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to: Mr Uwe CORSEPIUS, Secretary-General of the Council of the European
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MACRO-ECONOMIC REPORT
to the COMMUNICATION FROM THE COMMISSION TO THE
EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN
ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF
REGIONS
Annual Growth Survey 2012

Delegations will find attached Commission document COM(2011) 815 final VOL. 3/5 - ANNEX II.

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ANNEX

MACRO-ECONOMIC REPORT

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INTRODUCTION

EU economic growth is faltering. In the euro area, this is exacerbated by the sovereign debt crisis and fragilities in the banking sector. These have created a dangerous feedback loop. The lack of confidence of the financial market has created volatility and undermined confidence in wider markets therefore weighing heavily on future economic prospects. After several years of crisis, there is very little further room for macroeconomic policies to boost growth. In particular, fiscal policy has been constrained in many countries by the high costs - or even the loss - of access to market financing.

In this context, measures to strengthen growth have become central. Growth-friendly fiscal consolidation is necessary in view of market pressure and policy challenges related to ageing. Robust banking sector and stronger financial backstops for the sovereigns are key to contain financial turbulence and hence for growth to resume. Structural reforms are critically important to enhance the EU economy's overall efficiency and speed up its capacity to adjust. In a positive feedback loop an improved growth outlook will support other objectives by enhancing confidence and boosting employment, contributing to fiscal consolidation and to the stability in the banking sector, as well as easing the situation in vulnerable countries.

1. ECONOMIC SITUATION AND OUTLOOK: NEW HEADWINDS

In the aftermath of the global financial and economic crisis the EU economy started to pick up. Growth was subdued, as is usually the case after financial crises, but the differences between Member States were significant. In particular, Member States with large accumulated imbalances embarked on a painful, but necessary adjustment, which weighed on growth. At the same time Member States free from major imbalances took advantage of the more resilient external environment and registered robust growth rates (Graph 1). These differences have been mirrored or even amplified in unemployment developments. In aggregate, however, the recovery has entailed only slow employment growth. While this partly reflects labour hoarding during the recession, employment growth has not been strong enough to reduce persistently high unemployment markedly.

These growth differences helped to significantly narrow the macroeconomic imbalances, in particular current account deficits, but the stock of accumulated debt remains large. Largely due to reductions in domestic consumption, the most significant corrections were recorded in Member States where external imbalances were the largest prior to the crisis (Graph 2). However, some structurally high current-account surpluses also appear to be coming down gradually, reflecting stronger domestic demand and dynamic imports. Nevertheless, further adjustment is needed in some Member States as the overall level of indebtedness continues to be high and progress in recovering cost/price competitiveness has been slow in some (notably euro area) Member States.

Graph 1: External imbalances and economic growth, EU Member States	Graph 2: Current account in 2007 and 2011, EU Member States (% of GDP)
<i>Source:</i> Commission Services	<i>Source:</i> Commission Services

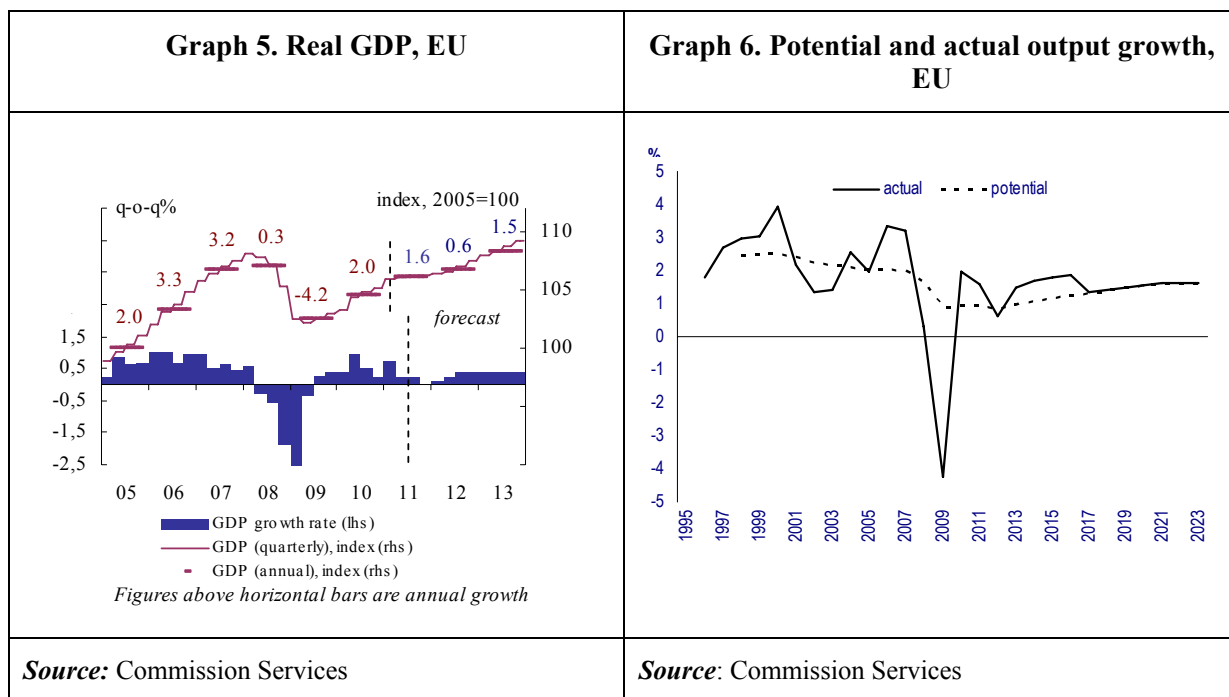
Fiscal imbalances continued to persist. Fiscal consolidation has started in 2011, as agreed among Member States in October 2009: the aggregate EU fiscal deficit improved by almost 2 percentage points from 6.6% in 2010 to 4.7% of GDP in 2011. Nevertheless, the debt challenge remains daunting. The debt-to-GDP ratio in the EU jumped by over 20 percentage points since 2007 and exceeded 82% in 2011 – the highest level on record. It is forecast to further increase to almost 85% of GDP in 2012 before stabilising at this level.

Financial tensions have deepened. Doubts about the sustainability of government debt in some euro area Member States has increasingly sapped investors' confidence since the early summer. This triggered bouts of heightened volatility on financial markets and a further strong rise in sovereign bond spreads of vulnerable euro area Member States relative to the benchmark (Graph 3). More recently, tensions have spread further to other Member States and yields of some triple-A rated sovereigns started to increase. The tensions spread to the banking sector, as European banks are the main holder of European government bonds. Finally, uncertainty related to policy choices in the euro area and in the US in the summer triggered a sharp correction on global financial markets, leaving them very tense ever since (Graph 4).

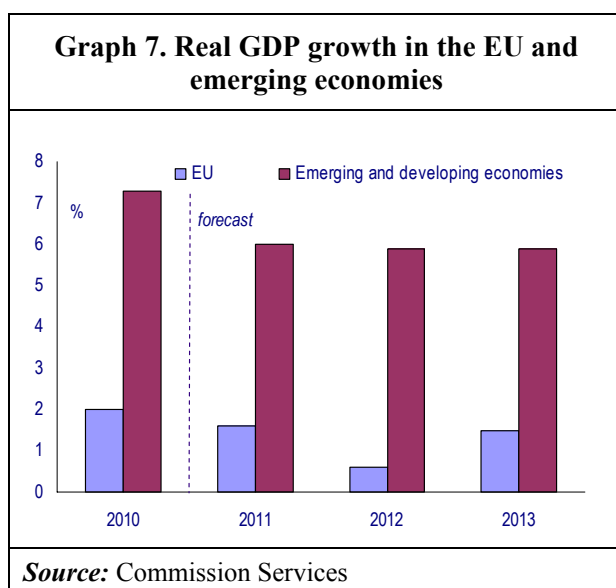
Graph 3. Government bond yields, selected euro-area Member States	Graph 4. Stock market indices, euro area
<p><i>Source:</i> Commission Services</p>	<p><i>Source:</i> Commission Services</p>

The recovery has now stalled in the EU. Financial turbulence and prospects of a global slowdown seriously undermined confidence in the whole economy weighing on consumption and investment. The necessary fiscal consolidation is putting a drag on growth. While resolute policy action to solve the debt crisis in the euro area should rekindle confidence, growth is not expected to pick up swiftly. Financing conditions are expected to be challenging going forward weighing on investment. The need to adjust the imbalances and deleverage both the private and the public sector will hold growth back for some time. Growth in the EU economy is expected to stall at the beginning of the 2012 and record only a meagre 0.6% in the year as a whole (Graph 5). Employment growth is expected to grind to a halt in 2012 and remain meagre in 2013. With weak job prospects the duration of unemployment has increased and there is the risk that unemployment becomes entrenched, with adverse effects on the contribution of labour to potential growth.

The current slowdown in growth adds to the long-term weaknesses in European growth. While there has been substantial convergence of income levels within Europe, the EU has ceased to catch up with the US over the past quarter-century. The moderate growth potential of the EU has been further weakened by the financial crisis. The Commission estimates show that the EU and the euro area in particular can be expected to lose further ground relative to the US in terms of growth and productivity in the coming decade. Over the next 10 years average annual growth rate in the EU is expected to be 1 percentage point lower than in the last decade and reach 1 ¼% only (Graph 6).



The gravity of the world economy is shifting towards very dynamic economies, which will make the global environment even more competitive. The role of emerging economies in the global economy has been increasing rapidly and is forecast to continue to do so. Although some of the open emerging economies have been also severely affected by the crisis, they have been recovering fast (Graph 7). Their development models are currently skewed heavily towards export sectors, and although this model cannot be sustained indefinitely and some gradual rebalancing can be expected in the long term, in the foreseeable future the intensity of competition in the world economy will continue to increase. In particular the export baskets of emerging markets have been climbing up the technology ladder, in some cases venturing successfully into sectors where Europe has traditionally held competitive advantage. Altogether, with the forecast slowdown in the global economy, this implies that the external environment will become increasingly challenging both in the short-term and the long-term unless the EU increases its competitiveness.



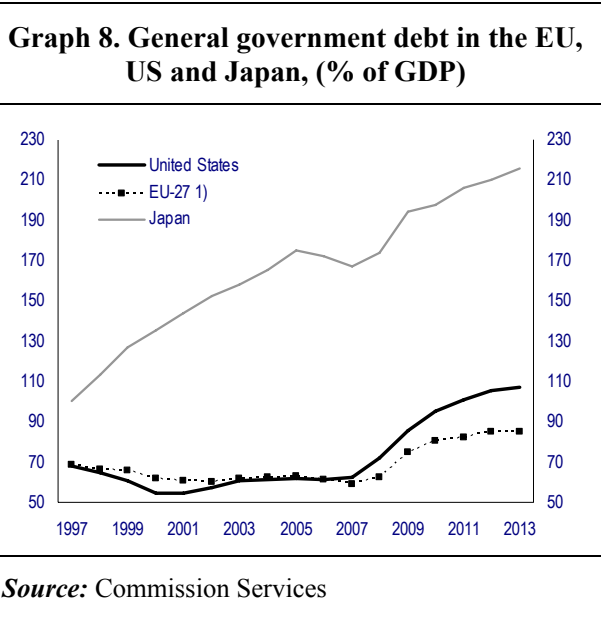
Dangerous negative feedback loops have developed in the European economy. First, investors' concerns about the sustainability of the sovereign debt burden in Europe have triggered the sovereign debt crisis and led to rising tensions in the banking sector, which holds large amounts of sovereign debt. In turn, the strains in the banking sector add to the sovereign risk as investors perceive Member States as an ultimate backstop for vulnerable financial institutions. Second, these tensions and existing imbalances in some of the Member States prompt both private and public sector to de-lever, which puts a drag on growth, while lower growth prospects further undermine debt

sustainability. Finally, the tensions in the markets raise the interest rates for government borrowing, further undermining the sustainability of public finances.

All the elements of the negative feedback loop have to be tackled together, but growth plays a prominent role. A comprehensive reform strategy was agreed at the European Council on 26 October 2011 to ensure fiscal sustainability and rebuild trust in the European banking sector. Growth is a vital component of this strategy, having the potential to alleviate all the other challenges without creating side costs. More economic growth will create better conditions for the repayment of debt in the future. Expectations of higher growth will contribute to restoring confidence and stability on financial markets. With improved prospects, business will start to invest again. Finally, growth is an indispensable element of the European social model, which was created in the "golden years" of European growth. Preserving the current level of social protection will not be possible if growth remains on the current trend.

2. GROWTH-FRIENDLY FISCAL CONSOLIDATION, PUBLIC EXPENDITURE AND REVENUES

Public finances played a key stabilising role during the global crisis, but the price is higher debt. Since the onset of the crisis in 2007, government debt levels across the EU have increased from 59% of GDP in 2007 to an estimate of 82.5% of GDP in 2011. This increase is the result of a number of factors. First, the slump in economic activity during the crisis, led to an increase in general government deficits as automatic stabilisers were allowed to cushion the impact of the recession. Additionally, the unprecedented depth of the crisis triggered the European Economy Recovery Plan – a coordinated plan of fiscal measures to support the economy, launched by the European Commission in December 2008. Finally, some Member States were forced to grant targeted support to financial institutions to secure the viability of the financial system.



The projected increase in debt is not without precedent either in historical terms or among peers. Financial crises have proved to be fiscally costly in the past: they have led to large and persistent increases in the debt ratio. Moreover, while the current crisis has also led to a sharp increase in public debt in Europe, the increase and the level of debt has been even higher in other advanced economies, such as US and Japan than in the EU (Graph 8).

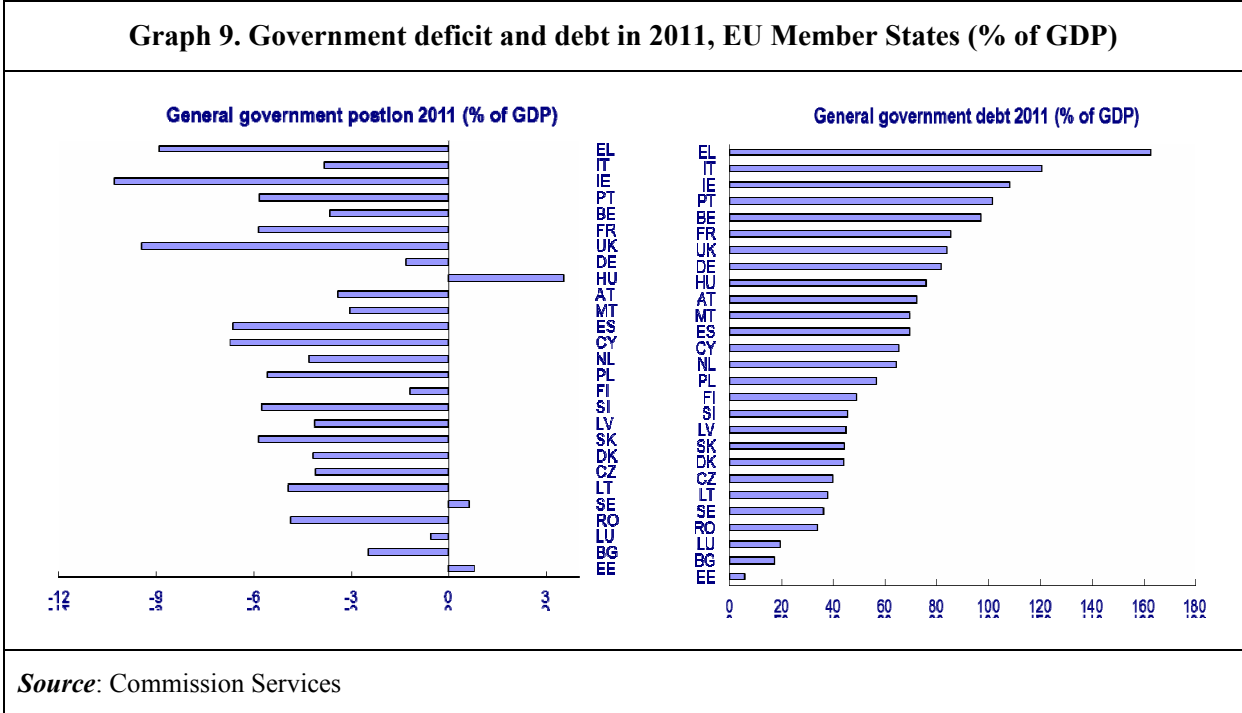
However, there are several aggravating factors at the current juncture, which put pressure on debt sustainability in the EU.

- **First, debt levels are currently higher than in the past, and particularly so in several Member States** (Graph 9). In 2007, debt stood at above 60% of GDP for nine EU countries and exceeded 100% of GDP in the cases of Greece and Italy. Moreover, while the average foreseen increase of debt-to-GDP ratios projected between 2007 and 2013 is around 25 percentage points of GDP, there is wide cross-country variation, with increases in excess of 96 percentage points in Ireland, 90 percentage points in Greece and 40 percentage points in Spain, Portugal and the United Kingdom.
- **Second, the fiscal costs of ageing populations will be an increasing burden for public finances.** Based on current policies, age-related public expenditure is projected to increase by about 4¾ percentage points of GDP over the next fifty years on average in the EU – especially through pension, healthcare and long-term care spending. However, again, the situation differs considerably across Member States, both in terms of demographic prospects, growth potential, design of pension and welfare systems, but also in terms of constraints related to the fiscal situation and external competitiveness.
- **Third, market pressure has reached unprecedented intensity.** In view of the subdued growth prospects financial markets have had serious doubts about sustainability of the fiscal position of some euro-area Member States. This led to increases in interest for government borrowing and further to all the negative spillovers and feedback loops, described in the previous section.

Therefore, there is currently no viable option but to implement a comprehensive and credible fiscal exit strategy. Principles of such a strategy have been agreed by the ECOFIN Council and stipulate that consolidation should be coordinated across EU countries taking into account the specificities of country situations. It was agreed that consolidation in all EU Member States should start in 2011 at the latest, with a number of countries having to start consolidating earlier. As importantly, it was agreed that EU Member States would strengthen national budgetary frameworks and take structural measures that would lift potential output growth and thus support long-term fiscal sustainability.

The agreed exit strategy is delivering: the consolidation is underway. Budgetary plans presented by the Member States in the 2011 updates of the Stability and Convergence Programmes envisaged that the general government deficit would fall to below 3% of GDP in the EU in 2013. Implementation of budgetary plans is under way. Government finances in the EU started to improve somewhat already in 2010 on the back of both strengthening economic growth and first consolidation measures. A more noticeable improvement is being recorded in 2011 due to a broad-based consolidation effort in essentially all EU Member States. Further progress is expected in 2012 and – based on unchanged policies – in 2013, although at a somewhat slower pace. However, aggregate trends mask significant differences across countries. At present, 23 Member States are in the EDP, of which five are benefiting from a

financial assistance programme.¹ Some Member States are making good progress towards a timely and sustainable correction of excessive deficits, while others exhibit adjustment gaps and need to step up their efforts to achieve the fiscal targets (Graph 9, Table 1).



Ensuring sustainability is currently the key factor affecting economic stability. Until mid-2011 the implementation of the fiscal exit took place against the background of recovering economic activity. Growth, however, is forecast to come to a standstill next year. Nevertheless, the severe turbulences in the sovereign bond market imply that most Member States have no scope to allow higher deficits as fiscal sustainability has become priority. This is particularly the case for Member States being subject to close market scrutiny and those suffering from large fiscal macroeconomic imbalances (Graph 10). Insufficient consolidation risks causing higher risk premia, which would in turn be very damaging to economic prospects.

¹ Greece, Ireland, Portugal, Latvia (EU's Balance of Payment assistance programme is set to expire in January 2012) and Romania (which has a precautionary programme).

Table 1. General government net lending (% of GDP) according to Commission Autumn 2011 forecast, EDP deadlines				
	2011	2012	2013	Deadline for correction
Belgium	-3.6	-4.6	-4.5	2012
Germany	-1.3	-1.0	-0.7	2013
Estonia	0.8	-1.8	-0.8	Not in EDP
Ireland	-10.3	-8.6	-7.8	2015
Greece	-8.9	-7.0	-6.8	2014
Spain	-6.6	-5.9	-5.3	2013
France	-5.8	-5.3	-5.1	2013
Italy	-4.0	-2.3	-1.2	2012
Cyprus	-6.7	-4.9	-4.7	2012
Luxembourg	-0.6	-1.1	-0.9	Not in EDP
Malta	-3.0	-3.5	-3.6	2011
Netherlands	-4.3	-3.1	-2.7	2013
Austria	-3.4	-3.1	-2.9	2013
Portugal	-5.8	-4.5	-3.2	2013
Slovenia	-5.7	-5.3	-5.7	2013
Slovakia	-5.8	-4.9	-5.0	2013
Finland	-1.0	-0.7	-0.7	Not in EDP
Bulgaria	-2.5	-1.7	-1.3	2011
Czech Republic	-4.1	-3.8	-4.0	2013
Denmark	-4.0	-4.5	-2.1	2013
Latvia	-4.2	-3.3	-3.2	2012
Lithuania	-5.0	-3.0	-3.4	2012
Hungary	3.6	-2.8	-3.7	2011
Poland	-5.6	-4.0	-3.1	2012
Romania	-4.9	-3.7	-2.9	2012
Sweden	0.9	0.7	0.9	Not in EDP
United Kingdom	-9.4	-7.8	-5.8	2014/15
EU	-4.7	-3.9	-3.2	-
Euro area	-4.1	-3.4	-3.0	-

Source: Commission Services

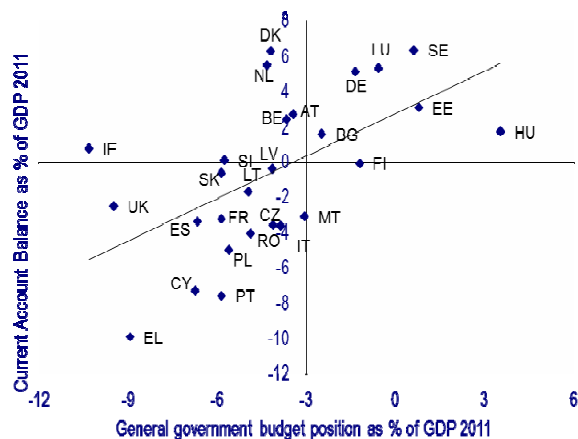
Therefore, consolidation should be differentiated across countries. Recognising the different situation across Member States, on 4 October 2011, the ECOFIN reiterated the principle that the speed of fiscal adjustment should be differentiated according to country specific fiscal and macro-financial risks. In particular:

- Member States benefitting from financial assistance programmes and those under close market scrutiny should continue to meet agreed budgetary targets in spite of possibly changing macro-economic conditions.
- Member States with a significant adjustment gap under the excessive deficit procedure or a high deficit, should step up their consolidation efforts. Possible limited downwards revisions of the main macro-economic scenario should not result in delays in the correction of excessive deficits.
- In Member States which do not have an excessive deficit and that are on an appropriate adjustment path towards their medium-term objectives, budgetary policy can play its counter-cyclical and stabilizing

role fully, as long as medium-term fiscal sustainability is not put at stake.

It is vital in the current economic context to ensure that the consolidation plans on both the expenditure and the revenue sides are designed to limit the negative short-term effects on growth.

Graph 10. Fiscal and external imbalances, EU Member States



Source: Commission Services

Evidence shows that expenditure-based consolidations have a better chance of success, but the composition and quality of expenditure matters:

- cuts in productive spending, notably capital investment, should nonetheless give priority to projects with the highest return in order to minimise the impact on growth potential.
- efficiency of public spending in a given category of expenditure differs a lot across Member States, but also within the same country. This gives potential room for improvement: bringing the least efficient units up to higher standards could deliver large

savings for the same volume of public services.

- the need to prioritise expenditure and increase the efficiency of spending on all levels of government calls for developing appropriate supporting institutional tools within the budget, such as spending reviews, programme budgeting or performance budgeting. Equity considerations should be taken into account to ensure a fair distribution of the budgetary adjustment burden.

At the same time, the structure and design of taxation should be developed to better spur growth. Tax reforms can serve two aims: first, they can support the consolidation of public finances in those Member States where there is room for potential tax revenue increases and as a complement to expenditure control; secondly, they can support growth via changes in the structure of taxation or a better design of individual types of tax, which e.g. improve the incentives to work, produce, invest or raise resource efficiency. With regard to the structure of taxation:

- Member States with heavy taxation on labour, especially for vulnerable groups, such as low-skilled workers and second earners, should shift taxation towards taxes which are less detrimental to growth, such as consumption, real estate or environmental taxes. A re-profiling of labour taxation across income levels could also be considered;
- Member States with high corporate income taxation should avoid increasing tax rates further, especially in current times when investment performance is lacklustre;

- To enhance labour mobility and the efficient allocation of the housing stock, rebalancing of housing taxation away from transaction towards recurrent taxes might be warranted;
- Cutting tax expenditures in personal and corporate income taxation and limiting VAT exemptions and reduced rates, in respect of the VAT directive, will broaden the tax base, allowing for higher revenues and/or lower tax rates with a positive growth impact;
- The incentives in many Member States for building private debt should be reduced in corporate taxation and the treatment of housing in personal income taxation.
- Taxation can be made more environmentally-friendly in a majority of Member States by phasing out hidden tax subsidies.
- Member States with weak tax compliance should improve the efficiency of their tax collecting administration and better prevent tax evasion.
- Reduction of the compliance burden deriving from taxation can improve the business environment. This implies increasing transparency, reducing the complexity of tax codes and compliance regulations, and simplifying payment procedures.
- Member States are encouraged to take full advantage of the instruments that facilitate cooperation between tax administrations to ensure the identification and sharing of best practices within the EU, the improvement in revenue collection and the reduction of compliance costs.

Urgent reforms are needed to address the challenges to public finances stemming from population ageing. There has been considerable progress in the last decade in terms of implementing reforms of welfare systems (pensions, but also health care), but a lot more needs to be done. The last Annual Growth Survey highlighted pension reform as an area for immediate policy action. For several countries where the pension reform process has not been set in motion and where large increase in pension expenditure is projected in the future, there is a need to align the 'pension promise' with what the rest of the economy can be expected to support. There is also a need to make health systems more cost-efficient, sustainable and prevention oriented to curb estimated cost increases due to ageing.

Raising pension ages to link them to life expectancy is of particular relevance. Increasing pension age would make up for some of the earlier longevity growth which has not yet been factored in pensions systems. Linking it then to life expectancy would help stabilising the balance between working years and years in retirement. In order to enable and encourage people to work longer, reforms in pension systems need to be underpinned by policies ensuring the effective integration of older workers in the labour market and policies to support active and healthy ageing and complemented with tax and benefit policies giving incentives to stay longer at work.

Implementation of country-specific recommendations is under way to improve long-term fiscal sustainability, albeit with varying speed and determination. Of the 17 Member States that received recommendations in this area, 12 have taken some action, including through reforming the pension system and through raising incentives for older workers to stay

in the labour market. Raising the statutory retirement age and linking it to life expectancy based on an agreement between social partners and government has been an important step forward, although such agreements—on the agenda in a number of countries—have so far only been finalised in very few Member States. Action to monitor access to invalidity pension schemes and reform long-term care insurance has been limited.

Credible fiscal frameworks and effective surveillance mechanisms will strengthen long-term fiscal sustainability. The current dilemma between short-term stabilisation role for public finances and the investors' fears about debt sustainability in some Member States could be alleviated if credible commitments to fiscal sustainability are in place. If markets' expectations are firmly anchored in a credible medium-term path, investors will be less sensitive to the short-term fluctuation of fiscal aggregates, leaving more room for stabilisation policies. To anchor the expectations the role of national fiscal frameworks and EU fiscal surveillance is crucial in this respect.

Sweeping changes to the Stability and Growth Pact will increase the effectiveness of fiscal surveillance. In order to strengthen economic surveillance, a package of six legislative proposals on economic governance, proposed by the Commission in September 2010, will enter into force by the end of the year thus ensuring a reinforced legal framework for the EU economic surveillance and coordination framework as of 2012. The legislation will be a step-change in the way economic surveillance is conducted in the EU. But swift and rigorous implementation of the package is necessary to anchor market expectations, unwind fiscal and macroeconomic imbalances and lay the ground for sustainable economic growth (Box 1).

A new Directive on minimum requirements for domestic budgetary frameworks has a potential to improve the budgetary processes on national level. The quality of the institutional and procedural arrangements governing domestically fiscal policy making, such as national fiscal rules, multi-annual fiscal frameworks and independent institutions, may significantly improve budgetary outcomes. In this respect, reforms spurred by the Directive have the potential to improve the conduct of fiscal policy at national level while promoting the respect of the SGP provisions. Member States should press ahead with its implementation by adopting the appropriate reforms in the areas covered by this Directive. Euro area Member States have a particular interest to speed up the transposition of the Directive into the national legislation and the October agreement in the euro area summit to go beyond these minimum requirements is welcome. In this connection, the domestic fiscal rules recently enshrined in the Constitutions of some euro area Member States go further than the provisions contained in the Directive (e.g. Spain).

Implementation of country-specific recommendations to improve fiscal frameworks is so far mixed. Eleven Member States had received a country-specific recommendation in this area. Recommendations spanned a broad range of issues, including the efficiency of the tax administration and revenue collection, the introduction of multi-annual budgetary rules and expenditure ceilings, the operationalisation of debt brakes, the role of independent fiscal councils as well as issues relating to budgetary data and transparency more broadly. At this stage only five out of the ten Member States have made clear progress. Actions taken concern introducing balanced-budget- or debt brake rules with constitutional status, strengthening the powers of central fiscal authorities to improve the predictability of budgetary planning, and the establishment or strengthening of independent fiscal councils. Where implementation is under way, it is still at an early stage of the legislative process but goes in the right direction.

Coordination of economic policies will have to be strengthened further, particularly in the euro area. The European Semester and the "six-pack" already provide a strong governance framework. Nevertheless, there is still need and room to strengthen the governance framework further, including its Community dimension. There should be a stronger euro-area dimension in the planning, implementation and ex-post assessment of Member States policies to ensure stronger economic policy co-ordination, based on surveillance procedures that become increasingly tighter (i.e. imply greater constraints on national budgets and economic policies), whenever a member state deviates from the agreed prudential policy line. In this context the Commission has further reinforced of the role of the commissioner responsible for economic and monetary affairs, who has become the Vice-President of the Commission for economic and monetary affairs and the euro. A single, coherent framework for better economic governance on the basis of the Community method is necessary.

Box 1. "The six-pack": legislation to improve economic governance in the EU

The economic and financial crisis revealed important weaknesses in the EU's economic governance.

As part of a comprehensive response to the crisis, the Commission – on 29 September 2010 – presented six legislative proposals to strengthen economic governance, the so-called "six pack": three Regulations strengthening the Stability and Growth Pact (SGP), two Regulations introducing a new procedure to prevent and correct excessive macroeconomic imbalances and a Council directive prescribing minimum requirements for national budgetary frameworks.

The six pack introduces a number of key changes in the way that economic surveillance is conducted. For example, the launch of an Excessive Deficit Procedure (EDP) can now result not only from a government deficit but also from public debt developments in Member States with debt in excess of 60% of GDP, which have to reduce their debt in line with a numerical benchmark. A new surveillance mechanism of macroeconomic imbalances (Excessive Imbalances Procedure, EIP) aims to prevent and correct macroeconomic imbalances, relying on an alert system that inter alia makes use of a scoreboard of indicators and on in-depth studies of countries considered at risk. Enforcement of the SGP and the new EIP is strengthened not only by the introduction of progressive financial sanctions for euro area Member States that do not comply but also by the expanded use of 'reverse qualified majority' voting. Under this voting system, a Commission recommendation or proposal to the Council is considered adopted unless a qualified majority of Member States vote against it. The new Directive on minimum requirements for domestic budgetary frameworks ensures that national fiscal frameworks abide by a set of essential requirements, thereby enhancing the capabilities of Member States to deliver on the fiscal obligations deriving from the Stability and Growth Pact.

After intensive negotiations, the Council and the European Parliament came to an agreement on the legislation. It is expected to enter into force around mid December 2011.

Policy priorities

In order to address the challenges outlined above, action is needed particularly in the following areas in 2012-2013:

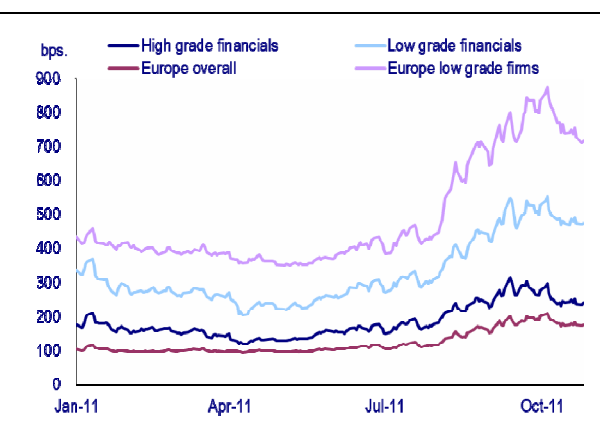
- Fiscal consolidation should continue with a differentiated speed of fiscal adjustment.
- Growth-friendliness of fiscal adjustment should be a key consideration. While expenditure-based adjustments should be favoured in general, growth-enhancing expenditure should be prioritised. Overall improvement in quality of expenditure should be aimed at.

- The impact of tax structures on growth should be reflected.
- Pension reforms have to be set in motion or implemented fully, if already started. Rising of pension age could be a promising short-term priority.
- The adopted "six-pack" legislation should be implemented quickly and rigorously, including the requirements of the fiscal frameworks Directive. Euro area Member States should build on this without delay and honour their agreement to go beyond the requirements of the Directive. Commission proposals on further strengthening of euro area governance have to be swiftly implemented.

3. FINANCIAL SECTOR: BREAKING THE VICIOUS CIRCLE

The negative feedback loop between the banking sector and the sovereign has been the main stress-amplifier in the current crisis. As outlined in Section 1, the negative feedback loop between the banking sector and the sovereign debt markets has fed investors' doubts about sovereigns' and banks' ability to service their debt. This led in consequence to high costs of borrowing for both sovereigns and financial institutions, unsustainable if prolonged beyond the short term (Graph 11). Together with the measures discussed in the previous section, simultaneous strengthening of the banking sector and creating a credible and potent backstop for banks and sovereigns is indispensable to break this vicious circle.

Graph 11. iTraxx – default risk, financials and overall



Note: the indicator summarises the spread development of the most liquid investment grade credit default swaps (CDS) contracts in the euro credit market and provides the benchmark for the price investors have to pay for protecting their bonds against default. The increase suggests that investors have started to pay more attention to banks financing their national sovereign debt or having a large exposure to programme countries and areas with contagion.

Source: Commission Services

Healthy financial system and a robust banking sector are vital to support the recovery and to finance the long-term growth. The financial excesses that led to the global crisis have undermined the credibility of the financial sector and its role in the economy. The financial sector was hard hit during the crisis and a collapse was avoided only at the expense of public support. However, the financial sector plays a crucial role in the market economy, matching the needs of savers and borrowers across time and across space and facilitating the financing of the real economy. In Europe, the banking sector plays a crucial role in this regard providing credit to enterprises and households. It is therefore essential to complete the ongoing financial repair and banking sector restructuring in order to safeguard the conditions of sustained recovery.

Numerous measures have been taken by the public and the private sector to restore the viability of the financial sector in the EU. Public support, in full compliance with the EU state aid framework, took mainly the form of capital injections, to cover past losses and improve the resilience of the banks to adverse conditions. Also guarantees were provided to restore confidence across the sector and to revive the wholesale funding market for banks. The availability of the necessary public support, on terms compatible with the internal market,

was facilitated by the special crisis rules for state aid to financial institutions introduced by the Commission in 2008-09. While some progress was observed as a result of these policy measures, the situation remained fragile, and confidence was never fully restored. Three consecutive EU-wide stress tests since 2009 have failed to convince investors about the quality of EU bank balance sheets, even though in anticipation or as a response to the tests banks have considerably improved the quantity of capital and its quality. In view of the ongoing fragility of the banking sector, the Commission intends to extend the applicability of the crisis state aid rules beyond 2011.

Financial regulation and supervision has been strengthened and should play an important role in restoring the confidence in financial market. Since the beginning of 2011 three new European Supervisory Authorities have been in place to foster supervisory convergence in the supervision of banks, markets, insurances and pensions. They are cooperating closely with the new European Systemic Risk Board responsible for macro-prudential supervision. Furthermore, on 20 July 2011, the Commission adopted a legislative package to strengthen the regulation of the banking sector. The proposal transposes into EU legislation the Basel III agreement, which is the international standard on bank capital agreed at the G20 level. It will require banks to hold more and better capital to resist future shocks. The proposal also includes a Single Rule Book for banking supervision, which will improve both transparency and enforcement of prudential rules. Looking forward, a proper EU-wide crisis management framework for financial institutions will be needed to reinforce banks' resilience and better prevent failures.

Recently, the European Council endorsed a 'banking package' of measures to further strengthen the banking sector. The package, building on a proposal by the European Banking Authority is an integral part of a comprehensive plan to restore the confidence in the markets and address the sovereign debt crisis in the euro area. The agreed package comprises two parts: (i) an EU coordinated term funding guarantee scheme to support banks' access to term funding; and (ii) measures to strengthen banks' capital positions to provide a further capital buffer for the EU banking system. National supervisors were asked to cooperate with banks and to devise recapitalisation strategies that would not endanger credit growth to the economy. New capital should be sought from private sources in the first instance and if those are not available, public resources should be provided – first from national sources and if those are not available – from the EFSF as a last resort. It is of utmost importance that the package is implemented within the agreed timeframe. High-degree of coordination at the EU level among supervisors and governments is indispensable for the plan to work.

The strengthened EFSF will limit contagion in the sovereign and the financial sector. The last few years have clearly shown that purely national approaches to deal with the crisis are not effective and not compatible with the high degree of financial and economic integration in the EU, even more so in the euro area. Therefore, while strengthening sovereigns' and banks' accounts is the first line of defence, EU-level instruments are necessary to backstop financial institutions and sovereigns. With this in mind, on 21 July 2011 euro area Heads of State or Government agreed to improve the effectiveness of the EFSF, and later of the ESM by equipping it with new instruments allowing them to: (i) act on the basis of a precautionary programme; (ii) finance recapitalisation of financial institutions through loans to governments including in non programme countries and; (iii) intervene in the primary and secondary sovereign bond markets. Further, on 26 October 2011, the European Council decided to extend the capacity of the EFSF by leveraging its resources, indicating two non-

excluding options: (i) providing credit enhancement to new sovereign debt and, (ii) combining resources from private and public financial institutions and investors.

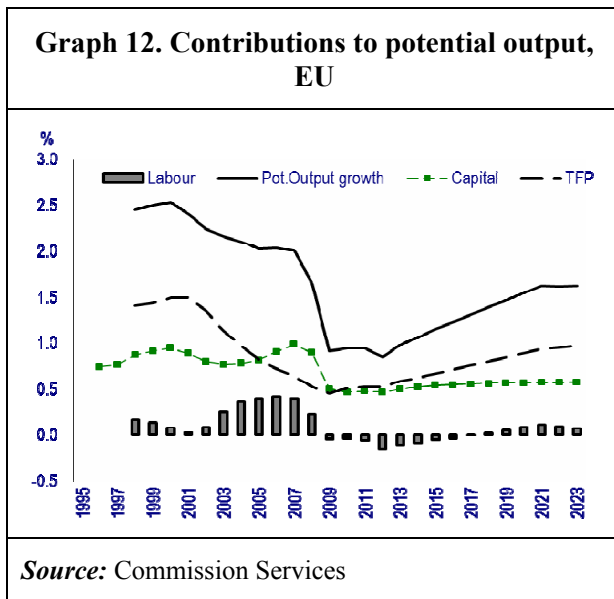
Swift implementation and good cooperation between authorities is key for the success of the strategy. The measures agreed with regard to the EFSF and the ESM are bold, but it is now crucial to implement them without delay to make the new tools operational without delay. At the same time, efforts should be made to reach an agreement to establish the ESM as quickly as possible since its more robust structure based on capital would alleviate some of the shortfalls of the EFSF. Moreover, a high degree of coordination between Member States and a good cooperation between fiscal authorities and the monetary authority in formulating the strategies to address the current crisis would strengthen confidence in EU's ability to regain stability. Coherent communication is crucial in this respect.

Significant progress is being made regarding the implementation of country-specific recommendations on the financial sector, but not across the board. Eight Member States had received country-specific recommendations in this area. Action is being taken in several countries to strengthen further the prudential supervision framework, make progress with on-going bank restructuring, enhance competition in the sector, and to support access to venture capital financing. In a few cases, the ambition of announced policy plans is insufficient and implementation is partial. Against the background of the risks and uncertainties outlined above, more determined action appears warranted, especially where spill over effects can be expected to be large.

Policy priorities:

- The main strategic objective of any financial policy initiative is to sever the link between the sovereign crisis and the financial sector.
- The capacity of the EFSF and of the ESM should be maximised by devising an appropriate mechanism of leverage, while respecting the Treaty provisions.
- As some Member States do not have the fiscal space necessary to provide support to their financial sectors, mechanisms should be designed to support Member States and increase EU coordination of these interventions.
- The capital requirement legislation should be adopted and implemented rapidly, while an EU crisis management framework for financial institutions is being developed. Attention should be given to limiting the impact of banking-sector reform on the flow of credit to the real economy.

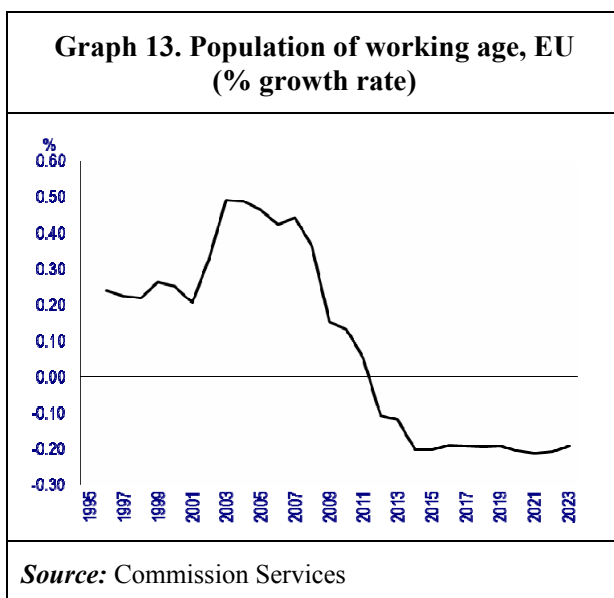
4. STRUCTURAL REFORMS TO SUPPORT GROWTH AND CORRECT IMBALANCES



Growth enhancing structural reforms must come to the forefront of the policy agenda. Europe's long-term growth potential has been lagging behind its peers and has been further weakened by the financial crisis (Graph 12). Also, the short-term growth prospects are subdued, but macroeconomic tools to support growth, especially fiscal policy, have been largely exhausted and must now focus on ensuring stability, as explained in the previous sections. An ambitious programme of bold structural reforms can transform this outlook into a more positive one by increasing growth potential, tackling competitiveness divergences and facilitating adjustment. Member States need to put structural reforms in place and so does the

EU overall (detail on the latter is to be found in Annex I on progress on Europe2020).

Structural reforms have the capacity to increase growth potential and tackle macroeconomic imbalances. Structural reforms improve the efficiency of the economy, including resource efficiency, thereby expanding the level of output which the economy could produce at full employment as well as accelerating its growth rate. Reforms can also increase adjustment capacity of economies, as they facilitate the necessary reallocation of labour and capital across sectors. Structural reforms play a key role in addressing macroeconomic imbalances. Despite the recorded reductions in imbalances, significant adjustments are still necessary in some Member States. Structural problems e.g. in terms of competitiveness or demand sustainability, underlined the build up of imbalances before the crisis. Structural reforms to tackle these underlying problems are crucial to secure orderly adjustment and prevent rebuilding of imbalances in the future and to allow growth to pick up.

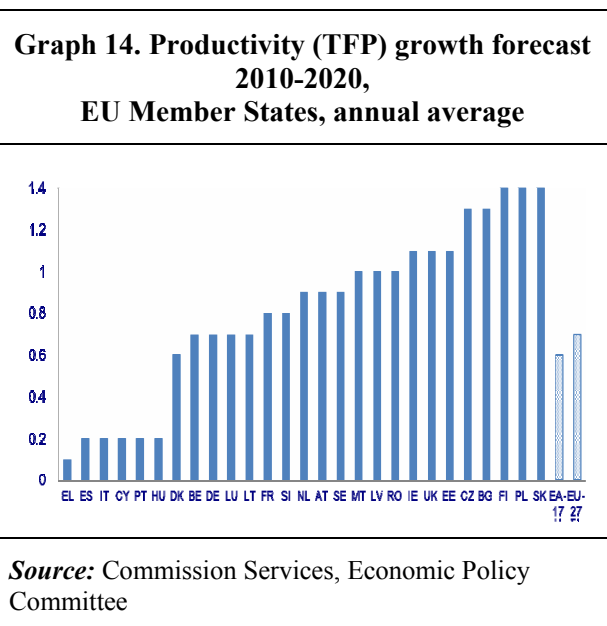


Reforms promoting a sustained rise in employment rates are necessary in view of the prevailing demographic prospects in the EU. The share of the working-age population in the EU has been on a declining trend and is projected to remain so (Graph 13). The Europe2020 Strategy aims at increasing the rate of employment from 69% currently to 75% in 2020, to partially counterbalance that trend. Moreover, the crisis has led to sharp increases in unemployment, which risks becoming entrenched. In this context reforms boosting job creation, tackling unemployment and keeping participation rates should feature high on policy agenda. There is room to learn

from the successful labour market reforms in some Member States and to share good practices which had resulted in increased employment and a fall in unemployment before the crisis.

Productivity growth should be given priority due to its positive impact on output growth and adjustment. The current demographic trends imply that, productivity growth will be the main source of growth per capita in the coming decades. At the same time, comparing productivity trends across Member States it seems that there is ample room for improvement in a number of countries (Graph 14). Importantly, among available sources of growth, capital deepening or job creation have only temporary effects on output. Productivity gains, on the other hand, can be sustained over time if coming from innovation and technological improvement. **ICTs are a major growth driver, explaining half of the productivity growth of modern economies.** In such cases, productivity growth is compatible with employment growth.

Productivity growth can help reduce current account imbalances in a sustained way. In particular, productivity improvements in the non-tradable sector, such as most services, reduce domestic price pressures, including on domestic inputs to the export sector, and hence improve its competitiveness. Moreover, improved productivity in services gives room for a transfer of resources to the export sector, which is necessary for a durable adjustment. These adjustment channels are particularly important for countries with external deficits. At the same time, higher productivity growth boosts domestic demand to the extent it is constrained by market and policy failures. This is particularly relevant for surplus counties with weak domestic demand.



The scale of the productivity challenge differs across countries (Graph 14). Whilst the need to increase productivity spans across the whole EU, for some Member States it is particularly pressing. This is chiefly the case for Member States suffering from large external imbalances. For them increases in productivity bring additional value in facilitating rebalancing, as explained above, but they also seem to be lagging behind the other Member States.

An efficient adjustment of labour costs is crucial to reduce imbalances and address the high rise in unemployment. This is of particular importance in the euro area since costs and price adjustment is the only way of

nomianl adjustment in a monetary union. Such adjustment has already started, but needs to continue to reduce internal imbalances (high and persistent unemployment, structural impediments to private domestic demand) as well as external ones (progressive competitiveness deterioration leading to current account imbalances). It is important that wage setting mechanisms take these objectives into account.

In the current macroeconomic context, a careful and selective approach to structural measures is necessary. Due to slowing growth and financial tensions, priority has to be given to reforms which can deliver a positive impact on growth already in the near term and which incur the lowest budgetary costs. Regulatory reforms and opening up of sheltered sectors largely fulfil these conditions.

Equity considerations should be factored into reform plans. After years of subdued growth and difficult adjustment in some countries, the waning recovery inevitably puts a strain on jobs and the social fabric of Europe. Certain population groups – including the young and low-skilled – are hit particularly hard. Therefore reforms also need to take into account equity considerations. In this respect, there is a need to ensure the adequate financing and efficient design of social safety nets, especially in those countries where social exclusion is becoming a serious issue.

Enhancing the quality of public institutions will bring significant gains. In many Member States there is scope for increasing the efficiency in the delivery of public services as well as the transparency and quality of public administration, **for example through enhanced eGovernment**. Addressing existing problems would allow reconciling the aims of fiscal consolidation and improving competitiveness and growth prospects. In particular, tax collection systems are a stumbling block to fiscal adjustment in some Member States, but improving the efficiency of tax collection would contribute to a fairer sharing of the consolidation burden also in others. Also, to create a business friendly environment conducive to improving the economy's competitiveness efficient functioning of competition authorities, market regulators and judicial authorities is necessary.

The size of the economic challenges looming ahead means that a true structural change is necessary in the EU economy. For that to happen, resources need to be allowed to move from slow-growing to dynamic firms and sectors, within and across borders. Resource reallocation is particularly important for countries with large imbalances, where resources have to be shifted from non-tradable to tradable sector. This implies that some activities in some countries would have to be phased out to make space for new, higher-productivity enterprises. In this context particular attention has to be paid to labour mobility across companies and sectors but also regions and countries. Adequate price signals would facilitate mobility and hence wage-setting mechanisms need to ensure that wage growth adequately reflects local and sector-level productivity developments. Also, the education and vocational training system need to be able to provide the necessary re-skilling and re-training for easier mobility.

Implementation of country specific recommendations to strengthen competition in services markets and network industries is so far overall rather poor. This is disappointing both in view of the importance of competition for bolstering productivity, competitiveness, and growth and of the large gains that could be expected from forceful reforms in these areas. Of the 12 Member States which received recommendations on competition issues, seven have taken some action. However this action remains generally rather partial and so far clearly insufficient to reach the objectives. The recommendations of June 2011 had inter alia called for enhancing competition in retail services, removing unjustified restrictions in certain regulated professions and crafts, to reform regulatory frameworks, improve competition in network industries, and strengthening the administrative

capacity of the competition authority. Among the actions taken by a number of Member States are additional powers to agencies monitoring price developments in energy networks, reports issued by relevant agencies, and political agreements that may form the basis for future legislative action.

Reform action to ensure that wage growth better reflects developments in labour productivity should be continued. Among the action taken in some Member States are agreements between social partners on new wage bargaining frameworks to facilitate the use and flexibility of firm-level contracts and legislation to contain the public sector wage bill, including through the introduction of pension contributions of civil servants. So far there has been little progress on reforming wage indexation systems and on minimum wages. Steps have been taken in the area of contractual arrangements and employment protection legislation but it is too early to draw conclusions on their ability to attain the intended objectives of removing labour market segmentation.

Policy priorities

In order to address the challenges outlined above, action is needed in particular in the following areas in 2012-2013:

- Structural reforms have to be prioritised according to their potential to lift growth in the short term without incurring large budgetary costs.
- Priority should be given to reforms promoting productivity growth due to their positive impact on output growth and adjustment capacity as well as due to shrinking labour resources. These reforms have particular relevance for Member States suffering from macroeconomic imbalances.
- Reforms on labour markets and in particular to wage setting mechanisms need to ensure efficient adjustment of labour costs in order to facilitate absorption of macroeconomic imbalances and to reduce unemployment. Reforms of the tax and benefit systems and policy actions that address rigidities in employment protection legislation should be also given priority with a view to boost job creation and reducing segmentation, while supporting adjustment.
- Improving the efficiency of public institutions, in particular in the fiscal, market regulatory and judicial areas, can be an easy way to support fiscal consolidation and improving competitiveness at the same time.
- Policies facilitating resource reallocation across firms, sectors, regions and countries need to be implemented to support structural change towards dynamic sectors and high-productivity activities. At the national level, policies promoting labour mobility and human capital formation are important, while strict implementation of competition policies at both EU and national level would contribute to this effect.

Annex. Selected macro-economic indicators [including Euro Plus Pact indicators]

	Growth and jobs					Competitiveness						Public Finances						Financial Stability					
	GDP per capita in PPS	GDP growth projection	Employment rate	Long-term unemployment*	Youth unemployment (<25)*	Labour force participation rate*	Nominal Unit Labour Costs*			Nominal Compensation per employee*		Current Account Balance*	Market share of exports (goods + services)*	Government Debt*	Government surplus/(-) /	Overall tax burden (including SSC)	Sustainability Indicator (S2)*	Average exit age from the labour force*	Life expectancy*	Private debt*	Non performing loans	LT interest rate spreads vis-à-vis Germany	Return on equity
							Whole economy	Services	Manufacturing	Public sector	Private sector												
	Level compared to EU27=100	Annual rate of change	Age group 15-64	% of active population	% of active population	%	Annual rate of change	Annual rate of change	Annual rate of change	Annual rate of change	Annual rate of change	% of GDP	% change	% of GDP	% of GDP	% of GDP	2010	2010	2010	2010	2010	June 2010	September 2011
BE	119	0.9	62.0	4.1	22.4	67.7	0.0	0.2	0.6	0.6	1.5	-3.8	96.2	-4.1	45.4	5.7	61.6	23.4	2.1	4.0	2.1	9.9	
DE	117	0.8	71.1	3.2	9.9	76.6	-1.1	0.7	-7.9	1.9	2.3	-3.1	83.2	-4.3	39.8	4.0	62.2	127	2.5	2.5	2.5	2.2	
IE	127	1.1	60.0	6.7	27.8	69.5	-6.9	2.1	-1.2	-1.9	0.5	-9.4	94.9	-31.3	30.3	13.0	64.1	341	14.7	6.7	6.7	-41.2	
EL	88	-2.8	59.6	5.7	32.9	68.2	-1.6	-2.6	11.4	-6.3	-1.6	-10.8	144.9	-10.6	32.8	13.3	61.5	123	6.1	6.1	16.0	-4.7	
ES	100	0.7	58.6	7.3	41.6	73.4	-2.6	-0.5	0.5	0.5	-4.6	-5.9	61.0	-9.3	32.9	10.6	62.3	225	3.8	3.4	3.4	11.0	
EE	64	3.2	61.0	7.7	32.9	73.8	-5.6	-5.7	-18.5	-2.2	-1.0	0.0	6.7	0.2	33.9	3.4	62.6	20.9	10.0	10.0	10.0	-11.8	
FR	107	0.6	63.8	3.9	23.3	70.5	0.7	0.7	0.7	0.7	-1.7	-6.4	82.3	-7.1	44.0	3.9	60.0	20.9	4.6	4.6	0.8	9.2	
IT	100	0.1	56.9	4.1	27.8	62.2	-0.3	0.4	-4.8	1.3	-3.5	-4.4	118.4	-4.6	42.6	2.0	60.1	20.9	7.2	7.2	3.9	4.0	
CY	97	0	69.7	1.3	17.8	74.4	1.4	0.0	0.0	0.0	-7.8	0.0	61.5	-5.3	36.3	11.4	62.8	20.9	4.3	4.3	5.2	10.0	
LU	274	1	65.2	1.3	16.1	68.2	1.7	0.0	0.0	0.0	7.7	-2.1	19.1	-1.1	36.3	8.7	59.4	254	0.4	0.4	0.4	8.7	
MT	83	1.3	56.1	3.2	12.9	60.3	-0.8	0.0	0.0	0.6	-3.9	0.0	69.0	-3.6	33.8	7.9	60.3	24.1	5.6	5.6	2.3	8.8	
NL	133	0.5	74.7	1.2	8.7	78.2	-0.8	-0.8	0.0	1.1	6.6	-1.5	62.9	-5.1	39.0	6.9	63.5	223	0.2	0.2	0.5	6.8	
AT	126	0.9	71.7	1.1	8.8	75.1	-0.3	1.0	-5.4	1.4	3.0	-6.7	71.8	-4.4	43.9	4.8	60.9	274	3.0	3.0	0.8	4.9	
PT	81	-3	65.6	6.3	22.4	74.0	-1.2	0.0	0.0	0.0	-10.0	-7.0	93.3	-9.8	34.7	9.8	62.6	248	2.8	2.8	9.5	7.7	
SI	86	1	66.2	3.2	14.7	71.5	0.3	0.8	-5.9	2.0	3.3	-0.8	38.8	-5.8	37.6	9.9	59.8	127	0.0	0.0	3.0	2.3	
SK	74	1.1	58.8	9.2	33.6	68.7	-1.3	-3.6	-3.5	3.8	2.9	-3.5	41.0	-7.7	28.4	9.4	58.8	19.9	3.8	3.8	2.4	9.6	
FI	116	1.4	68.1	2.0	21.4	74.5	-1.5	1.2	-7.8	2.1	11.2	-5.3	48.3	-2.5	42.1	3.0	61.7	178	1.0	1.0	0.5	6.8	
BG	44	2.3	59.7	4.8	23.2	66.5	0.8	-0.4	7.5	3.6	5.8	0.0	16.3	-3.1	27.2	3.5	64.1	169	14.9	14.9	3.5	7.4	
CZ	82	0.7	65.0	3.0	18.3	70.2	-0.7	-0.7	-6.7	1.8	1.7	1.3	37.6	-4.8	34.7	6.6	60.5	20.9	7.5	7.5	1.2	17.2	
DK	125	1.4	73.4	1.4	13.8	79.5	-1.1	-0.5	0.0	2.8	5.6	-6.5	43.7	-2.6	34.7	2.3	62.3	245	3.6	3.6	0.2	2.2	
LV	52	2.5	59.3	8.4	34.5	73.2	-10.2	-10.5	-12.3	-7.0	-5.2	3.0	44.7	-8.3	27.6	6.1	62.7	141	16.1	16.1	3.8	-34.3	
LT	58	3.4	57.8	7.4	35.1	70.5	-7.3	-7.8	-6.8	-5.6	0.2	7.7	38.0	-7.0	27.7	6.9	59.9	81	16.1	16.1	3.2	-16.7	
HU	63	0.5	55.4	5.5	26.6	62.4	-3.2	-0.3	-8.4	-1.6	0.5	-1.6	81.3	-4.2	37.1	3.3	59.3	155	8.2	8.2	5.8	8.7	
PL	62	2.5	59.3	3.0	23.7	65.6	2.2	0.0	8.6	0.0	-4.7	1.9	54.9	-7.8	31.8	2.7	59.3	74	6.4	6.4	3.9	9.4	
RO	45	2.1	58.8	2.5	22.1	63.6	1.7	2.5	0.0	-1.5	-4.0	0.0	31.0	-6.9	28.1	8.6	64.3	230	7.2	7.2	5.6	6.8	
SE	123	1.4	72.7	1.5	25.2	79.5	-1.7	1.0	-12.8	3.1	2.3	2.4	39.7	0.2	46.3	1.0	64.3	215	2.0	2.0	0.0	8.7	
UK	114	0.6	69.5	2.5	19.6	75.5	1.7	0.0	0.0	0.0	-2.5	-0.3	79.9	-10.3	37.2	9.9	63.0	215	2.0	2.0	0.6	6.8	
E/A	108	0.5	64.1	4.3	20.9	71.4	-0.8	0.0	0.0	0.0	0.1	0.0	80.2	-6.2	40.1	5.5	61.2	20.9	0.0	0.0	2.3	2.3	
EU	100	0.6	64.1	3.9	21.1	71.0	-0.4	0.0	0.0	0.0	-0.2	0.0	85.4	-6.6	39.5	6.0	61.4	20.9	0.0	0.0	2.1	2.1	

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

Sources: Commission services, Eurostat, ECB