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COMMISSION STAFF WORKING DOCUMENT

Analysis of the Euro Area economy

Accompanying the document

Recommendation

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

{COM(2018) 759 final}

Introduction

This Staff Working Document provides an analytical underpinning for the euro area recommendation which outlines an overall orientation for the collective challenges ahead, focusing on the years 2019 and 2020. Since 2015, the recommendation is adopted at the beginning of the European Semester, to precede and inform the package of country-specific recommendations which is adopted in the Spring.

The euro area is entering its sixth year of uninterrupted economic growth and the negative output gap is closing, but risks to the outlook are increasing and growth is expected to moderate. Against the backdrop of a gradual normalisation of monetary policy, appropriately differentiated fiscal policies and focus on structural reforms are needed to continue supporting growth in the short and long term. Strengthening fiscal sustainability in the euro area and its Member States while differentiating national policies in full respect of the Stability and Growth Pact and taking into account fiscal space is imperative to be able to react to the next crisis. Fiscal structural reforms also remain crucial for improving economic resilience, fiscal sustainability and strengthening the economic growth potential.

The robustness of the euro area financial sector has increased since the crisis, but vulnerabilities remain to be addressed and some urgent actions are pending. Strengthening the architecture of the EMU requires completing the Banking Union and the Capital Markets Union as a matter of priority, but also action on all the elements of the Commission roadmap for the EMU for the period until 2024.

1. Macroeconomic context and developments

The euro area is entering its sixth year of uninterrupted growth, but risks to the outlook are increasing. The economy has been expanding at rates above potential, also as a result of the dynamics of euro area exports and improved competitive position, and the output gap is expected to turn positive at some 0.3% of potential GDP in 2018 up to 0.8% in 2020 (Graphs 1 and 2). Growth is forecast to continue at a moderate pace of some 2.1%, 1.9% and 1.7% for 2018, 2019 and 2020 respectively. The expansion is still supported by robust domestic demand, with private consumption growth projected to move from 1.6% in 2018, to 1.8% in 2019, and back to 1.6% in 2020[1]. Nonetheless, the outlook is subject to a number of downside risks which have become more pronounced and inter-connected, arising from the impact on confidence of trade tensions, volatility in emerging markets, heightened uncertainty and rising energy prices. Inflation is accelerating, driven mainly by energy prices, but core inflation (excluding energy and unprocessed food prices) is forecast to rise only slowly to 1.6% in 2019. Wages are also gradually rising – following several years of stagnation – as seen in recent data and collective bargaining agreements reached in a number of Member States, but pockets of labour underutilisation at country level remain.

Notwithstanding the closing of the output gap, potential GDP growth is set to remain below pre-crisis levels over the forecast horizon. Potential GDP growth is projected at

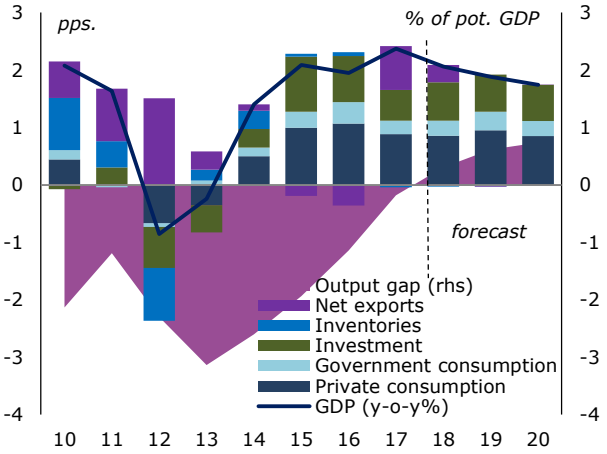
[1] All forecast figures in this document are from the European Commission autumn 2018 forecast.

some 1½% for 2018-20, significantly below its pre-crisis level of some 2 percent (Graph 2). Structural unemployment, as measured by the non-accelerating-wage rate of unemployment (NAWRU), has been declining since 2013 from 9.4% to 7.8 in 2020 but is still far above levels of best performers in the euro area, at around 4%, and the contributions of capital and total factor productivity (TFP) growth remain subdued.

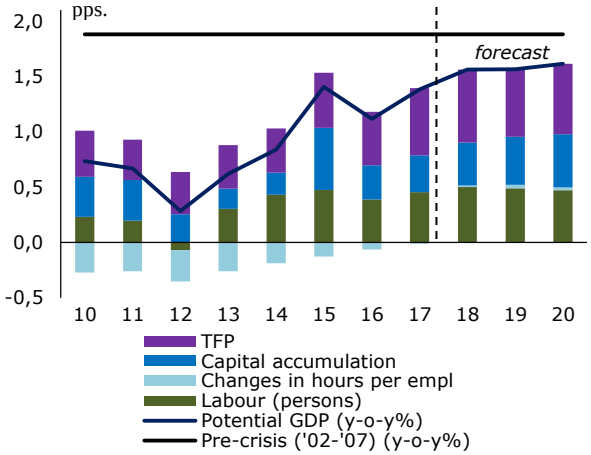
The euro area has recorded a large current account surplus over the past five years while country divergences continue to be significant on the external side. The euro area current account surplus is forecast at 3.8% in 2018 and 3.6% for 2019 and 2020, though declining from a peak of 4% in 2017. The euro-area surplus gradually built up during the post-crisis period. Private sector deleveraging and subdued real wage growth has contributed to shifting deficit positions into surpluses. Fiscal consolidations have more recently added to private sector deleveraging in driving current account dynamics. At country level, the correction of large deficits was not matched by a symmetric adjustment of large surpluses, which remain persistent or are further increasing particularly in countries with already a net creditor position, which therefore continues to increase their net international investment positions (NIIP). The NIIP/GDP ratios of the most indebted Member States have improved only recently, supported by improving nominal growth and external surpluses, although sustained rebalancing efforts are still needed. Countries that recorded large deficits for a long time still have large negative NIIPs that represent vulnerabilities, and are often mirrored by large stocks of private and/or government debt. An appropriate deleveraging pace, a supportive growth and inflation environment and continued reforms to increase productivity are crucial for successful rebalancing in the euro area. [2] Favourable demand dynamics are also key, and large surplus countries would also contribute to rebalancing by strengthening the conditions that support wage growth, as well as public and private investment.

[2] European Commission (2018), Alert Mechanism Report 2019

Graph 1: GDP and its components, euro area



Graph 2: Contributions to potential growth, euro area



Source: European Commission 2018 autumn forecast, Ameco.

2. The policy mix

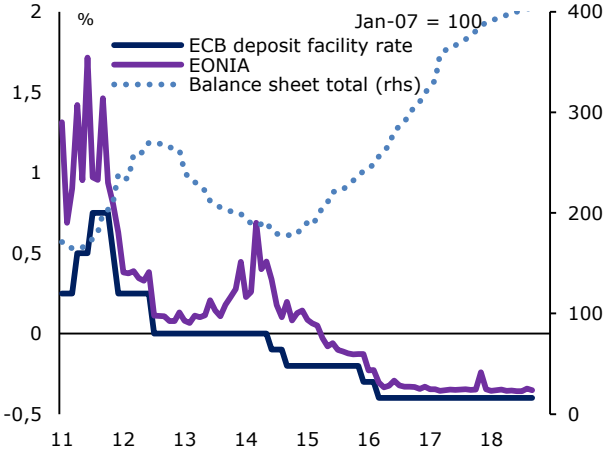
Monetary policy in the euro area is gradually adjusting in line with the ongoing cyclical upswing, but remains highly accommodative. Interest rates were lowered at historically low levels in the aftermath of the crisis while non-standard measures were implemented to deal with the crisis and led to a considerable expansion of the ECB's balance sheet (Graph 3)**.** The ECB began progressively lowering its monthly net asset purchases in 2018 and has announced that, subject to data confirming their medium-term inflation outlook, it will end net purchases at the end of December 2018. Key interest rates remain at very low levels and the ECB has indicated that it expects them to stay at current levels at least through the summer of 2019. Overall credit costs have remained supportive for households and non-financial corporations.

The euro area fiscal stance[3] remained on average broadly neutral over 2015-18 (Graph 4). However, national fiscal policies are currently insufficiently differentiated according to Member States' available fiscal space. Several Member States face fiscal sustainability challenges due to a high level of public debt, while others have some fiscal scope for increasing investment. Going forward, and in view of the ongoing economic expansion, it is the time to rebuild fiscal buffers in Member States with still high level of public debt, which would also reduce their vulnerability to shocks and allow for full functioning of automatic stabilisers. Besides reforms in the broad economy, fiscal structural reforms could also strengthen economic growth potential and consequently contribute to fiscal sustainability. Member States with fiscal space could increase investment to sustain the expansion in a durable way.

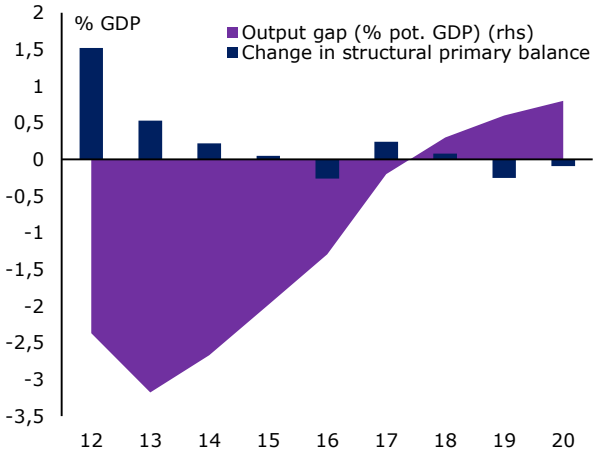
Pursuing structural reforms is ever more important to support both fiscal and monetary policies and help boost productivity and resilience. Ongoing reforms should focus on boosting productivity and economic resilience to ensure that countries are better able to

[3] Measured by the change in the structural primary balance.

Graph 3: Monetary policy, euro area



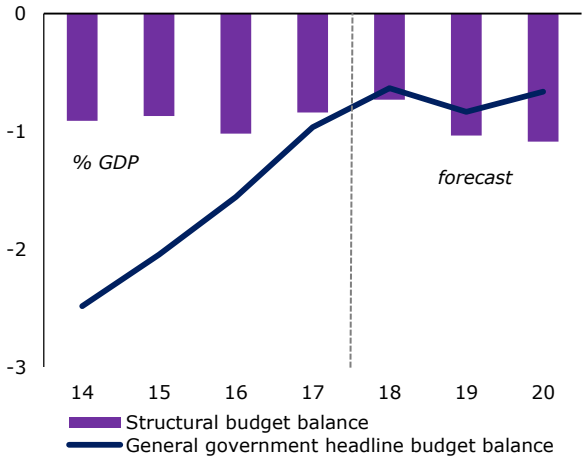
Graph 4: Fiscal stance, euro area



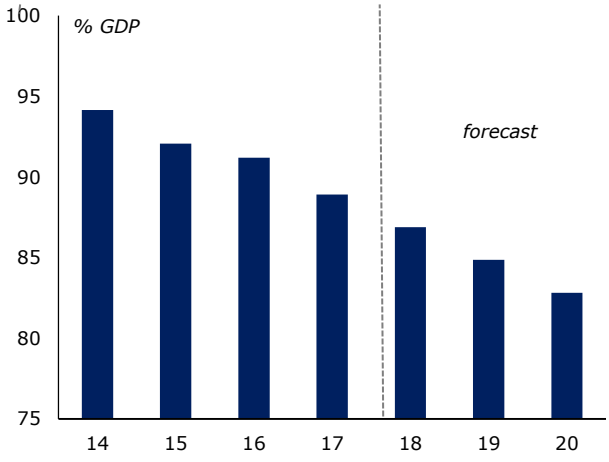
withstand shocks that could disrupt growth and convergence in the euro area. Deepening the Single Market also increases productivity by creating opportunities for innovative investment. Focusing on completing the reform agenda would help upward convergence in terms of institutional and market structures, which are equally important drivers for resilience, investment and productivity. Spillovers from structural reforms are generally found to be positive too, although smaller than for fiscal policy.[4] The simultaneous implementation of structural reforms throughout the euro area would have a bigger effect on output than they would if they were implemented by countries in isolation. This highlights the benefits of coordinated policy action such as through the recommendations for the euro area.

[4] European Commission (2014), Quarterly report on the euro area, Issue 4, December 2014.

Graph 5: Government budget balance, euro area



Graph 6: Government debt, euro area



Sources: European Commission 2018 autumn forecast(Graphs 4, 5, 6), ECB (Graph 3).

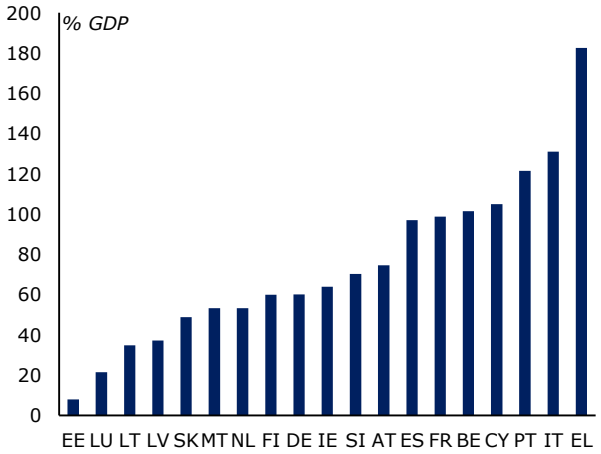
3. Fiscal policy

3.1 Fiscal balance, government debt and the fiscal stance

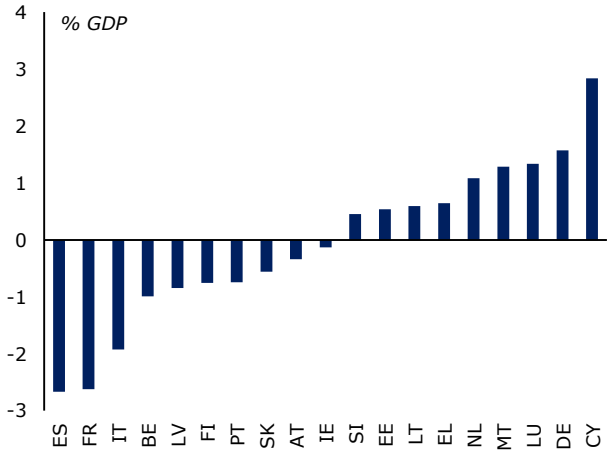
Over the five years up to 2017 deficits gradually fell on the back of the consolidation packages adopted in 2011-2013 and the economic recovery. The euro area headline budget deficit declined by 5.2 percentage points to 1.0% in 2017, from 6.2% in 2010 (Table 1, Graph 5). It is forecast to decline further to 0.6% of GDP in 2018 with the improvement being driven mainly by cyclical conditions. Looking ahead, the aggregate deficit is projected to remain around 0.8% in 2019 and 0.7% 2020, after incorporating policy measures from the 2019 Draft Budgetary Plans.

The euro area debt to GDP ratio is gradually decreasing (Graph 6). The aggregate debt-to-GDP ratio has been on a declining path since 2014 (Table 1 and Graph 6), when it reached a peak of 94%. In 2017, the debt ratio fell to 89% and it is projected to fall further over the forecast period to reach around 83% in 2020, under a no-policy-change assumption. Despite low interest rates paid on debt and robust nominal GDP growth supporting deleveraging of the government sector such dynamics are offset in some countries by pro-cyclical fiscal

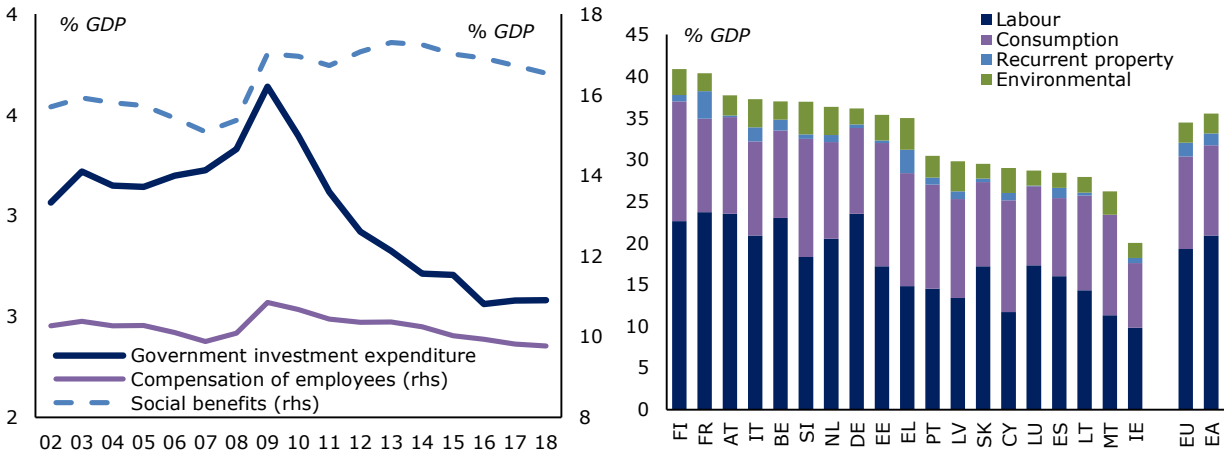
loosening, with implications on the room for cushioning shocks in bad times via fiscal expansions. In countries with high levels of public debt, deleveraging by government has started only recently and proceeds at low pace, with large differences remaining among Member States in 2018 (Graph 7).



Graph 9: Government expenditure, euro area



*Graph 10: Composition of tax revenues, 2017**



* Consumption taxes often include environmental taxes, thereby total tax revenues presented in Graph 10 may be inflated.
Source: European Commission 2018 autumn forecast, Ameco (Graphs 7, 8, 9), Tax report (Graph 10).

The aggregate structural balance remained broadly unchanged between 2014 and 2018. This follows a significant decline in the structural deficit (i.e., the headline budget deficit corrected for cyclical factors, one-offs and other temporary measures) of over 3 percentage points between 2010 and 2014. The structural deficit is projected to increase slightly in 2019 and 2020, to 1.1%.

Table 1: General government budgetary position

	2014	2015	2016	2017	2018	2019	2020
Total receipts (1)	46.7	46.2	46.0	46.1	46.0	45.7	45.5
Total expenditure (2)	49.1	48.3	47.5	47.0	46.7	46.5	46.1
Actual balance (3) = (1)-(2)	-2.4	-2.1	-1.5	-1.0	-0.6	-0.8	-0.7
Interest expenditure (4)	2.6	2.3	2.1	2.0	1.9	1.8	1.8
Primary balance (5) = (3)+(4)	0.2	0.2	0.6	1.0	1.2	1.0	1.1
One-Offs (6)	-0.2	-0.2	0.1	-0.1	-0.1	-0.2	0.0
Cyclically-adjusted budget balance (7)	-1.1	-1.0	-1.0	-0.9	-0.8	-1.2	-1.1
Cyclically-adjusted primary balance =(7)+(4)	1.5	1.4	1.1	1.1	1.0	0.6	0.7
Structural budget balance =(7)-(6)	-0.9	-0.8	-1.1	-0.8	-0.7	-1.0	-1.1
Structural primary balance = (7) -(6)+(4)	1.7	1.5	1.1	1.2	1.1	0.8	0.7
Change in actual balance:							
of which change in:							
- Cycle		0.2	0.6	0.4	0.3	0.2	0.1
- Interest (reverse sign)		0.3	0.2	0.1	0.1	0.0	0.0
- One-Offs		0.1	0.2	-0.1	0.0	-0.1	0.2
- Structural primary balance (fiscal stance)		-0.2	-0.4	0.1	0.0	-0.3	-0.1
Change in structural budget balance		0.1	-0.3	0.2	0.1	-0.3	-0.1
Public debt (% GDP)	94.2	92.1	91.1	88.9	86.9	84.9	82.8

Source: European Commission 2018 autumn forecast, Ameco.

According to both the Commission forecast and the Member States' budgetary plans, the aggregate fiscal stance of the euro area is projected to become slightly expansionary in 2019[5]. Several Member States with high debt-to-GDP ratios are currently forecast to have sizeable and in one case increasing structural deficits in 2019, which in some cases, would not be consistent with requirements under the Stability and Growth Pact. Failure to reduce public debt hampers the rebuilding of fiscal buffers and would have negative effects on the countries concerned and on the euro area as a whole. In contrast, large net external creditor countries with ample fiscal space and large current account surplus countries have room to increase investment. Based on the Commission forecast, Member States with sizeable budget surpluses are projected to use some of their fiscal space. An increase in public investment in these countries would be appropriate as it would also generate positive spillovers to the rest of the euro area: long-term GDP effects would exceed the short-term impact as public investment would also raise the productivity of private capital and labour over a sustained period of time.

3.2. The composition and quality of public finances

Between 2014 and 2018, the reduction in the headline budget deficit reflected the positive budgetary impact of the economic expansion and a decline in interest expenditure. This resulted in a larger fall in the expenditure ratio as compared to the marginal drop in the revenue ratio (Table 1). The expenditure-to-GDP ratio decreased from 49.5% in 2014 to 46.7% in 2018 with one-third being explained by lower interest expenditure. Over the same period, the revenue ratio also declined, but by a smaller amount from 47.0 to

[5] For an analysis of the 2019 Draft Budgetary Plans, see Commission Communication of 21 November 2018, COM(2018)XXXX, "*2019 Draft Budgetary Plans: Overall Assessment*"

46.0% of GDP in 2018. This follows the period between 2011 and 2013, when the fiscal consolidation was driven mainly by revenue increases. Going forward, the decline in the expenditure ratio is forecast to be driven by lower interest expenditure, set to fall by 0.2 percentage points of GDP from 2017 to 1.8% in 2019 and 2020, and by current expenditure. As the revenue ratio is forecast to decline as well, there would be no further improvement of the headline budget balance.

Public investment spending is a clear priority since it remains at historically low levels (Graph 9)**.** The ratio of public investment to GDP remains historically low and is projected to increase only marginally over the forecast horizon (close to 2.8% in 2020, from 2.6% in 2016) and thus remain below its pre-crisis average (3.2% of GDP over 2000-2007). At the same time, social benefits as a percentage of GDP remained around the same level since 2009 while public sector wages declined by around 1 percentage point of GDP since 2009 (Graph 9). Increasing public investment can be achieved in a budgetary-neutral way in those countries that lack fiscal space by improving the efficiency of current spending. This can be achieved through improved public procurement processes and other savings identified in spending reviews as well as efficient use of EU cohesion policy funding. In surplus countries additional investment spending would boost potential growth while also contributing to rebalancing in the euro area.

Against the need to build fiscal buffers as well as to increase public investment, the efficiency of public spending and of the tax system is crucial. Spending reviews can in general help improve the quality of spending and create room for rebuilding much-needed buffers. Member States spend a considerable part of their public expenses on procurement. Yet in several countries, the publication rate remains low and the use of procurement procedures restricting competition remains high in many countries. This results in insufficient openness to cross-border business opportunities and indicates that the Single Market for public procurement is not sufficiently integrated. On taxation, a number of challenges remain:

- **The overall tax burden in the euro area is skewed towards labour** (Graph 10). The tax burden on labour, measured by the tax wedge,[6] is among the highest internationally. Reducing the tax burden on labour, particularly for low income and second earners, can improve labour demand and supply. To finance its reduction, the tax burden could be shifted towards tax bases that are less detrimental to growth, including consumption taxes, recurrent property and environmental taxes, while taking into account the redistributive impact of taxation systems.[7]

[6] Tax wedge: sum of personal income taxes and employee and employer social security contributions net of family allowances, as a percentage of total labour costs (sum of gross wage and social security contributions paid by the employer).

[7] Kalyva, A., Princen S., Leodolter, A., and C Astarita (2018), ''Labour taxation & Inclusive growth'', European Commission Discussion Paper 084, Publications Office of the European Union.
Johansson, Å., Heady, C., Arnold, J., Brys, B. and L. Vartia (2008), "Taxation and economic growth", OECD Economics Department Working Paper 620, OECD Publishing.

- **Addressing tax fraud, evasion and aggressive tax planning (ATP[8]) are essential to make tax systems more efficient and fairer.** These are essential to secure government revenues, impede distortions of competition between firms, preserve social cohesion and fight increasing inequalities. The mobility of capital, which has increased with the introduction of the euro and the ensuing suppression of currency risks, facilitates tax arbitrage by multinational enterprises operating within the euro area, which make the adoption of measures to address ATP particularly urgent for euro area Member States. This is therefore a particularly relevant issue for the euro area[9]. A study by the European Parliament estimates corporate income tax revenues losses between EUR 40-60 billion in the euro area.[10]
- **Simplifying tax systems and addressing the debt bias would make tax systems more resilient and investment-friendly**. Corporate income taxation (CIT) in most euro area Member States still favours debt over equity financing. Reducing or eliminating this debt bias would provide an incentive to reduce firms' leverage, making economies less prone to financial stability risks. In addition, efforts should be concentrated on simplifying tax systems and considering well-designed tax incentives to boost real investment.

Overall euro area countries could consider joint action in a number of areas to improve the efficiency and fairness of their tax systems. Policies that simplify tax systems and shift taxes away from labour, particularly for low-income and second earners would support labour participation and higher potential growth. A coordinated action to deal with ATP at European level – notably by fostering progress on the relaunched Common Consolidated Corporate Tax Base[11] (CCCTB) or the VAT Action Plan, – would strengthen the business environment in the euro area and therefore of the Single Market by contributing to increasing tax certainty and enhancing the simplification of tax systems. All measures to tackle tax abuse can also provide additional revenues to support labour tax reductions. At the international level, enhancing cooperation on tax matters can further contribute to a fairer tax competition.

4. Structural reforms, economic resilience and real convergence

Structural and institutional reforms are essential for productivity, resilience and convergence. Well-designed structural policies can foster the convergence of Member States while bringing the euro area closer to an optimal currency area, including by supporting the transmission mechanism of monetary policy. Co-ordinating economic and social policies is

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

[9] ATP negatively affects government revenues, has clear spillover effects within the euro area and distorts the level playing field between firms. Profits shifted to or through one country implies tax base loss for another country. ATP creates therefore a tax-induced redistribution of tax revenues across euro area Member States on top of an overall loss due to lower effective taxation.

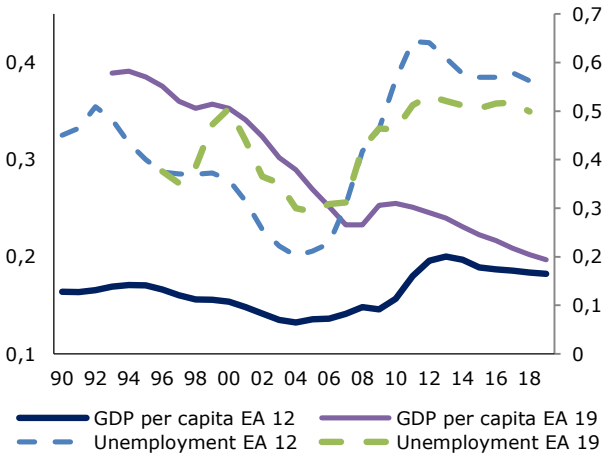
[10] Estimates based on Dover, Ferrett, Gravino, Jones, and Merler (2015), "Bringing transparency, coordination and convergence to corporate tax policies in the European Union", European Parliament Research Centre

[11] The relaunch of the CCCTB provides as a first step a single set of rules to calculate companies' taxable profits in the EU and as a second step the allocation of the consolidated taxable profits shared between the Member States using an apportionment formula.

important to absorb the effects of shocks, avoid economic and social divergence, and increase potential growth. These remain key challenges that require a broad set of policies, notably those that support well-functioning labour and product markets, decrease barriers to an efficient resource allocation and support a balanced territorial and social development.

The economic and financial crisis had a deep impact on real convergence among euro area countries, but it started to improve again. Progress in real convergence has substantially weakened since the crisis. Disparities in terms of real GDP per head – which were declining at a fast pace prior to 2008 – had increased significantly during the crisis years. On the back of the continued economic expansion, convergence in living standards in the euro area has resumed albeit at a lower pace.. Real convergence has been stronger for Member States that have joined more recently as the difference between euro area-12 and euro area-19 countries reveals[12]. Slow total factor productivity growth linked to lower levels of investment appear to be factors holding back real convergence. Considerable disparities are also present within countries and, for more than half of the euro area Member States for which data at sub-national level is available, they have widened in recent years, in some cases significantly. .

Graph 11: Dispersion of real GDP per capita and unemployment



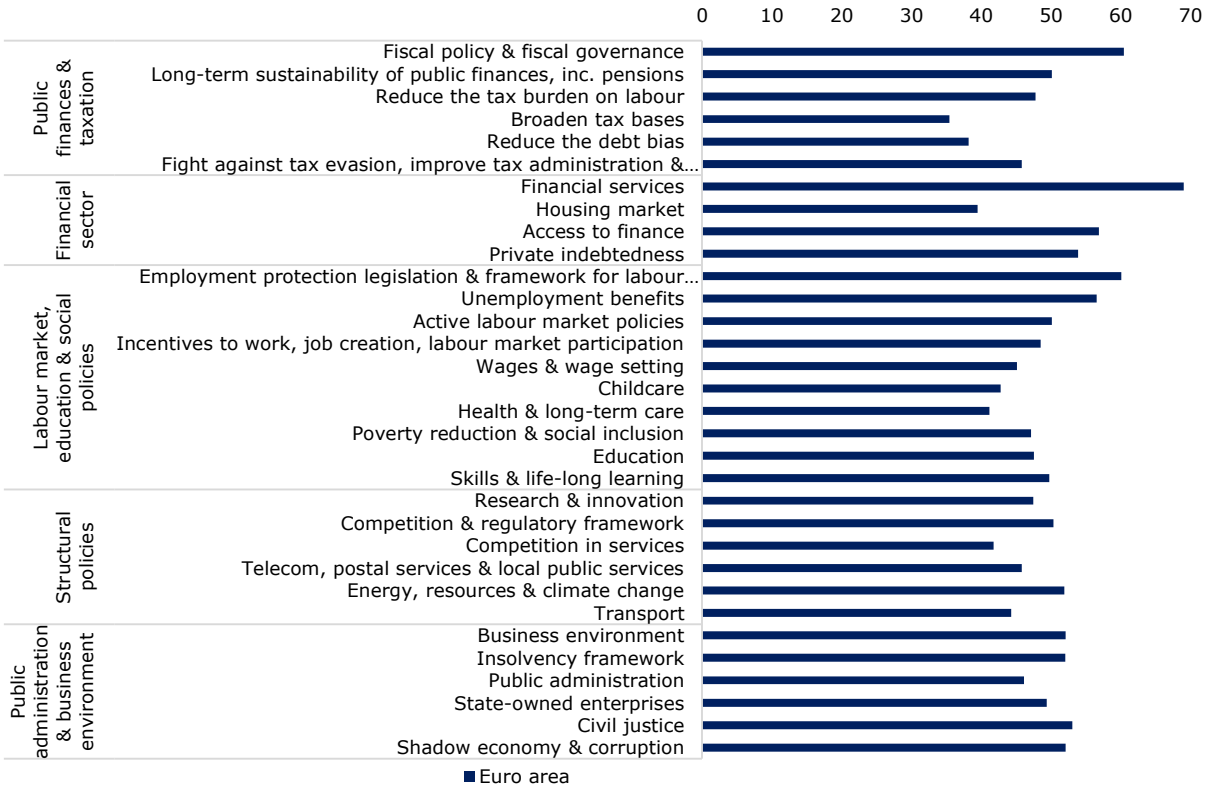
Source: Eurostat.
Note: Changing composition of the aggregates excluding LU and IE. Germany prior to 1991 has been extrapolated using the growth rates of West Germany.
Source: AMECO.

Euro area countries made significant reform efforts following the crisis but pace has slowed down, not taking full advantage of the favourable economic environment. In a multiannual perspective, there has been visible progress in Country Specific Recommendations (CSR) implementation, which takes into account the time needed to consult stakeholders and social partners, design and implement reforms.[13] Overall, since the outset of the European Semester, almost half of the CSRs have been implemented with at

[12] European Commission spring 2018 forecast.
[13] Estimations are based on the Country Reports which assess annual progress in terms of CSR implementation (see figure 11)

least 'some progress'.[14] However, in recent years, CSR implementation seems to have slowed down as the pressure of the crisis has abated. It is important to step up the pace of growth-enhancing reforms both in the labour and product markets, while avoiding reversal of previously enacted reforms. The growing external risks, and the past experience in the euro area, make the need to strengthen the resilience of national economies and the euro area as a whole more pressing. Institutional quality and administrative capacity are important factors behind a country's ability to implement needed structural reforms. In the euro area, Member States still vary considerably in terms of administrative capacity as measured by the World Bank indicators of government effectiveness and regulatory quality.

Graph 12: Annual assessment of implementation of CSRs (2011-2017)



Source : European Commission.
Note: This graph shows the average of the annual implementation scores of country-specific recommendations per policy area. The scores attributed are 25 for 'limited progress', 50 for 'some progress', 75 for 'substantial progress', and 100 for 'fully implemented'.

Recent implementation of structural reforms focused on areas most affected by the financial crisis[15]. Although the pace of reforms has differed across countries, in terms of policy areas most of the reform efforts appear to have been concentrated in financial services, followed by fiscal policy and fiscal governance, employment protection legislation, access to finance and unemployment benefits (Graph 12). These reforms were triggered in many instances by the recent crisis and aimed at addressing the impact of the shock and to increase the adjustment capacity of the economies and improve competitiveness. Conversely, little progress was visible in broadening the tax base and addressing debt bias in taxation, in

[14] A total of 47% according to the European Commission CSR database.
[15] European Commission CSR database.

reducing distortions in the housing market, weaknesses in healthcare systems and in boosting competition in services. These areas however remain crucial for the long-term sustainability of the economy. The European Commission's proposal for a Reform Support Programme aims at aiding Member States to pursue and implement reforms aimed at modernising their economies, notably reform priorities identified in the context of the European Semester. Also, channelling EU Cohesion policy funding to address country-specific investment needs, as identified in the European Semester, could in particular contribute to strengthen economic, social and territorial cohesion in the euro area.

4.1 Labour market and social protection systems

The situation in the labour markets of the euro area as a whole is improving and employment continues to expand. The current job-rich expansion has brought total employment to 155.9 million in 2017 – compared with some 148.9 million at the depth of the crisis in 2013.[16] The number of persons employed is forecast to continue increasing by some 1½ % in 2018 and 1% in 2019-20[17] with the employment rate expected to rise from 61.8% in 2018 to 62.7% in 2020.[18] The unemployment rate is ebbing and is projected to continue to decline from 8.4% of the labour force in 2018 to 7.5% in 2020, 1 percentage point below pre-crisis levels. Youth unemployment declined to 16.9%[19] in September 2018 while long-term unemployment also continued to decline to 3.9% in the second quarter of 2018 (Graph 13).[20]

However, despite these broadly positive developments, pockets of slack remain, and significant divergences among Member States persist while in-work poverty is still on the rise in many Member States. Despite the recovery in employment, the total number of hours worked remains below pre-crisis levels reflecting both a longer-term structural decline[21] – hours worked per person have been on a steady decline, down by 3.8% between 2008-17 (Graph 14) – and the level of part-time work being still above its pre-crisis level as a percentage of total employment (Graph 15). Involuntary part-time work also remains high at 29.2% of part-time employment, though it has declined from a peak of 31.7% in 2014. In addition, important country divergences remain in a number of areas e.g., youth and long-term unemployment rates, participation rates in education and training (Graphs 16, 17, 18).[22]

[16] See Eurostat.

[17] See European Commission autumn 2018 forecast.

[18] Employment as a percentage of population of working age (15-64) based on full-time equivalents where available. See European Commission autumn 2018 forecast.

[19] Among the active population less than 25 years old.

[20] Source: Eurostat (code une_ltu_q).

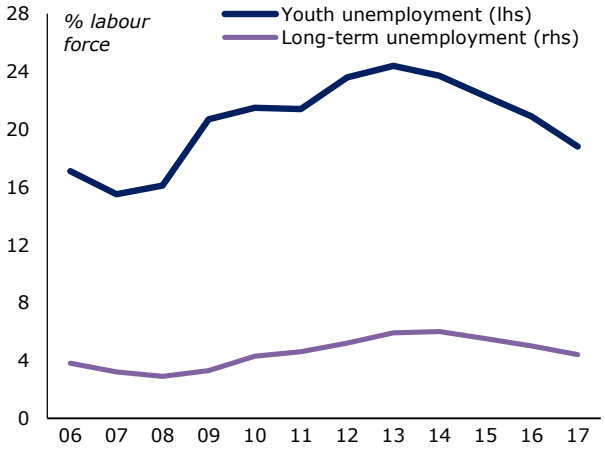
[21] Driven by factors such as the rise of services and the diffusion of flexible working arrangements, so that a reversal of this trend seems unlikely. See, for instance, DG Employment (2018), Labour market and wage developments in Europe. Annual review.

[22] For example, youth unemployment stood at 6.3% of active population less than 25 years in Germany and at 7.2% in the Netherlands, but at 39.1% in Greece and 34.2% in Spain (Graph 17). At the same time, while the participation rate in education and training of the low skilled was 36.2% in Lithuania and 28.8% in Finland, it was only 3.8% in Greece and 4.9% in Malta. For more details on country divergences, see DG Employment (2018), 'Chapter 1: Main Employment and Social Developments', in Employment and Social Developments in Europe 2018 Report

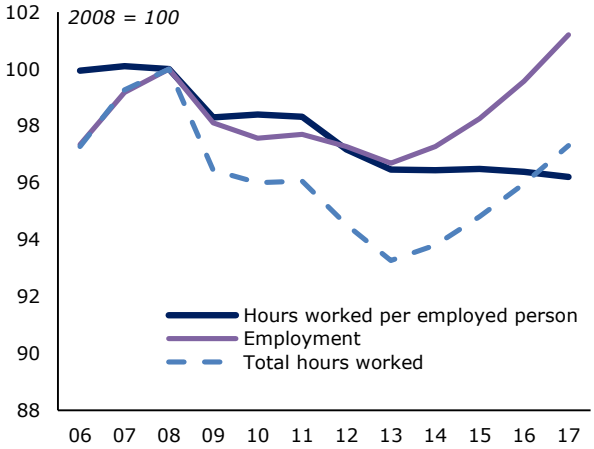
Overall, these developments reflect an uneven capacity of Member states to absorb and recover from the adverse shocks that have hit the euro area in the last decade.

In some sectors and some countries, on the other hand, labour shortages are emerging. The Commission's quarterly surveys indicate that firms are facing challenges from a tightening labour market. The share of euro area firms mentioning the availability of labour as a factor limiting production in the industry has almost steadily increased in recent years. There is also evidence of binding labour shortages from unmet demand for labour, as expressed by the job vacancy rate. It has broadly risen since late 2014 in the euro area and reached its highest value since 2006 at 2.1% in the first quarter of 2018.

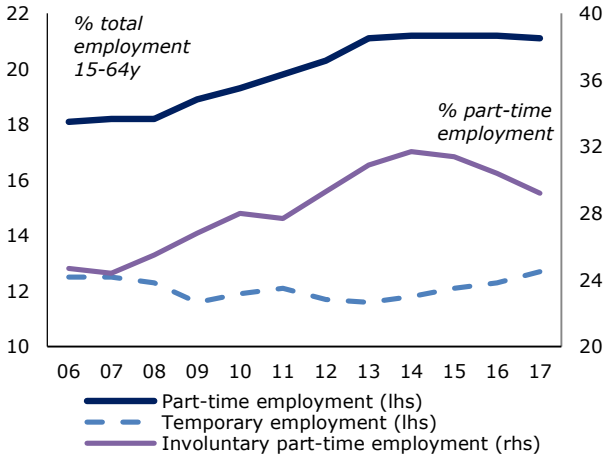
Graph 13: Youth unemployment and long-term unemployment, euro area



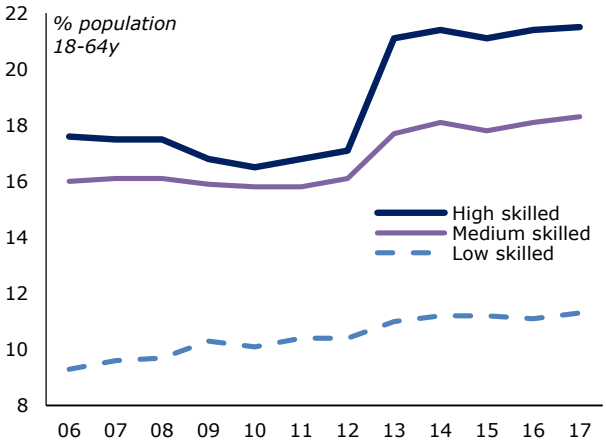
Graph 14: Employment and hours worked, euro area



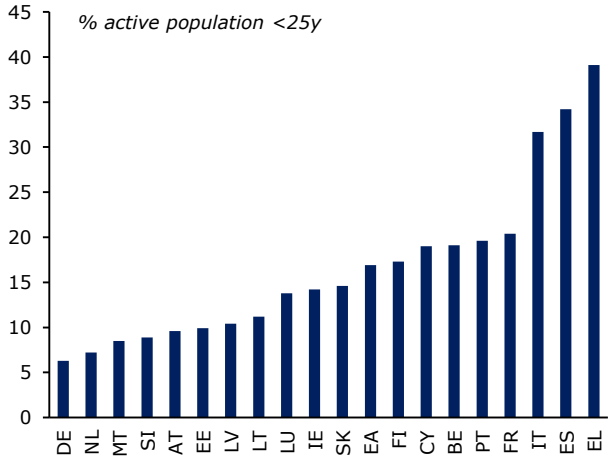
Graph 15: Part-time and temporary work, euro area



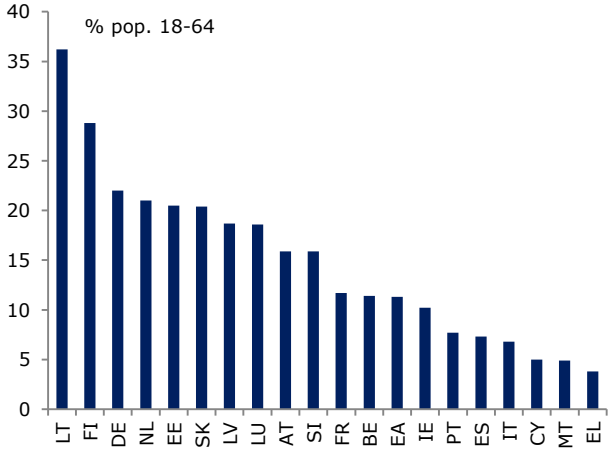
Graph 16: Participation in education and training (last 4 weeks), euro area



Graph 17: Youth unemployment, June 2018



Graph 18: Participation in education and training (last 4 weeks), 2017



Source: Eurostat

Wage growth remained subdued in recent years at the euro-area aggregate level, despite continued improvements in the labour market but is slightly accelerating. Nominal compensation per employee has remained moderate in 2016 (+1.2%) and 2017 (+1.6%) but is projected to grow at some 2–2½% over 2018-20. In a context of rising inflation, real wages have stagnated in 2017, but are forecast to increase by some 0.5% in 2018.[23] Unit labour cost dynamics in the post-crisis period have contributed to contain external imbalances, as net-debtor countries benefited from stronger cost competitiveness gains as compared with net-creditor countries. More recently, the advantage of net-debtor countries in terms of cost competitiveness dynamics has slowed in comparative terms due to tightening labour markets and a reduced pace of productivity improvements.[24] Against this background, and while respecting the role of social partners, maintaining wage growth in net-creditor countries and productivity growth in net-debtor countries would be supportive of further euro-area rebalancing. Additionally, – especially in countries characterised by low productivity growth – upgrading skills, in particular those of the low-skilled through well-designed education and training systems and participation rates in adult learning, remains crucial to help increase productivity, while addressing skill shortages and creating room for sustainable wage growth.

While technological change and the digital revolution create new job opportunities, they also raise challenges related to the loss of low-skill jobs and the increase in non-standard work. In this context, investment in skills is key to ensure that all citizens reap the benefits of technological transformation. Significant differences across euro area Member States persist in terms of the share of early leavers from education and training and participation rates in adult learning, which has been recovering slowly.[25] Reducing labour market segmentation has positive effects in terms of higher investment in human capital as, employers tend to invest

[23] See European Commission autumn 2018 forecast.

[24] European Commission (2018), Alert Mechanism Report 2019

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

less in upgrading the skills and competencies of temporary employees. In turn, such reduction may translate in higher productivity, stronger resilience and long-term growth.

A broad set of reforms would help to address the challenges facing labour markets and their social and economic implications. In this perspective it is important that national reforms aim at implementing the principles of the European Pillar of Social Rights which aims at delivering effective rights for citizens in terms of equal opportunities and access to the labour market, fair working conditions as well as social protection and inclusion. Such reforms will help to strengthen inclusive growth and resilience across the euro area.[26] Social dialogue remains of key importance to strengthen the implementation of reforms as well as the effectiveness of collective bargaining frameworks. Reforms at national level should promote quality job creation and reduce labour market segmentation and structural unemployment while promoting social cohesion. Key elements of such reforms include high-quality, efficient and inclusive life-long education and training systems in combination with well-designed skills anticipation strategies that aim at better matching skills with labour market needs, employment legislation that provides fair working conditions for all workers, as well as flexibility and security for employees and employers, effective active labour market policies that support labour market transitions, and sustainable and adequate social protection systems. The latter – which should be adapted to cover all workers as new forms of work emerge - provide automatic stabilization during economic downturns, support labour reallocation, and pave the way for higher living standards in the longer term. Adequate social protection systems, together with the portability of social rights and pension entitlements, promote a fair labour mobility, which also improves the resilience of the euro area.

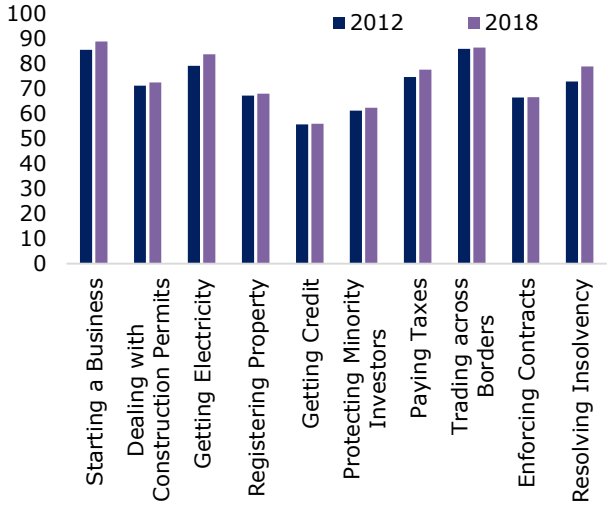
4.2 Product markets and the business environment

Product market and business environment reforms can improve allocative capacity and foster economic resilience with positive impact on innovation, competition, productivity and potential growth. In markets where firm entry, exit and growth is easier, resources are allocated to the most productive sectors and firms, which have a higher propensity to make high-quality investment, with a positive impact on productivity and potential growth. At national level, structural reforms to decreasebarriers to investment would improve the business environment. Relevant reforms include better justice and administrative systems, decreasing investment uncertainty, easier licensing procedures to speed up investments and promoting Research and Innovation (R&I) investments.[27]

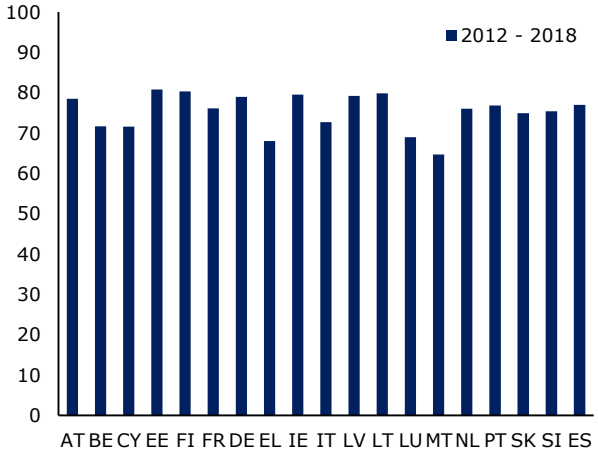
[26] The Social Pillar sets out 20 key principles and rights to support fair and well-functioning labour markets and welfare systems. For more details see http://ec.europa.eu/social/main.jsp?catId=1226&langId=en

[27] "The third pillar of the Investment Plan", European Commission 2018.

Graph 19: Ease of doing business indicators, euro area



Graph 20: Ease of doing business, per Member State, euro area



Source: World Bank

The business and investment environment have improved but a number of challenges and significant country differences persist, underlying the need for national reforms (Graphs 19, 20). In 2018, the euro area scored the highest in starting a business and trading across borders while access to credit, protection of minority investors and contract enforcement remain key challenges.[28] Member States have also made some progress in facilitating investment notably by improving the regulatory environment and public administrations but companies continue to report that improvements in the business environment would facilitate conditions for investment.[29,30] Further, skill shortages remain a major concern for businesses and require action across the euro area.[31] Finally, a number of Member States further improved the effectiveness of national justice systems but challenges remain. The 2018 Justice Scoreboard shows positive developments in most euro area Member States, including those facing challenges for the effectiveness of their justice systems, *inter alia* in terms of length of first instance proceedings, backlog of pending cases, online access to court judgments. [32]

Member States have taken measures to support intangible investment including private R&I and skills. These include financing private R&I either through indirect aid (for instance tax advantages, e.g. in France, and various types of fiscal incentives, as with the "Impresa 4.0" strategy in Italy). In addition, a number of Member States have put forward policies to better

[28] Ease of Doing Business (2018), World Bank Database.

[29] Eurobarometer Flash 459

[30] A majority of respondents still see two main regulatory obstacles to doing business as a barrier to investments, namely administrative burdens other than costs (67%) and the lack of stability in the legislation concerning products or services (57%). The administrative costs of starting a business, the length of legal proceedings, and building permits and other authorisations are seen as detrimental by relatively fewer firms but still significant with 44%, 43%, and 42% of respondents, respectively.

[31] EIB Group Survey on Investment and Investment Finance (2017)

[32] EU Justice Scoreboard (2018), European Commission COM(2018)

exploit the economic benefits of the public and private research by encouraging cooperation between academia, research and businesses, for instance by encouraging the set-up of competitiveness clusters, or through Smart Specialisation Strategies supported by Cohesion policy. However, overall investment levels remain low. Investment in R&D in the euro area was 2.1% of GDP in 2016, still far from the EU 2020 target of 3%.[33] Skilled-staff shortages coupled with uncertainty about the future remain the main barriers for EU businesses.

The insufficient Single Market integration also remains a major barrier for firms to grow and invest in the euro area, as returns can be much higher than at national scale. At present, many of the potential gains in terms of both growth and inclusiveness from improving the functioning of the Single Market have yet to be realised. Several key sectors are still not covered by the Services Directive, and there is high heterogeneity in regulations and in transposition of EU legislation[34] while the mutual recognition principle in the goods market remains unsatisfactory.[35] Making decisive progress in deepening the Single Market would probably be the single most important way to increase resilience in the euro area.

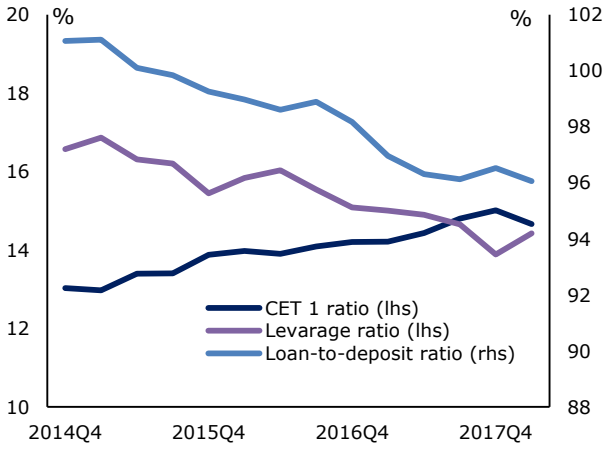
5. Financial markets and completing the Banking Union and Capital Markets Union

Risk reduction in the banking sector continued to progress in 2017 and in early 2018.[36] Banking sectors in nearly all Member States continued to increase the quantity and quality of their capital and reduce their leverage (Graph 21). Their reliance on short-term funding also continued to fall and asset quality improved further. Non-performing loans (NPLs) fell to 4.5% of total loans in the first quarter of 2018 in the euro area, compared to 6.1% a year earlier, and provisions increased by 8.39 percentage points. NPLs fell faster in most Member States with the highest stock of such loans but some national NPL ratios remain far apart from the euro area average and continue to require attention (Graph 22).

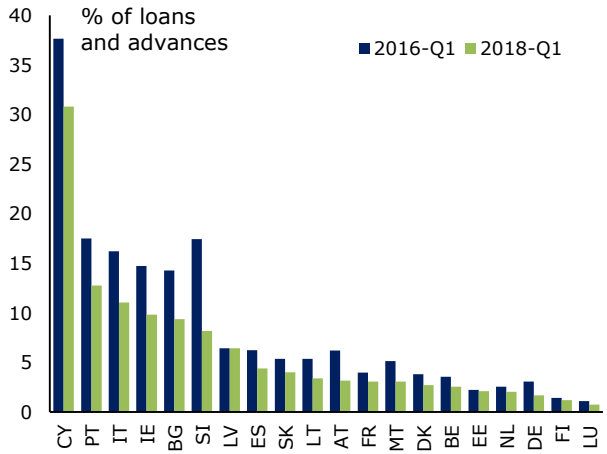
Bank performance has recovered moderately but the sector continues to face challenges from the economic environment and business-model transformation. Profitability remains low by historical standards but recovered moderately in 2017 amidst improved asset quality and market conditions. However, some national banking sectors still post negative or very low margins given tight interest margins, legacy assets, market fragmentation and operational inefficiencies (Graphs 23 and 24). A number of challenges lie in the horizon, including the gradual normalisation of monetary policy and competition from fin-tech firms. The continued fragmentation of retail banking markets limits the ability of the sector to respond to these challenges and is another reason to progress faster in the completion of the Banking Union.[37]

[33] Eurostat Europe 2020 indicators - R&D and innovation
[34] QREA 2018, Economic resilience, the Single Market and EMU.
[35] EC Goods market package 2017.
[36] "Overview of Progress in Achieving Risk Reduction Measures", Follow-up Note to the February 2018 discussions on EMU deepening, Economic and Financial Committee, June 2018.
[37] "Financial integration in Europe", ECB 2017.

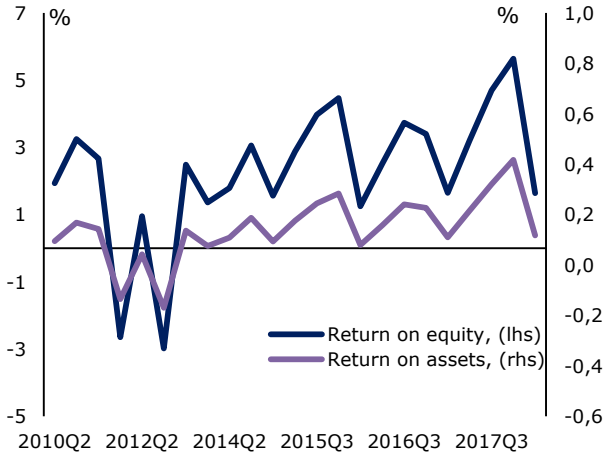
Graph 21: Bank stability indicators



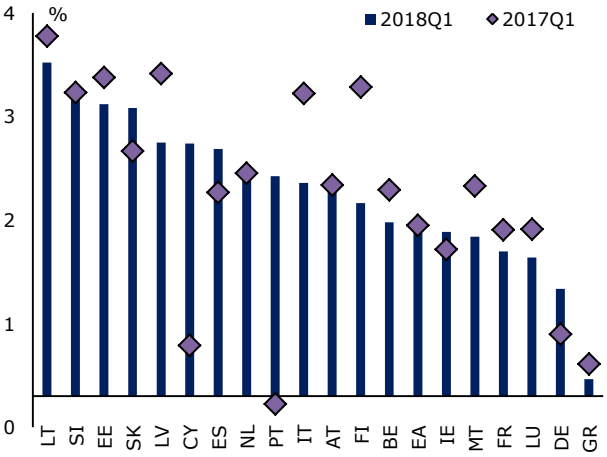
Graph 22: Non-performing loans



Graph 23: Return on equity and on assets



Graph 24: Return on investment



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

Additional measures are being put in place to strengthen banks resilience and financial sector integrity further. Following a request from the Council, the Commission published a dedicated Action Plan to address legacy NPLs and avoid their build-up in the future, with actions at euro area and national level.[38] The adoption, by the end of 2018, of the November 2016 Banking Package, which further reduces risks by implementing internationally agreed norms on capital buffers and liquidity in banks, also remains crucial for the completion of the Banking Union. The Commission has also proposed to reinforce the European Banking Authority and supervisory cooperation to address the recent serious breaches of anti-money laundering rules.[39] Moreover, the work of the Single Resolution Board also contributes to reducing risks by increasing the preparedness for bank orderly resolution and setting the

[38] http://europa.eu/rapid/press-release_IP-18-1802_en.htm?locale=en
[39] ECOFIN conclusions 02 October 2018.

targets for increasing loss absorption. Overall, the EU has adopted more than fifty legislative proposals to increase the resilience of the financial sector since the crisis.

However, other important areas remain to be completed, including notably the backstop to the Single Resolution Fund and a European Deposit Insurance Scheme (EDIS). In June 2018, the EU Heads of State and Government agreed that the backstop to the Single Resolution Fund will be provided by the European Stability Mechanism and that work should start on a roadmap for political negotiations on EDIS. Fast progress in both areas is necessary in light of their key stabilising properties and their importance for promoting financial integration. This can allow for the emergence of more pan-European banks that are less linked to their own sovereigns and local economic developments, given the impact of these factors on the credit channel in periods of turbulence.

The share of non-bank finance in the euro area's financial system has continued to grow, creating a more diverse mix of funding sources. Assets under management by investment and pension funds, venture capital and online alternative financing continued to grow in 2017 and non-financial corporations have increased their reliance on market funding and, in particular, on bond issuance. Capital markets are therefore becoming more prominent in the euro area in line with policy goals, which also demands additional efforts to strengthen supervisory capabilities and fill data gaps to monitor and appraise risks.[40] Low yields continue to challenge pension funds and insurance companies offering guaranteed returns.

The implementation of the Capital Markets Union (CMU) action plan continues but regulatory, legal and tax divergences need to be more decisively addressed. Deeper and more integrated capital markets create more funding opportunities for companies to support investments at lower costs and are also essential for making the euro area more resilient to economic shocks through private sector risk sharing. The implementation of the Commission's CMU action plan, as reinforced by its mid-term review, progressed further in 2017 in several important areas.[41] However, advancing in the harmonisation of insolvency and securities law, and some parts of taxation that make it difficult for agents to invest and raise funds across borders, are also necessary steps to build a genuine CMU.

6. Deepening the Economic and Monetary Union

Completing the Economic and Monetary Union's (EMU) is essential to address the remaining weaknesses of its construction. The economic and financial crisis of the last decade exposed the limits of individual Member States in absorbing the impact of large shocks. It also interrupted the convergence trend within the euro area and the start of a divergence of economic and social performance, which is only being slowly corrected. These regional and social imbalances imply that a substantial part of the euro area population cannot make the most of the EMU and fails to fully grasp its benefits. Moreover, high levels of

[40] European financial stability and integration review (EFSIR), European Commission SWD (2018).

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

public and private debt, non-performing loans and exposures of banks to their sovereigns in a bond market characterised by national safe assets with asymmetric perception of risk bear risks for the future stability of the financial system. The incomplete nature of the financial union and the absence of a fiscal stabilisation function for the euro area result in insufficient mechanisms for risk-sharing and shock-absorption – notably at the euro area level to deal with large shocks, – while governance has become too complex.

The currently robust economic growth provides a unique opportunity to complete the EMU, also on the basis of Commission's proposals. Significant reforms have been implemented in the past decade but the EMU architecture remains incomplete. Besides the reforms in the areas of Banking Union and Capital Markets Union mentioned in the section above, the Commission presented a number of proposals in December 2017 and May 2018, as part of the roadmap to complete the EMU, and building on the actions taken since the Five Presidents' Report. Among these proposals: (i) a *Reform Support Programme*, open to all Member States wishing to benefit from it, would provide budgetary incentives and technical support to implement structural reforms identified in the European Semester; (ii) a *European Investment Stabilisation Function* would protect public investment in the event of large asymmetric shocks and help the economy rebound quickly and (iii) a *European Monetary Fund*, would build on the structure of the European Stability Mechanism, with additional functions and an improved decision-making framework. These reforms, which would make EMU function more smoothly and more resilient, could also contribute to strengthen the international role of the euro, making it more commensurate to the euro area global economic and financial relevance.