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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK AND THE EUROGROUP

2017 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011

{SWD(2017) 67 final to SWD(2017) 93 final}

1. INTRODUCTION

Europe's recovery from the economic crisis is steady and is supporting positive labour market trends. The 2017 Annual Growth Survey[1] priorities are being put into action by Member States. The recovery is the result of an accommodative monetary policy, a broadly neutral aggregate fiscal stance, pro-growth fiscal adjustment and the impact of structural reforms. It is supported by stronger confidence among businesses and consumers about the economic outlook. The disbursement of the European Structural and Investment Funds and the projects being rolled out under the Investment Plan for Europe are helping to mobilise private and public investment. Employment is growing in almost all Member States, unemployment is falling and long-term and youth unemployment rates are gradually receding. However, high unemployment, poverty and inequality remain key concerns in some countries, and socioeconomic convergence across the EU has yet to resume fully. Productivity growth has improved but differs considerably between Member States and overall remains at low levels. To secure the recovery, all policy tools — monetary, fiscal and structural — need to be used to strengthen growth, investment and financial stability.

Member States need to act on investment, structural reforms and public finance at the same time to accelerate growth and make it last. Monetary policy alone cannot lift the level of demand or investment. Fiscal policy continues to play an essential role, both in those Member States that have fiscal space and those which need to adjust. It needs to be oriented toward policies that improve medium-term growth potential. Structural reforms need to focus on providing enabling conditions for investment, boosting labour force participation, and ensuring sustainability of public finance. Reforms also need to promote a better business environment, foster innovation and increase dynamism in product and services markets. They need at the same time to address inequalities, including by encouraging investment in skills, improving matching processes in labour markets, modernising tax and social protection systems.

This Communication summarises the progress in implementing reforms and in addressing the imbalances in Member States' economies. A detailed assessment for every Member State, except Greece[2], of the progress made in addressing the challenges identified in the country-specific recommendations in 2016 is included in the respective country report published by European Commission staff. For 13 Member States identified in the 2017 Alert Mechanism Report[3], the country reports also include the in-depth reviews carried out under the macroeconomic imbalance procedure.

The country reports provide a longer-term view of the progress made and the challenges ahead. While the European Semester runs on an annual cycle, reform priorities in the Member States are often decided upon at the start of a new government's term and implementing comprehensive structural reforms may take years. To reflect this better in the analysis, the country reports include for the first time a longer-term assessment of the implementation of the country specific recommendations.

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[1] COM(2016) 725. For an overview of EU-level priorities, see also the Commission Work Programme 2017 (COM(2016)710) and the Joint Declaration of 13 December 2016 on the EU's legislative priorities for 2017.

[2] To avoid duplication with reform measures set out in the macroeconomic adjustment programme and to be consistent with the approach followed in the previous years, the Commission has not issued additional recommendations to Greece as part of the European Semester.

[3] COM(2016) 728.

The analysis also takes stock of the budgetary situation of the Member States. It is based on the Commission's latest economic forecast[4] and builds on the Commission's opinions on the draft 2017 budgetary plans for the euro area Member States.[5]

The Commission has taken steps to increase the ownership of the reform agenda. It has streamlined the country-specific recommendations in recent years. In this European Semester round, the Commission has strengthened dialogue with the Member States at technical and political level, most notably through the high-level visits of Vice-Presidents and Commissioners. The Member States have also been consulted on the analytical content of the country reports before their publication and have had the opportunity to check the accuracy of the data and facts presented, but the views remain those of the Commission staff.

The European Semester process goes well beyond an individual assessment of each Member State's performance. It is also a vehicle to facilitate more policy coordination within the Member States, including their national parliaments and the closer involvement of social partners. The relevant country reports also identify the potential risks of spillovers in the euro area Member States if policy action is not taken. The country-specific recommendations that the Commission intends to propose in May 2017 will also take into account the recommendations for the euro area[6].

2. ECONOMIC AND SOCIAL CONTEXT

The European economy has proven to be resilient, despite a number of challenges in 2016. Growth is primarily supported by private consumption, which has been benefiting from the improving labour market and low inflation.

Moderate growth is also expected in 2017-2018, although there are both domestic and external risks. GDP growth in the EU is expected to remain fairly steady at 1.8% in both 2017 and 2018. It should be supported by continued improvement in the labour market, low borrowing costs and the expected strengthening in external demand. Private consumption is set to remain the main source of growth, while investment growth is projected to remain moderate. However, the economy still has to overcome the legacies from the crises, in particular long-term unemployment that, if unaddressed, could become structural. A new challenge for the EU economy originates from potential changes in US policies. Other challenges include the implications of the United Kingdom's referendum vote to leave the EU, the increase in long-term interest rates and the low profitability of some European banks.

Employment in the EU reached 232.5 million people in 2016, the highest number ever measured. Unemployment has fallen to 8.5 %, and the long-term and youth unemployment rates are at 3.8 % and 18.2 % respectively, lower than in previous years. The proportion of the EU population at risk of poverty or social exclusion (23.7 %) is the lowest in five years.

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[4] European Commission, Directorate-General Economic and Financial Affairs (2017): 'European Economic Forecast, Winter'. *European Economy Institutional Paper* 48.

[5] COM(2016) 730.

[6] COM(2016) 726.

While income distributions in the EU are more equal than in other major economies, income inequality remains a policy challenge in the EU. Even before the crisis, structural changes translated into growing inequalities in the distribution of income, wealth and opportunities, prompting social concerns that redistributive and social policies could not assuage. The financial crisis has increased the perception of unequal opportunities and unfair burden-sharing in society. In a number of countries, stagnating economic conditions for the middle class have gone hand in hand with the richest layers of society often capturing an increasing share of wealth. Weak fiscal positions and the slow recovery reduced the margin of manoeuvre for policies in a number of countries, thereby increasing social pressures to respond to inequalities[7].

3. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

An analysis looking back several years confirms the commitment of all Member States to actively pursue structural reforms. Since the start of the semester process in 2011 substantive progress on a large majority of recommendations has been made, but variety can be seen in the pace and depth of the implementation of reforms by Member States. Regarding the 2016 country-specific recommendations, most Member States made either some or limited progress in addressing the issues identified. The progress stayed broadly the same in the previous year. Particularly encouraging progress can be noted in the area of the financial sector and labour market policy, where many Member States have taken steps to address issues identified last year. In a favourable context of low interest rates, there is also progress in consolidating public finances. Progress in improving the business environment and boosting investment has been more varied across the Member States, while the areas showing least progress include opening product and services markets and addressing social exclusion.

Overall, Member States are on their way to meet the Europe 2020 strategy targets on energy and climate, while reaching other targets will require sustained efforts. Most Member States are likely to reach their targets on emission reductions, renewable energy and energy efficiency by 2020. Seventeen Member States have already reached their targets on early school leaving and 12 have reached their targets on tertiary education attainment. While the European employment target of 75% is within reach and the employment situation continues to improve in almost all Member States, national employment targets will prove difficult to reach for some Member States. Problems persist in reaching the poverty target as the number of people at risk of poverty or social exclusion in Europe remains high (119 million people). However, this number has decreased in most Member States as labour market outcomes continue to improve. The number is declining towards the level of 2008, the reference year for which the Europe 2020 target was set, but remains above the Europe 2020 target by around 21.6 million people. Progress towards the target of 3% in spending on research and development has been slow. Appendix 2 provides an overview of all Europe 2020 targets.

The funds available under the current EU multiannual financial framework are being used by the Member States to help prepare and implement structural reforms. The implementation of funds on the ground has improved over time in most Member States. The

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[7] See Employment and Social Developments in Europe Review, 2014-2016.

consistency between the country-specific recommendations related to the main economic and social challenges and the European Structural and Investment Funds was ensured at the programming stage (2014-2015) through targeted investment and ex ante conditionalities. Commission staff have assessed the 2016 country-specific recommendations and concluded that, at the current stage, there is no need to re-programme the operational programmes. In addition to the European Structural and Investment Funds, Member States can access financing under the European Fund for Strategic Investments, Horizon 2020, the Connecting Europe Facility and other directly managed EU funds. They can also obtain advice from the Structural Reform Support Service to facilitate the reform agenda.

4. ADDRESSING MACROECONOMIC IMBALANCES

EU Member States are making progress on correcting macroeconomic imbalances, although a number of risks remain. Public budgets are in better shape. Nonetheless, the stock of private, public and external debt has been falling at a slow rate. Progress so far has been uneven in a context of low inflation and low growth. The reduction of domestic and foreign debt implied a major deleveraging process in several Member States, with implications for short-term growth. The correction of current account balances in the euro area and the EU is ongoing. Competitiveness developments have been broadly consistent with rebalancing needs. Financial sector deleveraging has resulted in improved capital positions.

The 2017 Alert Mechanism Report found that 13 Member States warranted an in-depth review. All of them experienced imbalances or excessive imbalances in 2016 in the context of the macroeconomic imbalance procedure. This selection has been supported by the Council in its conclusions on the Alert Mechanism Report[8]. The country reports analyse macroeconomic developments and progress in terms of the policy response to relevant policy recommendations. The aim is to prevent the build-up of risks and monitor progress on correcting existing imbalances[9]. Given the importance of trade and financial links among EU countries, the assessment takes into account cross-border implications.

4.1. Rebalancing in the EU and the euro area

Large current account deficits have been corrected but large surpluses have been growing. After the crisis, a sharp correction took place in countries with large external deficits following a reversal in private cross-border financial flows. The process was aided by improvements in relative price competitiveness. Thereafter, domestic demand and imports remained subdued in net debtor countries. Since the stocks of net foreign liabilities remain high in a number of Member States, their current account positions need to remain at prudent levels. Conversely, a symmetric and comparable post-crisis correction did not take place in most countries with positive current account balances, and large surpluses have been further

[8] Council document 5735/17.

[9] Article 2 of Regulation No 1176/2011 of the European Parliament and of the Council defines imbalances as "any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential to adversely affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole".

growing in some cases. As a result, there is a growing current account surplus for the euro area as a whole[10].

The persistent current account surplus of the euro area reflects aggregate demand dynamics that continue to lag behind economic activity. Real domestic demand growth in the euro area has been lagging behind compared with pre-crisis levels. The relatively low aggregate demand also affects negatively growth output and estimates of potential growth. This persistent slack underpins the current historically low levels of core inflation, providing a challenging environment for countries that need to reduce domestic and foreign debt.

Private and public debt deleveraging continues, but at a slow and uneven pace, hampered by low nominal growth. Persistent high levels of private debt in a number of countries, often compounded by high stocks of government debt, are inhibiting investment and weighing on the balance sheets of some banks. In most countries, balance sheet repair is progressing, with deleveraging ongoing as a result of increased net savings in the household and corporate sectors. However, deleveraging is not always taking place where it is most needed, with some high-debt countries reducing their liabilities more slowly than low-debt countries.

The resilience of the European banking sector has continued to strengthen, but the sector is facing a number of challenges linked to subdued profitability and, in some cases, a legacy of non-performing loans. Banks have continued to strengthen their capital buffers even in a context in which bank profitability, although improving, remains weak. Profitability is hampered by slow economic growth, traditional business models, cost inefficiencies and overbanked markets. These fragilities are being further exposed by the current low interest environment. Moreover, in some countries, the legacy of non-performing loans reduces the room for lending, while low profitability hampers provisioning efforts and the internal generation of capital, and reduces opportunities for raising capital in the market.

A number of Member States need to monitor closely possible overheating risks in some sectors. Member States that made the most rapid progress in addressing imbalances are witnessing dynamic growth and relatively higher inflation rates, and some are experiencing a rise in unit labour costs. Real house prices are on the rise in a majority of Member States. In some cases, the increase in real house prices is adding further pressure to already overvalued housing markets.

While the recovery has been reflected in labour markets, issues such as long-term unemployment and low productivity persist. Labour markets have been improving since mid-2013, accompanied by a reduction in the dispersion of unemployment rates across Member States. However, there are still very high unemployment rates and stagnant pay levels in a number of EU countries. Social distress persists, especially in the countries hardest hit by the financial and debt crises.

Structural reforms have contributed to macroeconomic rebalancing and reform commitments need to be maintained. Measures are needed to improve competitiveness, and

[10] Recital 17 of Regulation (EU) 1176/2011 of the European Parliament and of the Council states that "when assessing macroeconomic imbalances, account should be taken of their severity and their potential negative economic and financial spill-over effects." This recital also states that "furthermore, in Member States that accumulate large current-account surpluses, policies should aim to identify and implement measures that help strengthen their domestic demand and growth potential."

accelerate the efficient reallocation of resources. Insolvency frameworks should be made more effective in order to help the correction of stock imbalances. At the same time, the negative impact of deleveraging on short-term growth needs to limited. Past reforms have helped to varying degrees. In some countries with imbalances, reform efforts have been put on hold, and there is a risk of back-tracking in a number of cases, often linked to political uncertainty. Maintaining existing commitments and completing reform processes is a pre-requisite for reaping reform benefits fully.

4.2. Implementing the macroeconomic imbalance procedure

Monitoring of policy implementation under the macroeconomic imbalance procedure has been strengthened. Since the categorisation of such imbalances was streamlined in 2016, a process of 'specific monitoring' has been applied to all countries with imbalances or excessive imbalances. The aim is to enhance the continuous monitoring of the policies undertaken under the procedure, by means of Commission reports discussed in Council committees. The monitoring has been tailored to reflect the scope of the challenges and the severity of the imbalances. The Council has broadly supported the conclusions of specific monitoring reports.

Fewer Member States are identified with imbalances than in 2016. Of the 13 Member States retained for further analysis, the in-depth reviews have found that one Member State is experiencing no imbalances, six are experiencing imbalances and six are experiencing excessive imbalances. Appendix 3 summarises the findings of the in-depth reviews.

The Commission will monitor closely policy commitments of countries identified with imbalances:

- **Ireland and Slovenia** are still identified with imbalances. A number of positive economic developments and implemented reforms point to their ongoing gradual correction. The sustainable correction of their imbalances is within reach, provided that further efforts are made. The Commission will therefore monitor economic developments in these two countries and forthcoming commitments, notably their National Reform Programmes (NRPs), to prepare its next in-depth review.

- **Germany** is identified with imbalances reflected in its large current account surplus. Recent economic developments do not point to a correction of these imbalances, although some progress has been made in addressing last year's MIP-related CSRs. The Commission will therefore monitor economic developments and forthcoming policy commitments, notably the National Reform Programme (NRP) and a possible new NRP by the next government, to prepare its next in-depth review.

- **France** is still identified with excessive imbalances but a number of economic developments and implemented reforms point to their ongoing gradual correction. Further efforts remain necessary to achieve a sustainable correction of the imbalances. The Commission will therefore monitor economic developments and forthcoming commitments, notably the National Reform Programme (NRP) and a possible new NRP by the next government, to prepare its next in-depth review. On the basis of this review, the Commission could consider revising the classification from excessive imbalances to imbalances.

- For three countries identified with excessive imbalances, namely, **Cyprus, Italy** and **Portugal**, in light of persistent structural weaknesses emerging from the IDR analysis, the Commission will review its assessment in May, taking into account the level of ambition of their National Reform Programmes (NRPs).

Table 1: Outcome of the in-depth reviews over 2016-17

	2016	2017
No imbalances confirmed	BE, EE, HU, AT, RO, UK	FI
Imbalances	DE, IE, ES, NL, SI, FI, SE	DE, IE, ES, NL, SI, SE
Excessive imbalances	BG, FR, HR, IT, PT, CY	BG, FR, HR, IT, PT, CY
Countries not selected for an IDR	CZ, DK, LV, LT, LU, MT, PL, SK	BE, CZ, DK, EE, LV, LT, LU, HU, MT, AT, PL, RO, SK, UK

5. REFORMS BY THE MEMBER STATES

The strength and sustainability of the recovery depends on how effectively reforms are adopted and implemented. A determined process of reforms instils confidence and creates the conditions to sustainably generate higher growth and employment. In turn, these depend on the speed with which reform processes in product, services and labour markets deliver results that trigger investment and productivity-enhancing resource reallocation.

Support for necessary adjustment and transitions can maximise the benefits of reform and ensure synergies between reforms in different policy areas. Reforms in different policy areas may need to be synchronised and mutually supportive, for example by developing flexibility in labour and product markets in parallel. The appropriate sequencing of reforms is also important, as clear commitments and the announcement of longer-term policy agendas have an impact on ownership and public support.

Facilitating productivity gains in a larger number of firms can foster convergence and help reduce inequalities. The increasing heterogeneity in productivity performances is one of the main drivers of income inequalities in EU economies and societies. It also constrains competitiveness and growth potential. While the effects of income inequality can be mitigated by taxation and social security systems, the need for such corrective measures can be reduced by implementing reforms that allow for more evenly spread productivity growth across firms, sectors and regions[11]. Disparities in productivity performance can be tackled, for example by

[11] See European Commission (2016), Single Market Integration and Competitiveness in the EU and the Member States.

investing in skills and education, by facilitating technology transfers and by reallocating resources. Such policies help to increase wages and incomes and reduce the burden on public finances for correcting existing inequalities through redistributive measures. In Denmark, a Productivity Commission was established in 2012 to propose recommendations that could enhance productivity in the private and public sectors. Several of the recommendations published in 2014 have been implemented.

Distributional effects have to be taken increasingly into account in the planning and sequencing of structural reforms. Member States should introduce structural reforms in a manner that takes into account their short and medium term impact, including distributional effects and social costs. Some win-win reforms imply no trade-offs between growth and equity. Reforms in the education sector, such as increasing the quality of education and access to it, contribute to economic growth and to reducing inequality. Vocational training and lifelong re-training opportunities also help to mitigate the negative effect of skill-biased technical change because they improve the skills endowment of workers.

Member States have announced and implemented many tax reforms to support investment, employment and social justice. Progress has been made on improving tax compliance but the fight against tax fraud, avoidance and evasion remains essential to ensure fair burden-sharing. Striking the right balance between efficiency and equity requires securing the tax revenues needed for public investment and welfare. After labour tax reforms implemented at the start of 2016, new measures in the last year have been more limited and the labour tax burden, including for low-income earners, remains high in a number of Member States. In some countries, taxation still adds to barriers to private investment. Further efforts are needed to make tax compliance simpler, tackle the bias towards debt financing and design better fiscal incentives for R&D.

The 2014-2020 programming period under the EU's multiannual financial framework required Member States, for the first time, to undertake various reforms to facilitate and reinforce the impact of projects through *ex ante* conditionality. Key areas for these reforms are the public procurement framework; the existence of strategic policy frameworks in the fields of social inclusion, labour markets, education and administrative efficiency; and the implementation of relevant EU legislation. These requirements contribute to enhancing the overall investment environment and facilitate the implementation of both EU funds and European Fund for Strategic Investments projects. These reforms need to be duly followed up and implemented by the Member States. Administrative capacity building is important in this context. The enhanced use of financial instruments has the potential to leverage EU funds further and increase their impact, but requires appropriate know-how and expertise on the part of the administrative managing authorities.

New policy measures need to be designed and implemented with the close involvement of social partners to ensure ownership by a wider range of stakeholders. More complex reforms require several years for full implementation. For that reason, their design must be evidence-based and agreed with key stakeholders, such as regional and local authorities and the social partners. Member States are aware of the need to improve the functioning and effectiveness of social dialogue. Lithuania, which received a country-specific recommendation in 2016 on capacity building, has adopted a new Labour Code, which the government anticipates will improve collective bargaining. Furthermore, Poland has set up a new Social Dialogue Council and a new agreement on social dialogue has been established in Spain. On the other hand, there is still doubt about the genuine involvement of social partners in labour market reforms in some Member States.

5.1 Boosting investment

Investment growth has improved recently due to favourable financing conditions, capacity utilisation above its long-term average and lower corporate deleveraging pressure in some countries. However, a number of cyclical and structural factors explain the persistent weakness in investment. Low demand growth and expectations of weak potential growth continue to hold back a more sustained investment recovery. The historical level of investment in the EU has been 21-22% of GDP. After a drop to 19.4% in 2013, it is now gradually recovering. Total investment is expected to accelerate slightly by 2.9 % in 2017, both in the EU and the euro area, and to continue increasing in 2018 by 3.4 % in the euro area and by 3.1 % in the EU. It is particularly important to stimulate private investment, given that it represents 90% of total investment.

Investment in intangible assets is improving, albeit slowly and from low levels. While the significant fall in investment in equipment and machinery partly explains the drop in productivity after the crisis, structural issues affecting product, services, capital and labour markets are responsible for the subdued performance of total factor productivity in Europe, whose growth has been much lower in the last decade than in other economies. There is a particular need to increase investment in knowledge-based capital, support sustainable investments in line with circular economy principles, strengthen public-private cooperation and make better use of new instruments, including tax incentives.

Inflows of foreign direct investment into the EU are currently low and trade integration and diversification in some parts of the EU economy remain weak. Due to its open economy, the EU is a leader in exports and imports of goods and services, representing 16 % of world trade. Over 30 million jobs in the EU are supported directly and indirectly by exports of goods and services to the rest of the world. However, only 13 % of European SMEs are active outside the EU and there is scope for Member States to do more to facilitate the participation of SMEs in international trade. The situation between Member States, regions and sectors also varies considerably. While machinery and equipment in Germany, aeronautics in France, pharmaceutical products in the United Kingdom and enzymes in Denmark are world leaders, the share in global trade of a number of sectors and Member States continues to decline. The reasons for foreign investments, and their terms and nature, vary considerably and their impact on job creation is also variable. The countries of origin of foreign direct investment in the EU are changing - while the USA and Japan remain active investors, others such as China and Mercosur countries are taking a higher profile. It is important to ensure a level playing field in inward/outward foreign direct investment and increased EU access to respective markets in third countries.

The most frequent investment challenges in the Member States include an unfavourable business environment, inefficiencies in public administration, and high sector-specific administrative and regulatory burdens and barriers to investment. In several Member States a number of other factors also continue to hamper investment. These factors are rigidities in the product and labour markets; skills mismatches and shortages; weaknesses in research and innovation frameworks; the complexity of taxation systems; ineffective justice systems; sector-specific barriers, for example in infrastructure; and barriers to accessing finance, particularly for SMEs. In some Member States, there is still need to step up the fight against corruption. Overall, the rule of law, and trust in the quality and predictability of regulatory, tax and other policies and institutions are also important in the assessment of risks related to investment decisions.

Reforms in several Member States have begun to address some of these barriers to investment. Conditions of access to finance have generally improved, partly as a result of external factors (in Croatia, Ireland and Lithuania). Some progress is seen in labour market and education (in Italy and France). The same goes for regulatory and administrative burdens (in France, Italy, Portugal and Slovenia), public procurement (in Poland, Portugal and Sweden), public administration (in Italy and Slovakia) and the justice system (in Croatia, Italy and Malta). However, there has been only limited progress in removing sector-specific regulatory barriers, particularly in services and network industries, as well as barriers linked to the financing of research and innovation. France has continued to ease administrative procedures for investment in industry and services by implementing a comprehensive simplification programme.

In addition to the work of the Single Supervisory Mechanism as regards the significant institutions in the euro area, supervision of the banking sector has been strengthened at national and EU level and efforts were made to improve the management and disposal of non-performing loans. In several Member States, asset quality in the banking sector has deteriorated during the crisis and still and weighs on credit and investment. This is in spite of the declining trend in non-performing loans, whose EU average fell to 5.45% of total loans in Q2-2016. Nevertheless, dispersion is high across Member States, with several of them recording double-digit levels (Bulgaria, Ireland, Greece, Croatia, Italy, Cyprus, Hungary, Portugal, Romania and Slovenia). Measures to foster the development of a secondary market for non-performing loans have been taken (e.g. Italy), but they still have to show their full impact. Collateral enforcement and insolvency have been made more efficient in some Member States (e.g. in Bulgaria, Croatia, Italy and Cyprus). The setting-up of public or private Asset Management Companies and supervisory measures, including additional loan-loss provisioning and capital requirements as well as enhanced monitoring of debt restructuring against arrears reduction targets, have contributed to the decline in non-performing loans in Bulgaria, Croatia, Hungary, Ireland, Romania and Slovenia. In Italy, non-performing loans have been declining recently, but the disposal of impaired assets proceeds at a slow pace. The deterioration in asset quality continued in Portugal in the first half of 2016, reflecting developments notably in the real estate and construction sectors. In Cyprus and Greece, where non-performing loans increased to over 40% in the wake of the crisis, the measures adopted so far (including debt restructuring targets, impaired asset disposal) have yet to produce tangible results. In all, more determined and comprehensive efforts are needed in several Member States to bring down non-performing loans levels, together with flanking reforms to foster the restructuring of their banking systems.

Member States have taken action both to improve access to equity finance and to develop alternative forms of finance such as crowdfunding. The success of the 2015 crowdfunding law in Austria demonstrates the strong positive impact of creating a suitable legal framework for such alternative forms of financing. Other Member States such as Spain, Latvia, the Netherlands and Hungary have facilitated access to finance for SMEs while providing opportunities for institutional investors. Measures include the consolidation of public support instruments in a single development financing institution, which acts as a one-stop shop for businesses and provides non-financial support such as counselling and training. Another measure is the set-up of dedicated state-owned venture capital or funding for growth schemes and other types of funds-of-funds. Nevertheless, access to finance and administrative procedures also remain significant barriers to growth and investment in a number of Member States, particularly for start- and scale-up SMEs. Cumbersome start-up and licensing regulations continue to act as barriers to SME investment in a number of Member States.

Public investment declined significantly in most Member States during the crisis and it has not returned to the long term level. Beyond directly affecting output growth, underinvestment in both tangible and intangible assets — such as R&D — hurts long-term productivity as the rate of innovation and diffusion of existing technologies slows down. It is important to promote public investment — in particular in education and training, infrastructure, and research and innovation — while in parallel taking measures to leverage private investment. These efforts should also focus on the quality of investment.

A series of improvements in the public procurement framework have been implemented in recent years, both at EU and Member State level, but challenges persist. Barriers to efficient public procurement practices restrain economic growth and the functioning of the internal market. Annually public authorities in the EU spend around 14 % of GDP on public procurement, which is an essential vehicle for delivering governmental policies and achieving national strategic objectives. Well-functioning public procurement markets boost national competitiveness through stronger public finances, more focused investments and the provision of higher quality services such as infrastructure or e-government. In the healthcare sector, public procurement can provide useful instruments to obtain better value for money for medicines and medical equipment. In several Member States, the publication rate remains low, resulting in insufficient openness to cross-border business opportunities. The application of procurement procedures restricting competition, such as negotiated procedure without publication, varies greatly in Member States from close to 0 % to more than 20 %. The proportion of contracts for which there is only one bid also remains high. This indicates that the single market for public procurement is not sufficiently integrated and further opening could boost economic efficiency and growth.

Social investment is a prerequisite for a successful and lasting recovery. With the support of the European Social Fund, investments in active labour market policies are helping to ensure the better provision of individualised services and improve the capacity of public employment services. Social investment should also include the use of financial instruments such as loan schemes to support micro and/or social enterprises, targeting specific populations such as the self-employed, young people, young micro-borrowers, women and the disabled. The Investment Plan for Europe is increasingly contributing to these investments, for example by providing a guarantee on loans to about 1,300 microbusinesses in Poland. However, it is far from reaching its full potential in boosting human capital development. Additional efforts have to be deployed to design instruments adapted to this sector and to ensure that social and financial actors cooperate more closely.

5.2 Pursuing structural reforms

Reforms improving labour markets and social security systems

Many Member States have implemented important reforms in employment protection legislation to address segmented labour markets. Denmark has introduced a reform of active labour market policies and a package of measures to make work pay and Poland has taken steps to reduce the excessive use of civil law contracts. The effects of such reforms must be seen together with other institutional, public administration and product market conditions. The uncertainty and complexity surrounding labour litigation can be addressed, in particular by reducing the length of procedures and promoting alternative dispute resolution procedures, such as mediation. In France, the law adopted in August 2016 modifying the regulation on unfair dismissals and increasing the scope for company-level adjustment of working conditions is expected to contribute to reducing segmentation in the labour market.

Some Member States have taken steps to improve their wage-setting systems. Keeping wages and productivity developments aligned over time is crucial to foster competitiveness. It is, however, also important to ensure that pay levels allow decent standards of living. Belgium has made wage formation more responsive to the business cycle and changes in productivity. In Finland a new wage-setting model is being negotiated where wage increases in tradable industries set an anchor to the wages in non-tradable sectors.

In spite of some reforms to reduce labour taxation in a number of Member States, the tax wedge on labour remains high in most countries. This is particularly the case in the euro area. A high tax wedge on labour, by weighing on labour costs and reducing the net take-home pay of employees, hinders both labour demand and labour supply. There is potential in several Member States to shift taxation from labour towards more growth-friendly sources such as environmental and property taxes. A number of Member States, including Lithuania, Hungary and Austria, have taken steps to reduce the tax wedge, mostly targeting low income workers.

The participation in the labour market of some groups remains a challenge for several Member States. Policies targeted at integrating vulnerable groups into the labour market are needed to ensure equal rights, obligations and opportunities for all. In particular, non-EU nationals and people with a migrant background are under-represented in the labour market and face higher unemployment and a greater risk of poverty and social exclusion. These often result from a combination of factors such as limited language knowledge or access to education, lower skills or discrimination. These challenges have intensified since the economic crisis and more recently with the higher inflows of asylum seekers. Member States including Germany, Austria and Sweden are addressing these challenges through measures to promote the labour market integration of refugees. Likewise, measures that promote female labour market participation can reduce gender inequalities, while having significant beneficial effects on labour market performance and growth. In this context, Member States including Ireland and Slovakia have taken steps to extend the provision of childcare, for example.

Member States need to ensure that all young people, including the low-skilled, have their labour market opportunities improved. This includes helping workers adjust to technological change and globalisation. More Member States have been taking steps to improve the overall governance and coherence of their active labour market policies and public employment services. Romania has strengthened its national employment agency and Hungary is taking steps to reinforce active labour market policies. In Estonia, the Work Ability reform has been fully operational since January, providing better activation support services based on an individual approach.

Participation rates in education and training are increasing. Many Member States continue to reform their education and training systems to increase their inclusiveness and the quality of outcomes. Portugal has undertaken successful initiatives in recent years to address education inequalities, reduce school failure and raise the basic skills level of its population. Several countries are undertaking reforms to improve vocational education and training systems.

Modernising social protection systems is vital to ensure their sustainability and effectiveness and their link to the labour market. The demographic challenge underlines the importance of increasing the efficiency of social spending. An integrated approach to labour market support, combining activation services with adequate social protection and access to quality social services, can help maximise the return on public spending. Malta has

introduced a package of measures to make work pay, targeting women in particular in order to address their low participation in the labour market. In Cyprus, a guaranteed minimum income scheme has been introduced, which is expected to help reduce poverty.

A number of Member States face the need to adapt their taxation systems and social safety net systems. Both can have important redistributive effects, which differ widely across countries. Between 2010 and 2013, in countries including the Czech Republic, Spain, Italy and Portugal, the rising inequality in market income was mitigated (and in some countries offset) by the increasing redistributive impact of taxes and transfers. In other countries, the redistributive effect of taxes and transfers decreased significantly over the same period, and hence did not contribute to mitigating inequality in market income.

Reforms to foster competitiveness

Member States have pursued policies to strengthen overall competitiveness. For example, central labour market organisations in Finland agreed in February 2016 on a Competitiveness Pact to improve the cost competitiveness of the Finnish economy by 5 % (as part of a total cost competitiveness improvement of 15 %). A broad-based 'Competitive Romania' strategy was endorsed in July 2016, demonstrating political and societal consensus on the main areas for action in 2016-2020 that are necessary to put Romania on the path of sustainable economic development.

The rapid development of the collaborative economy has the potential to contribute to competitiveness and growth. Some Member States, regions and cities are putting in place a framework to develop the collaborative economy. Others are adopting a more restrictive approach to the collaborative economy business models. Denmark is currently developing a comprehensive strategy, the Netherlands and the United Kingdom have provided a framework in the tourism accommodation sector and Estonia and Lithuania have adapted their urban passenger transport framework to embrace new business models. In Belgium, Italy and Spain, regulation of activities in the collaborative economy suffers from strong regional divergences.

Member State reforms also address a vast array of challenges to attract and boost investment in the internal market. There is slow progress in reforming services markets in particular and regulatory restrictiveness remains a persistent barrier to services investment in many Member States. Restrictive regulatory requirements and burdensome administrative procedures can create barriers to entry or establishment. There is strong evidence that the functioning of services sectors affects the whole economy, not only due to their sheer size but also through their links with other sectors of the economy. High regulatory restrictiveness in the services sector, in particular business services, contributes to inefficiency and low productivity growth. This affects business dynamics and investment in the services sectors, but also has repercussions on the manufacturing sector. Anti-competitive regulation in the services sectors can impose potential costs on downstream industries that use the output of these sectors as intermediate inputs in the production process.

While the progress of reforms in professional services is particularly slow, there have been some positive developments. Following a 2016 recommendation, France has adopted almost all secondary legislation needed to implement the provisions of the 2015 law on growth and activity which were not directly applicable. This has allowed the lifting of certain restrictions on the exercise of a number of regulated professions, but the scope of the reform remains limited. For the professions of architects and engineers, in 2015 Luxembourg removed some shareholding and voting rights requirements and in 2016 removed fixed tariffs

in public contracts. However, the overall level of restrictiveness for these professions is still among the highest in the EU.

Some Member States have removed restrictions affecting the functioning of the retail sector and others have initiated reforms. Finland and Denmark plan to liberalise planning restrictions, which should allow retailers more flexibility in choosing the location of their shops and adapting their size to consumers' needs. However, progress is uneven between Member States and there is a trend in some towards introducing new restrictive measures in the grocery sector affecting, in particular, foreign retailers. Such measures hamper the single market integration in the retail sector.

Reforms in public administration are essential to deliver high-quality public services and boost entrepreneurship, competitiveness and growth. Spain has almost completed the implementation of the recommendations made under the 2013 CORA reform of the public administration. According to the national administration the expected savings may amount up to EUR 30.5 billion for the public administration services as a whole and EUR 3.44 billion for businesses and citizens.

Member States have taken some action to improve conditions for SMEs but more needs to be done. Member State action in this area includes the fourth national action plan to support SMEs in Luxembourg, the comprehensive simplification programme in France, the introduction of lifelong zero social contributions for employers in Belgium on their first hiring in 2016-2020 and specific tax exemptions in Romania for high-skilled, high-demand sectors. However, in many Member States conditions for entrepreneurship and SME growth remain difficult. In particular, in many Member States entrepreneurs who have been through bankruptcy do not get a second chance due to expensive and lengthy insolvency regimes and the lack of broad-based campaigns to fight the stigma of business failure.

Member States have continued to undertake reforms, provide support to exporters and promote rapid internationalisation of their start-ups. This includes active business and financing support and trade promotion abroad through private business networks as well as economic diplomacy and economic partnerships. Sweden started implementing its new export strategy to increase exports and foreign investments. Good practices in this area also include Italy's Start-up Act and new 'Business 4.0' strategy which provides, among other things, for tax deductions for equity investments in start-ups and innovative SMEs. It also fosters knowledge spillover and supports the transition towards high-tech and high-skill sectors.

5.3 Ensuring responsible fiscal policies

General government deficits and debt ratios in the euro area and the EU are expected to decline on the back of moderate growth and historically low interest rates, albeit at a slower pace. According to the latest European Commission forecast, the government deficit in the euro area is expected to continue to fall in 2017 before stabilising in 2018 at 1.4 % (1.6 % in the EU) of GDP. The general government debt-to-GDP ratio of the euro area is expected to have reached 91.5 % of GDP in 2016 (85.1 % in the EU). It is projected to continue declining gradually to 89.2 % in 2018 in the euro area (83.6 % in the EU). Debt reduction can be explained mainly by both primary surpluses and a more favourable snowball effect, resulting from reduced interest expenditure, modest real GDP growth and the expected increase in inflation.

Member States need to support investment to strengthen the recovery, and to balance sustainability and stabilisation concerns. The Commission recently issued a Communication[12] calling for a moderately expansionary fiscal stance and a better distribution of fiscal efforts across the euro area. For this purpose, Member States should pursue fiscal policies in respect of the Stability and Growth Pact, thereby ensuring sustainability, while making the best use of the flexibility in the existing rules. Member States that have fiscal space should use it to support investment to strengthen the recovery and boost their productive potential. Others should continue to pursue the consolidation of their public finances.

Box 1. Update on surveillance under the Stability and Growth Pact

In its assessment of the 2017 draft budgetary plans (DBPs) for euro area Member States, published in November 2016, the Commission indicated that for eight Member States (Belgium, Spain, Italy, Cyprus, Lithuania, Portugal, Slovenia and Finland), these plans posed a risk of non-compliance with the provisions of the Stability and Growth Pact. Five countries — Ireland, Latvia, Malta, Austria and France — were found to be broadly compliant, while Germany, Estonia, Luxembourg, the Netherlands and Slovakia were compliant with the requirements. Moreover, Germany, Luxembourg and the Netherlands were expected to be above their medium-term budgetary objectives and were encouraged to make use of the fiscal space available, while preserving the long-term sustainability of national public finances.

The assessments made for Spain and Lithuania in the November 2016 DBP round were based on no-policy-change DBPs as these countries had caretaker governments without full budgetary powers. Since then, the incoming governments in both countries submitted updated DBPs, on which the Commission issued updated opinions on 17 January 2017. The updated DBP of Spain was assessed as being broadly compliant with the requirements of the Pact. Lithuania's updated DBP was still assessed as being at risk of non-compliance, unchanged from the assessment made last autumn.

Following the finalisation of the 2017 budgets for most Member States, the Commission's 2017 winter forecast provides a basis for assessing how Member States have taken into account the Commission's opinions on their draft budgetary plans and have acted upon the commitments they made in the Eurogroup.

For Belgium, Italy and Finland, the Commission continues its close monitoring of compliance with the debt criterion and stresses the importance of continued strong implementation of compliance with the recommended structural adjustments under the Stability and Growth Pact. The Commission committed in spring 2016 to issue a new Article 126.3 report for Italy once new information became available on the adjustment path towards the medium-term budgetary objectives in 2017. The Commission issued this updated report on 22 February.

The Commission will monitor the budgetary developments of all Member States under the European Semester, based on the national reform programmes and stability or convergence programmes to be submitted by mid-April. It will provide its recommendations in May, together with other procedural steps under the Pact as needed.

The Commission will in this context also provide its full assessment of Finland's and Lithuania's eligibility for the flexibility they have applied for. If granted, this could improve the assessment of their compliance with the Stability and Growth Pact.

An appropriate fiscal stance concerns not only the direction and size of the budget balance, but also the composition and quality of the public finances behind it. Member States should improve composition inter alia by creating more room for tangible and intangible investment The effectiveness and efficiency of public expenditure by all government levels should be regularly reviewed, including with respect to the objective of

[12] COM(2016) 727.

promoting fairness. Ensuring the effective functioning of national fiscal frameworks would contribute to attaining these goals.

Improvements in national fiscal frameworks can foster growth-friendly public spending. In response to recommendations, Member States have continued to reinforce various aspects of their fiscal frameworks. Austria adopted a new equalisation law in January 2017 simplifying transfer rules across layers of governments. Italy finalised the 2009 reform of its budget process and structure. Finland enshrined in its legal order an unequivocal comply-or-explain principle in relation to the opinions of its independent fiscal institution on compliance with national fiscal rules. Moreover, there has been a substantive reflection in some Member States on improving their domestic frameworks. The Netherlands and Sweden set up dedicated working groups (an advisory group of high-level civil servants and a parliamentary committee, respectively) which reviewed the existing frameworks and proposed improvements during 2016. In almost all Member States, fiscal councils now play an active role in the national debate on fiscal policy. They regularly publish independent assessments of budget plans and outcomes. With the Bulgarian fiscal council having become fully operational in the first half of 2016, the Czech Republic, Poland and Slovenia remain the only Member States that have no operational fiscal council in place.

The Commission has reviewed the transposition of the Fiscal Compact. The Commission was invited to do so by the Treaty on the Stability, Coordination and Governance in the EMU. The Fiscal Compact provisions are designed to strengthen the consistency between the national and European fiscal frameworks and enhance ownership of them in Member States. The Commission's report is adopted alongside this package, following extensive consultation with the 22 Contracting Parties (the euro area countries plus Bulgaria, Denmark and Romania)[13]. The report shows that all Contracting Parties have significantly adapted their national fiscal frameworks as a result of the Fiscal Compact requirements, in conjunction with Union legislation.

Reforming pension and healthcare systems can enhance the quality of public finances, as their medium- and long-term sustainability poses significant challenges in view of high debt levels and population ageing. In a medium- to long-term perspective, most Member States face either medium or high sustainability risks[14]. These are due to the still high projected stock of public debt and projected increases in age-related public spending. The risks highlight the need for additional reforms, particularly in healthcare and pensions, which on the one hand address the fiscal concern and on the other hand ensure accessibility to healthcare and adequacy of pensions. Progress has been made in many countries with a positive impact on long-term fiscal sustainability, notably due to implemented pension reforms and supported by recent fiscal consolidation.

The pension system was identified as a challenge in a number of Member States last year. While, in previous years, many Member States had adopted important pension reforms,

[13] The consultations aimed to give the Contracting Parties the opportunity to submit observations on the Commission's findings, as provided for in Article 8(1) of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

[14] Fiscal sustainability risks were found to be medium or high over the medium and long-term in: Belgium, the Czech Republic, Ireland, Spain, France, Croatia, Italy, Cyprus, Lithuania, Luxembourg, Hungary, Malta, the Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland and the United Kingdom. For a detailed assessment of fiscal sustainability challenges, see European Commission (2017), 'Debt Sustainability Monitor 2016', European Economy, Institutional papers, No 47.

progress in reforming pension systems was limited or non-existent among the countries where country-specific recommendations were adopted in 2016. Policy challenges remain for this set of countries, which need to be addressed by ensuring better accounting equivalence and higher effective retirement rates or higher general employment rates.

Progress in reforming healthcare systems, with the aim of ensuring cost-effectiveness and access to services while safeguarding sustainability, varies among the Member States.[15] Several countries (Ireland, Lithuania, Austria, Portugal, Romania, Slovenia and Finland) have made some progress in addressing the country-specific recommendations addressed to them. This progress includes improving cost-effectiveness, using spending targets and reviews, shifting to and using less costly care, and curbing informal payments. Others have made only limited progress. The reforms initiated in a number of Member States need to continue and be accelerated to make healthcare systems more effective, accessible and resilient. This will help them contribute to the population's health, economic prosperity and social cohesion. Reforms involve: ensuring access to timely and good-quality healthcare for all; shifting from in-patient to outpatient care; investing in health promotion, primary care and integrated care; improving the governance of the systems; using medicines more rationally; using Health Technology Assessment; more centralised public procurement; and e-health and health information tools.

6. NEXT STEPS

The Commission will continue engaging in a constructive dialogue with the Member States. The analysis presented in the country reports will be discussed with the Member States in bilateral meetings. Commission Vice-Presidents and Commissioners will visit Member States to meet the governments, national parliaments, social partners and other stakeholders. The challenges identified are expected to be addressed by the Member States in their national reform programmes, as well as their stability or convergence programmes, to be published and presented to the Commission by mid-April. The Commission will discuss the main findings of the analysis with the European Parliament.

The Member States are expected to involve national parliaments and social partners closely and ensure the ownership of the reform process by a wider range of stakeholders. Given that the success of the implementation often relies on lower levels of government, the Commission has also called on the Member States to explain in their national reform programmes how regional and local authorities, depending on the division of competences in individual Member States, were involved in the preparation of the programme and in the implementation and/or elaboration of reforms.

[15] For a review of challenges and policy options in the health sector, see European Commission (2016), 'Joint Report on Health care and Long-term Care Systems & Fiscal Sustainability', European Economy, Institutional papers, No 36.

APPENDIX 1 — INTEGRATED SURVEILLANCE OF MACROECONOMIC AND FISCAL IMBALANCES

	Macroeconomic Imbalances Procedure (MIP) [16]	Stability and Growth Pact (MTO: medium term objective / EDP: excessive deficit procedure)	Comments
BE		Preventive arm Not yet at MTO; subject to debt rule[17]	
BG	Excessive imbalances	Preventive arm Overachieving MTO	
CZ		Preventive arm Overachieving MTO	
DK		Preventive arm At MTO	
DE	Imbalances	Preventive arm Overachieving MTO; subject to debt rule	
EE		Preventive arm At MTO	
IE	Imbalances	Preventive arm Not yet at MTO; subject to transitional debt rule	
EL		Corrective arm Excessive deficit, deadline for correction: 2016 At MTO; subject to transitional debt rule	Under a dedicated financial assistance programme

[16] Both the 'imbalances' and 'excessive imbalances' categories entail specific monitoring, to be modulated depending on the severity of the challenges.

[17] Debt rule: If the 60% reference for the debt-to-GDP ratio is not respected, the Member State concerned will be put in the Excessive Deficit Procedure, after taking into account all relevant factors and the impact of the economic cycle, if the gap between its debt ratio and the 60% reference is not reduced by 1/20th annually (on average over three years). Transitional debt rule: Each Member State in the Excessive Deficit Procedure is granted a three-year period following the correction of the excessive deficit for meeting the debt rule. This does not mean that the debt rule does not apply at all during this period as Member States should make sufficient progress towards compliance during this transitional period. A negative assessment of the progress made towards compliance with the debt benchmark during the transition period could lead to the opening of an Excessive Deficit Procedure.

ES	Imbalances	Corrective arm Excessive deficit, deadline for correction: 2018	
FR	Excessive imbalances	Corrective arm Excessive deficit, deadline for correction: 2017	
HR	Excessive imbalances	Corrective arm Excessive deficit, deadline for correction: 2016 AT MTO; subject to debt rule[18]	

[18] Condition on the abrogation of the EDP decision based on validated outturn budgetary data for 2016.

	Macroeconomic Imbalances Procedure (MIP)	Stability and Growth Pact (MTO: medium term objective / EDP: excessive deficit procedure)	Comments
IT	Excessive imbalances	Preventive arm Not yet at MTO; subject to debt rule	
CY	Excessive imbalances	Preventive arm At MTO; subject to transitional debt rule	
LV		Preventive arm At MTO	
LT		Preventive arm At MTO	
LU		Preventive arm Overachieving MTO	
HU		Preventive arm Not yet at MTO; subject to debt rule	
MT		Preventive arm Not yet at MTO	
NL	Imbalances	Preventive arm Overachieving MTO; subject to debt rule	
AT		Preventive arm Not yet at MTO; subject to debt rule	
PL		Preventive arm Not yet at MTO	
PT	Excessive imbalances	Corrective arm Excessive deficit, deadline for correction: 2016 Not yet at MTO; subject to transitional debt rule[19]	
RO		Preventive arm Not yet at MTO	

[19] Condition on the abrogation of the EDP decision based on validated outturn budgetary data for 2016.

SI	Imbalances	Preventive arm Not yet at MTO; subject to transitional debt rule	
SK		Preventive arm Not yet at MTO	
FI	No imbalances	Preventive arm Not yet at MTO; debt-to-GDP ratio above above 60% of GDP reference value	Exit from MIP
SE	Imbalances	Preventive arm Overachieving MTO	
UK		Corrective arm Excessive deficit; deadline for correction: 2016-17	

(*) The Recommendations under the '2-pack' (Reg. No 473/2013) regarding measures to be taken in order to ensure a timely correction of its excessive government deficit only concern euro area Member States.

APPENDIX 2: PROGRESS TOWARDS EUROPE 2020 TARGETS

Europe 2020 targets for the EU	2010 data	Latest available data	In 2020, based on recent trends
1. Increasing the employment rate of the population aged 20-64 to at least 75 %	68.6 %	70.1% (2015)	Target likely to be met
2. Increasing combined public and private investment in R&D to 3 % of GDP	1.93 %	2.03% (2015)	Target unlikely to be met
3a. Reducing greenhouse gas emissions by at least 20 % compared to 1990 levels	14.3 % reduction	22% reduction (2015)	Target likely to be met
3b. Increasing the share of renewable energy in final energy consumption to 20 %	12.8 %	16% (2014)	Target likely to be met
3c. Moving towards a 20 % increase in energy efficiency	5.7 % increase (for primary energy consumption)	10.7% increase (for primary energy consumption, 2015)	Target likely to be met
4a. Reducing school drop-out rates to less than 10 %	13.9 %	10.8% (2016)	Target likely to be met
4b. Increasing the share of the population aged 30-34 having completed tertiary education to at least 40 %	33.8 %	39% (2016)	Target likely to be met
5. Lifting at least 20 million people out of the risk of poverty and social exclusion	0.5 million increase (compared to the 2008 base year)	1.7 million increase (compared to the 2008 base year)	Target unlikely to be met

Sources: European Commission; European Environment Agency.

APPENDIX 3 — FINDINGS FROM IN-DEPTH-REVIEWS BY MEMBER STATE

Bulgaria is experiencing excessive imbalances. Vulnerabilities in the financial sector are coupled with high corporate indebtedness in a context of incomplete labour market adjustment. Net foreign liabilities have fallen against the background of a current account surplus. The banking sector has stabilised, but the legacy issues linked to weak governance and supervision have not yet been fully dealt with. The authorities have completed the asset quality review and stress tests for the banking sector, as well as the balance sheet reviews of pension funds and insurance companies. Follow-up actions have been addressed to the concerned companies but remain to be implemented. Deleveraging in the corporate sector has been orderly but slow, leaving a large private sector debt stock as well as still high non-performing loans levels. Labour market conditions have improved, but employment levels are low, long term unemployment is high, and labour market mismatches persist. Some policy action has been undertaken to address the main sources of imbalance, but further progress is needed to address remaining pockets of vulnerabilities in the financial sector, including bank and non-bank financial supervision, as well as weaknesses hampering the insolvency framework.

Germany is experiencing imbalances. The persistently high current account surplus has cross-border relevance and reflects excess savings and subdued investment in both the private and the public sector. The current account surplus increased further in 2015 and 2016 and it is expected to remain at a high level. Addressing the surplus has implications on the rebalancing prospects of the rest of the euro area because more dynamic domestic demand in Germany helps overcoming low inflation and ease deleveraging needs in highly-indebted Member States.. Public investment has increased in recent years, but as a proportion of GDP still appears low compared with the euro area and in view of the fiscal space and investment backlog, in particular at municipal level. Despite low interest rates that create favourable financing conditions, business investment on GDP is still subdued. While recovery in private consumption has continued, household savings have reached record high levels in the euro area. Measures have been taken to strengthen public spending and improve the design of federal fiscal relations. Further policy action should aim at further strengthening investment, including by reforming the services sector and improving the efficiency of the tax system, as well as stimulating labour market activity of second earners, low-income earners and older workers to boost households' incomes and counter the effects of ageing.

Ireland is experiencing imbalances. Despite improvements in flow variables, large stocks of public and private debt and net external liabilities constitute vulnerabilities. Strong productivity growth in past years has contributed to improved competitiveness, and the recent worsening in the Net International Investment Position appears to be driven by factors disconnected with the domestic economy. On the back of a strong recovery, the ratios of private and government debt to GDP remain high but are falling. The share of non-performing loans has been declining over the last years, but remains elevated. Banks are well recapitalised and their profitability, albeit still low, is improving gradually. House prices are growing at a rapid pace, mainly driven by supply constraints, but from likely undervalued levels. Policy measures have been taken in recent years to strengthen the financial sector, restructure debt, increase housing supply and put public finances on a sustainable footing, and further measures are in the pipeline.

Spain is experiencing imbalances. A strong economic recovery continues supporting the rebalancing of the economy. However, large stock imbalances in the form of external and

internal debt, both public and private, continue to constitute vulnerabilities in a context of high unemployment and have cross-border relevance. The rebalancing in the external sector is advancing, thanks to the current account surpluses recorded since 2013. However, net external liabilities remain very high and it will take time before they reach prudent levels. Private sector debt reduction is also progressing, supported by favourable growth conditions, while a healthier financial sector supports economic activity. However, deleveraging needs are still present, especially for households. Government debt as a share of GDP is not expected to be put on a declining path despite a quite robust recovery, on account of large though declining deficits. Despite a significant reduction over the past three years, unemployment remains very high. Measures have been taken to enhance competitiveness, but further policy action would help sustaining the external surplus, ensure a durable reduction of the general government deficit and support sustainable growth.

France is experiencing excessive imbalances. In a context of low productivity growth, high public debt and weak competitiveness may imply risks looking forward, with cross-border relevance. Competitiveness has started to improve, and export market shares have stabilised in recent years. However, subdued productivity growth prevents a faster recovery of cost competitiveness despite the measures to reduce the labour cost and a moderate evolution of wages. Profit margins of non-financial corporations have somewhat recovered since 2013, but continue to weigh on investment. Government debt is still growing, albeit at a decelerated pace, and sustainability risks in the medium term are high. Past policy commitments have been translated into action to improve the functioning of product and labour markets and the competitiveness of SMEs. While recent reforms constitute notable progress, some policy challenges remain to be addressed and further action would be needed, notably to increase the efficiency of public spending and taxation, to reform the minimum wage and the unemployment benefit system, and to improve the education system and the business environment.

Croatia is experiencing excessive imbalances. Vulnerabilities are linked to high levels of public, private and external debt, both largely denominated in foreign currency, in a context of low potential growth. The current account surpluses have begun to translate into a decrease of the gross external debt, which nevertheless remains elevated. The acceleration of the economic recovery is contributing to a further reduction in the private debt-to-GDP ratio, and as of this year public debt-to-GDP is also on a declining path. Despite recent losses, the financial sector remains relatively well-capitalised and profitability is recovering. The rate of non-performing loans has started to decrease, but remains high. A number of measures on insolvency frameworks and improving labour market flexibility have been adopted in previous years and public finances have improved markedly, but progress with structural reforms has been stalling since mid-2015. Policy gaps remains, notably on the front of the management of public finances, the modernisation of public administration, improving the business environment and addressing the low activity rates.

Italy is experiencing excessive imbalances. High government debt and protracted weak productivity dynamics imply risks with cross-border relevance looking forward, in a context of high non-performing loans and unemployment. The public debt ratio is set to stabilise but has not yet on a downward path due to the worsening of the structural primary balance and subdued nominal growth. Competitiveness remains weak as productivity dynamics have remained subdued, also due to the slow investment recovery. The stock of non-performing loans has only started to stabilise and still weighs on banks' profits and lending policies while capitalisation needs may emerge in a context of difficult access to equity markets. Labour

participation and employment are rising, but unemployment, particularly long-term, remains high, with negative consequences on future growth. After positive reforms of the budgetary process, labour market, banking sector, insolvency procedures, judiciary system and public administration, the reform momentum has weakened since mid-2016 and important policy gaps remain, in particular with regards to competition, taxation, fight against corruption and the reform of the framework for collective bargaining.

Cyprus is experiencing excessive imbalances. A very high share of non-performing loans burdens the financial sector and high stock of private, public, and external debt hangs on the economy, in the context of high unemployment and weak potential growth. The current account is still negative and is not adequate to guarantee a sustainable evolution of the net external liabilities stock. Government debt is expected to have peaked, but the current relaxation of fiscal policy is foreseen to slow down the needed adjustment. Despite a major restructuring of the banking sector and improved capital positions, the stock of non-performing loans is slowly declining but remains very high. Poor contract enforcement, inefficiencies in the judicial system and bottlenecks in the implementation of the foreclosure and insolvency legislation hamper private sector deleveraging and the reduction of non-performing loans. Reform momentum has weakened since 2016 and policy gaps persist in the areas of public administration, fiscal management, the justice system, the framework for title deeds, electricity and privatisation.

The Netherlands is experiencing imbalances. These imbalances are related to the high stock of private debt and the large current account surplus, with cross-border relevance. Private sector debt has only very gradually decreased in the last years. Nominal mortgage debt is increasing, against the background of resuming house price growth. The large current account surplus, which mainly reflects structural features of the economy and policy settings regarding non-financial corporations, is decreasing due to recovering domestic demand. Household deleveraging needs contribute to aggregate savings. Recent measures, aiming at reducing the tax and non-tax wedge on labour, can contribute to support domestic demand. However policy challenges remain on the front of pension reform and interest rate deductibility of mortgages, with a view to rebalance incentives to take up mortgage debt.

Portugal is experiencing excessive imbalances. The large stocks of net external liabilities, private and public debt and a high share of non-performing loans constitute vulnerabilities in a context of decreasing but still elevated unemployment and low productivity. Potential growth still lags behind its pre-crisis level, affected by persistent bottlenecks and rigidities in the product and labour markets together with major external imbalances. The current account balance is still below the level required for a significant adjustment of net external liabilities, and unit labour costs are increasing due to sluggish productivity growth and rising wages. Private debt is declining, and government debt has stabilised, in a context of remaining deleveraging needs. The large stock of non-performing loans is not yet stabilised and, together with low profitability and relatively thin capital buffers, they pose risks to banks' balance sheets. Labour market conditions have improved but youth and long-term unemployment, as well as market segmentation, are still high The reform momentum has weakened since 2014, and policy gaps persist in the areas of product and services markets, skills and innovation, fiscal sustainability, corporate debt restructuring, and labour market rigidities.

Slovenia is experiencing imbalances. Weaknesses in the banking sector, corporate indebtedness, and fiscal risks constitute vulnerabilities. Stock imbalances are gradually unwinding, including in light of resumed growth. The corporate sector has undergone a

substantial deleveraging, and private investment, including in the form of foreign direct investment, has resumed, although stocks of inbound foreign direct investment remain low compared to regional peers. Public debt has peaked in 2015, and a downward adjustment is expected in the coming years. Progress on the front of banking sector restructuring has coincided with a rapidly falling share of non-performing loans, which is expected to continue to decline. Relevant measures have been taken by the government to consolidate and restructure the banking sector, and to improve the governance of state-owned enterprises. However, further policy action is needed to address corporate debt and remaining weaknesses in the financial sector, to ensure the long-term sustainability of public finances, and improve the business environment.

Finland is experiencing no imbalances. In the past years, Finland recorded competitiveness losses linked to the decline of key sectors and wage growth above productivity. Potential growth has fallen post-crisis and the growth of labour productivity is expected to remain subdued. The banking sector is well capitalised and fairly profitable, and the share of non-performing loans is low. Private debt as a share of GDP is rising but at a slower rate. Government debt has been growing fast in past years but remains at relatively prudent levels and the pace of increase has recently decelerated. Dynamic start-up activity supports structural change. Following a strong push from the government, social partners agreed on measures to improve cost competitiveness especially on the front of labour costs and to enhance the resilience of firms through more flexible wage setting practices. Measures have been taken also to contain the incentives for taking up excessive mortgage debt. Emerging policy challenges are linked to the continued increase in long-term unemployment, which highlights the need to better target active labour market policies and to continue to invest in life-long learning and vocational training.

Sweden is experiencing imbalances. Persistent house price growth from already overvalued levels coupled with a continued rise in household debt poses risks of a disorderly correction. The already high household indebtedness keeps growing, while housing prices, which appear to be overvalued, continue to rise at an elevated pace. Although banks appear adequately capitalised, a disorderly correction could also affect the financial sector as banks have a growing exposure to household mortgages. In such a case, there could be spill-overs to neighbouring countries since Swedish banking groups are of systemic importance in the Nordic-Baltic region. Awareness of mounting risks among the authorities is high, and in recent years measures have been taken to rein in mortgage debt growth and raise housing construction. However, policy steps implemented so far have not been sufficient to address overheating in the housing sector. Overall, policy gaps remain in the area of housing-related taxation, the macro-prudential framework, and in addressing bottlenecks for new housing supply as well as barriers to efficient usage of the existing housing stock.