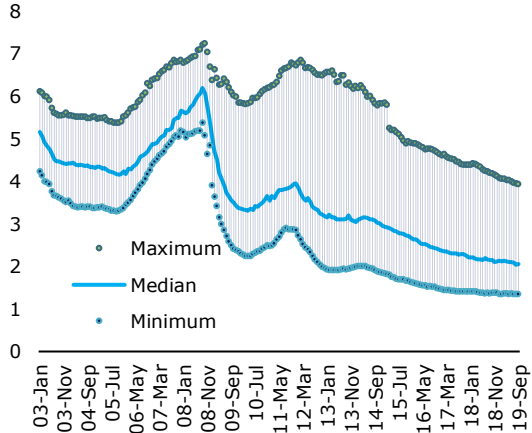
Graph 35: Banks' return on equity*, euro area



Graph 36: Credit to the private non-financial sector**, euro area



Graph 37: Variation across euro area Member States in MFI*** interest rates for non-financial corporations



*Domestic banking groups and stand-alone banks.
 **Stocks of total credit, adjusted for breaks.
 ***According to the ECB, "Monetary financial institutions" (MFIs) are resident credit institutions as defined in European Union law, and other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities.
 Sources: (Graohs 34, 35 and 37) ECB, (Graph 36) BIS.

Though starting from a low level, the share of non-bank finance in the euro area's financial system has continued to grow, creating a more diverse mix of funding sources. While total credit has seen an overall increasing trend, the stock of bank lending to the private non-financial sector relative to GDP has been on a steady downward trend since the crisis

⁸¹ "Financial integration in Europe", ECB 2018.

Though, (Graph 36). Capital markets are gradually becoming more prominent in the euro area in line with policy goals, which calls for additional efforts to strengthen supervisory capabilities and fill data gaps to monitor and appraise risks.⁸² However, Bank lending still accounts for a high share of total financing for non-financial corporations in the euro area, accounting for 55% of total credit as opposed to 34% in the United-States. And in 2018 the share of non-financial corporations' funding raised in capital markets declined compared to the period 2013-2017⁸³. Also, the role of equity financing remains low. These developments show that there is still much to be done to further develop capital markets in Europe.

Borrowing costs remain uneven across the euro area. The capital flight from periphery to core Member States during the crisis period exacerbated divergences and resulted in large differences in borrowing costs between Member States which started to decrease in 2014, though they are still evident (Graph 37). Even excluding Member States with the highest interest rates, there is evidence that spreads widened during shocks, and it is not clear whether the euro area's vulnerability to future shocks through this channel has been reduced. To support investment financing for the corporate sector across the whole euro area, and in particular for SMEs that are reliant on bank financing, policies to reduce financial fragmentation, accelerate banking sector restructuring and shift the euro area economy further from bank financing towards other types of financing, notably from capital markets, are warranted.

The Commission delivered on all of the actions announced in the Capital Markets Union (CMU) action plan. However, important barriers remain, including regulatory, legal and tax divergences that need to be more decisively addressed. Deeper and more integrated capital markets create better funding opportunities for companies to support investments at lower costs. They are also essential for making the euro area more resilient to economic shocks through private sector risk sharing. The implementation of the Commission's CMU action plan, as reinforced by its mid-term review, progressed further in 2018 and 2019 in several important areas.⁸⁴ The majority of the Commission proposals (11 out of 13) have been adopted or politically agreed. However, advancing in the harmonisation of insolvency and tax proceedings – including by applying the code of conduct on withholding taxes to simplify procedure for compliant investors – are also necessary steps to build a genuine CMU.

The Commission's work on sustainable finance has made significant progress. Key measures of the Action Plan on financing sustainable growth⁸⁵ adopted in March 2018 are being implemented. Proposals on disclosures of the financial sector related to sustainability investments and sustainability risks and EU climate benchmarks have been adopted. The co-legislators have reached a common understanding on the proposal for the EU taxonomy for environmentally sustainable economic activities; Furthermore, against the background of

⁸² European financial stability and integration review (EFSIR), European Commission SWD (2018).

⁸³ AFME, Capital Markets Union: Key performance indicators, October 2019.

⁸⁴ Investment funds, pension funds, venture capital, access to public markets, crowdfunding, covered bonds, securitisation, investment firms and supervision.

⁸⁵ Commission Communication, COM(2018) 97 final, Action plan on financing sustainable growth.

global green bond issuance increasing to EUR 140bn in 2018 and representing more than 2% of global bond issuances in the last two years, preparatory work on an EU Green Bond Standard has been undertaken⁸⁶. In light of substantial investment needs over the next decade (up to EUR 290 billion in low-carbon energy, transport and infrastructure) to reach the European Union’s climate and energy goals as well as international climate change targets, the Commission is elaborating its green financing strategy, as part of the “European Green Deal” priority of the next Commission. As the financial sector has significant exposures to fossil fuel and other climate-related sectors⁸⁷, work is progressing by financial institutions as well as regulatory authorities to more closely monitor and evaluate corresponding risks.

6. Deepening the Economic and Monetary Union

Progress on deepening the EMU has been slow since the Commission Communication of December 2017⁸⁸. In a Communication from June 2019⁸⁹ the European Commission took stock of progress made to deepen the EMU. Ongoing work focuses on reforms agreed by leaders at the December 2018 Eurosummit, including ESM Treaty reform and improvement of the ESM toolkit (introduction of the common backstop and revision of the precautionary financial instruments) and the creation of a budgetary instrument for convergence and competitiveness. On the Financial Union, discussions are ongoing for an agreement on the common backstop for the Single Resolution Fund and risk-reduction measures included in the banking package for the financial sector. Overall progress is limited on other reforms including on establishing a European Deposit Insurance Scheme. The beginning of political negotiations on EDIS is being deferred. After the foundation of the CMU has been laid, further work is needed to complete it, including finalisation of the legislative process on the three CMU proposals that are still in discussions with the Parliament and Council. Moreover, there has been no agreement towards a fiscal stabilisation function or on euro area governance proposals.

There has been some progress on the economic union, with political agreement on a budgetary instrument for convergence and competitiveness, and a Commission proposal to set a Structural Reform Support Programme. Together they would increase financial incentives to the implementation of structural reforms and investment as well as greater technical assistance. The CSRs already indicate the key areas for investment in each Member State. The BICC will further provide strategic guidance linking priority investments at national level with the priorities for the euro area.

⁸⁶ Technical Expert Group (TEG) on sustainable finance; https://ec.europa.eu/info/publications/sustainable-finance-teg-green-bond-standard_en

⁸⁷ See e.g. Weyzig et al. (2014) The price of doing too little too late, Green European Foundation, ESRB (2016) Too late, too sudden: Transition to a low-carbon economy and systemic risk, Dietz et al. (2016) ‘Climate value at risk’ of global financial assets, Nature Climate Change, Battiston et al. (2017). A Climate stress-test of the EU financial system, Nature Climate Change,

⁸⁸ Commission Communication, COM(2017) 821 final, Further steps towards completing Europe’s economic and monetary union: a roadmap.

⁸⁹ Commission Communication, COM(2019) 279 final, Deepening Europe’s economic and monetary union: taking stock four years after the Five Presidents’ Report.

The EMU reform agenda needs to be pursued in an ambitious manner. Strengthening the EMU, by completing the Banking Union and Capital Markets Union, is key for mobilising the necessary capital to foster the transition towards a sustainable economy and for fostering the international role of the euro to increase Europe's ability to project its interests in the world. This calls for a resilient and deep financial system and an increase in the available pool of euro denominated assets with a high credit rating. Strengthening the external representation of the euro area in international fora would also help to foster Europe's clout in the global economy. With the work on a proposal for a Budgetary Instrument for Convergence and Competitiveness (BICC) and discussions on a possible European Unemployment Benefit Reinsurance Scheme (see section 3), the Commission aims to reinforce the competitiveness and the resilience of the euro area economy. The lack of a central fiscal stabilisation function significantly weakens the euro area's counter-cyclical fiscal capacity. In addition, the Commission will issue its review of the framework for economic and fiscal surveillance, focusing on the six- and the two-pack, in the beginning of 2020, opening up the debate on possible ways to improve it. Going forward, it would also be important to integrate the intergovernmental agreements into Union law and under the European Parliament's oversight.