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Analysis of the Euro Area economy

Accompanying the document

Recommendation

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

{COM(2017) 770 final}

1. Macroeconomic context and developments

The economic expansion in the euro area continues and has become increasingly broad-based across countries. The recovery is increasingly driven by domestic demand, with private consumption as the key driver of growth and investment picking up. Employment continued to increase throughout 2016 and the first half of 2017. The unemployment rate has seen a significant reduction, though it is still higher than in 2008.

The recovery is nonetheless characterised by some atypical features: subdued core inflation and wage growth that do not reflect the labour market improvements as signalled by standard labour market indicators, a large current account surplus and a persisting, but declining, investment gap (Figure 1). In particular, subdued wage growth appears to be related to low inflation expectations feeding in wage negotiations, low productivity growth and remaining labour market slack.

Divergences across euro area countries in terms of GDP per capita and unemployment rates persist (Figure 2). The years prior to the crisis saw a trend of real convergence within the euro area, which was temporarily reversed by the economic crisis, with a diverging trend observed until 2012. Real convergence prior to the crisis coincided with widening current account imbalances within the euro area, also fuelled by large capital flows from the core to the periphery that did not always translate into sustainable investment, accompanied by increasing differences in relative competitiveness among countries. The accumulation of current account imbalances was accompanied by strong domestic demand dynamics leading to a moderate reduction in cross-country differences in unemployment rates. However, when the global financial crisis hit, the ensuing adjustment process led to sharp corrections in current account balances and to labour shedding in countries with current account deficits, which triggered divergences in unemployment in the area. After 2013, labour market reforms introduced in the aftermath of the crisis and the ensuing recovery process stimulated a reduction in unemployment divergences, without an associated increase in current account imbalances. While differences in unemployment rates decreased, differences in the total number of hours worked across the euro area started increasing (Figure 2). This relationship between the cross-country variation in current account balances, unemployment rates and hours worked throughout the process of rebalancing, as just described, also hints at persisting labour market slack. The latter could explain some of the aforementioned atypical features of the euro area recovery.

Significant imbalances persist, as the adjustment took place mostly on the side of net external debtors. While much progress has been achieved among net debtor countries in correcting their current account deficits, large current account surpluses remain in some creditor countries. This points to a remaining overall shortfall in aggregate demand at the euro area level, which contributes to a large current account surplus for the euro area, projected to decline gradually from at 3.3% of GDP in 2016 to 2.9% of GDP in 2019. The countries that lost competitiveness before the crisis indeed experienced significant adjustments thereafter (in terms of changes in the real effective exchange rate, REER, based on unit labour costs, ULC - see Figure 2). In some debtor countries, gains in cost competitiveness are now moderating or

even fading out, while prolonged wage moderation in creditor countries makes the relative competitiveness adjustments more difficult.

The net international investment positions of the most indebted Member States have been improving at a slow pace and sustained rebalancing efforts are still needed. Countries that had large deficits for a long time still have large negative net international investment positions that represent vulnerability. As large negative net international investment positions are generally coupled with large stocks of private or government debt, the maintenance of prudent current account positions in net debtor countries is also the counterpart of a necessary internal deleveraging process. The extent to which the deleveraging process in net debtor countries comes at the expense of their recovery prospects crucially depends on the deleveraging pace, on the growth and inflation environment and on the strength of demand dynamics in the rest of the euro area and in non-euro area countries.

2. The policy mix

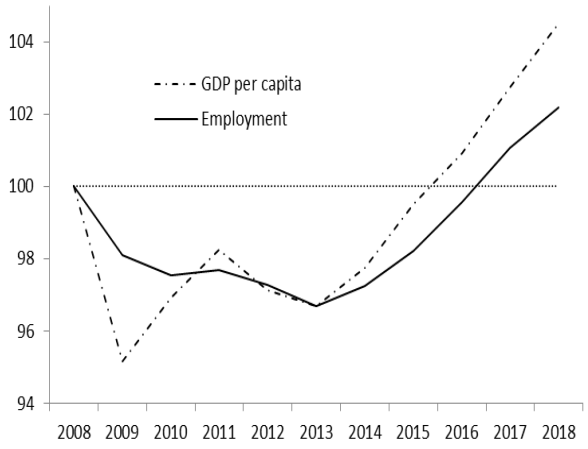
Consistency and balance in the overall policy mix for the euro area, including monetary, fiscal and structural policies, are crucial to ensure a robust and sustainable economic recovery.

In recent years, the policy mix in the euro area has been skewed towards monetary policy, which resorted to new unconventional tools to achieve the ECB's medium-term inflation objective, thereby supporting growth and job creation. In the aftermath of the crisis, fiscal policy became expansionary, however already in 2010 the stimulus was reduced and in 2011 it was contractionary. Monetary policy subsequently engaged in a sustained accommodative policy, although progressively approaching the effective lower bound on interest rates. In 2012 a monetary policy expansion went along with a contractionary fiscal policy stance. In more recent years, new unconventional monetary policy tools have instead been matched by a broadly neutral fiscal stance (Figure 3). Meanwhile, Member States, in particular those most hit by the crisis, engaged in long-delayed structural reforms of their economies.

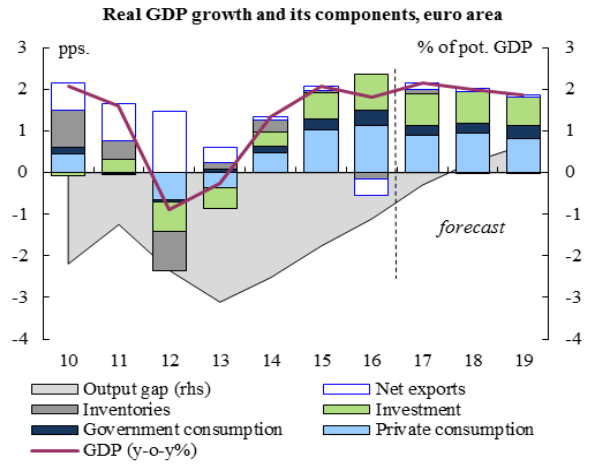
The ECB has initiated a recalibration of its asset purchases in view of the gradual convergence of inflation rates towards the ECB's aim, the increasingly broad-based economic expansion and the continued effective pass-through of monetary policy measures to the financing conditions of the real economy. An ample degree of monetary stimulus remains in the euro area as domestic price pressures are still muted overall and the economic outlook and the path of inflation remain conditional on continued support from monetary policy. This calls for a supportive role from other policies, whenever space for policy action is available. In particular, Member States with weak demand conditions and still significant slack in the labour market should remain firmly focussed on completing the reform agenda to converge upwards towards the best performers in terms of institutional and market structures.

Figure 1 – Macroeconomic developments and outlook for the euro area

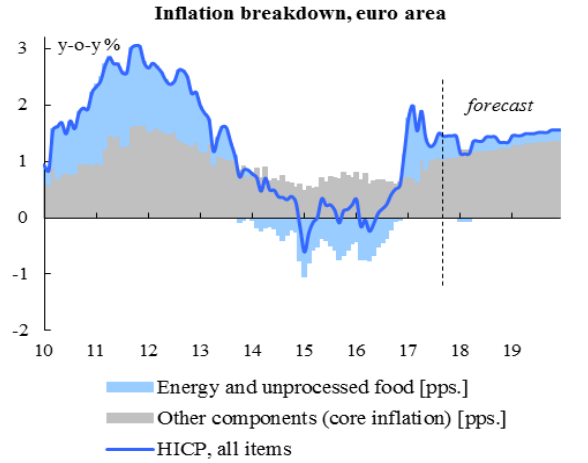
The euro area recovered its pre-crisis level of GDP per capita in 2016 and is expected to recover its pre-crisis level of employment in 2017.



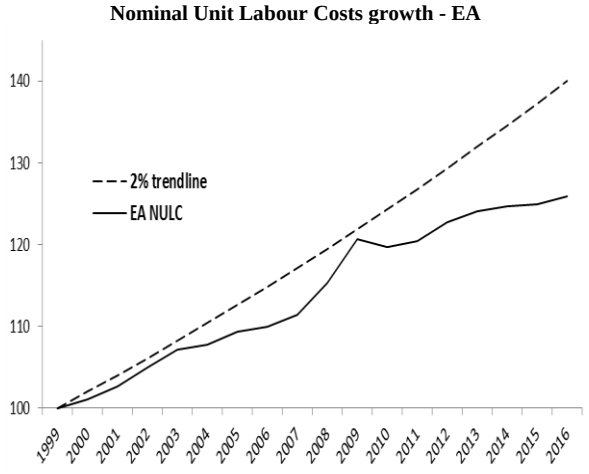
The latest European Commission economic forecasts project a continuation of the expansion with a slight moderation in the next 2 years (2.2% in 2017, 2.1% in 2018, and 1.9% in 2019).



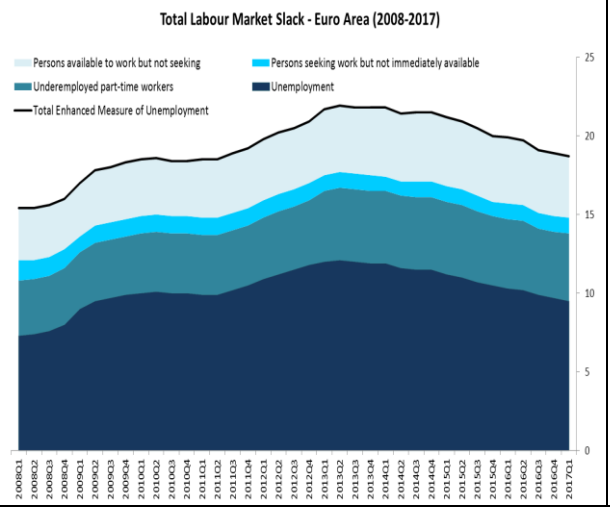
Inflation, and in particular core inflation, remains subdued. Inflation has been persistently below the 2% reference value.



Wage growth remains subdued. Growth in nominal unit labour costs based on hours worked remain below the inflation reference value, dragging down core inflation.



Labour market slack is still present in the euro area.



The euro area's current account surplus further increased in 2016 and remains large, pointing to low domestic demand.

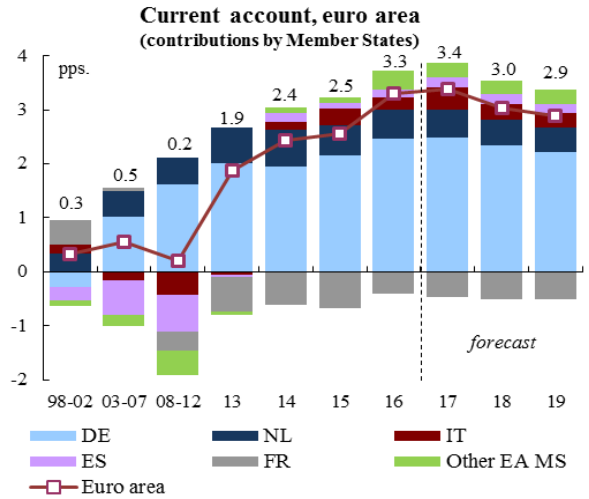
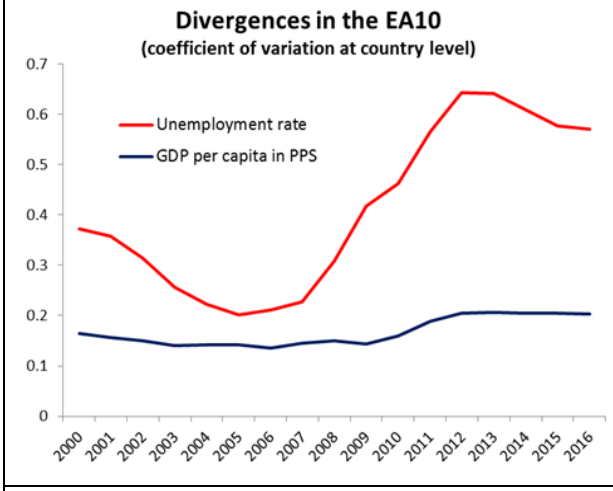


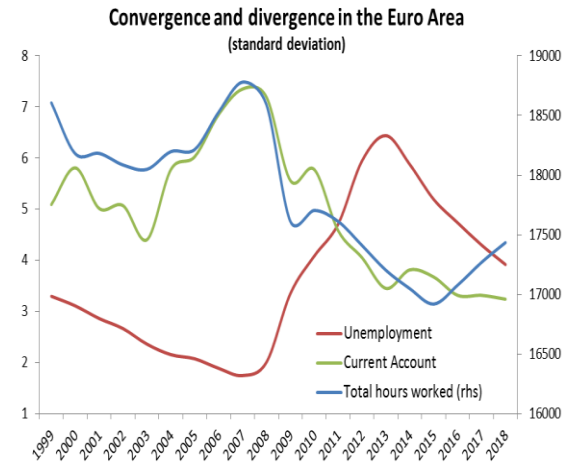
Figure 2: Divergences and rebalancing in the euro area

Differences in unemployment across the EA10 Member States strongly increased with the crisis. Dispersion of GDP per capita remained on a rising trend until 2012, followed by a very moderate decrease by 2016.

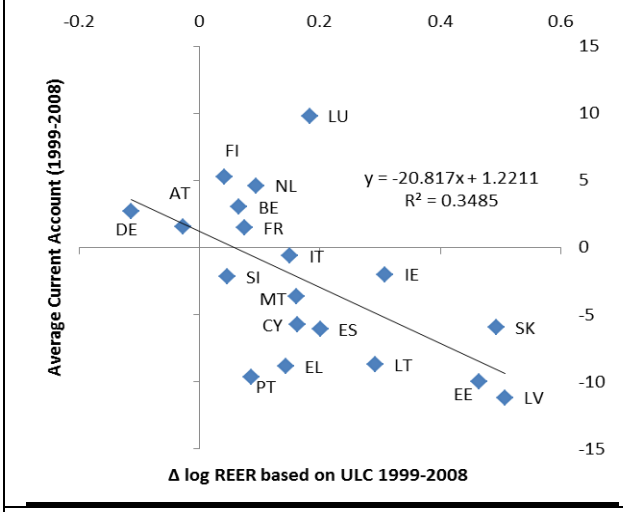
(EA10 is EA12 without LU and IE)



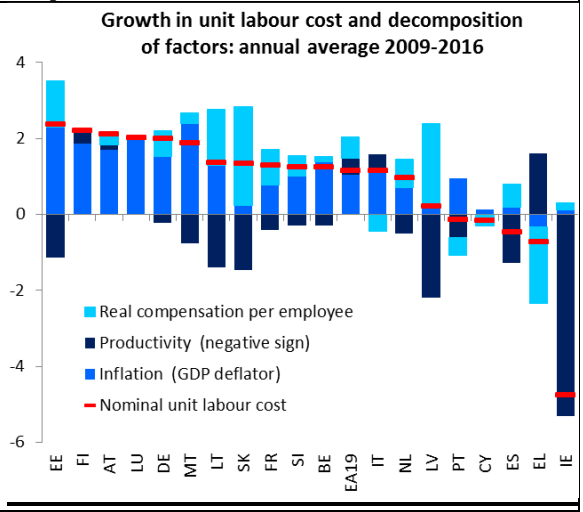
The post-crisis sharp adjustments in current account (CA) balances increased divergences in unemployment. After 2013, following labour market reforms, the reduction in unemployment has corresponded to increasing divergences in hours worked rather than increase in CA imbalances.



Prior to the crisis, losses in competitiveness were associated with lower current account balances…



…but since 2009 net external debtors have undergone significant adjustments in competitiveness.



Adjustment has taken place mostly in countries with large net external liabilities, while surpluses of large net creditors persist and imbalances in the euro area remain sizeable.

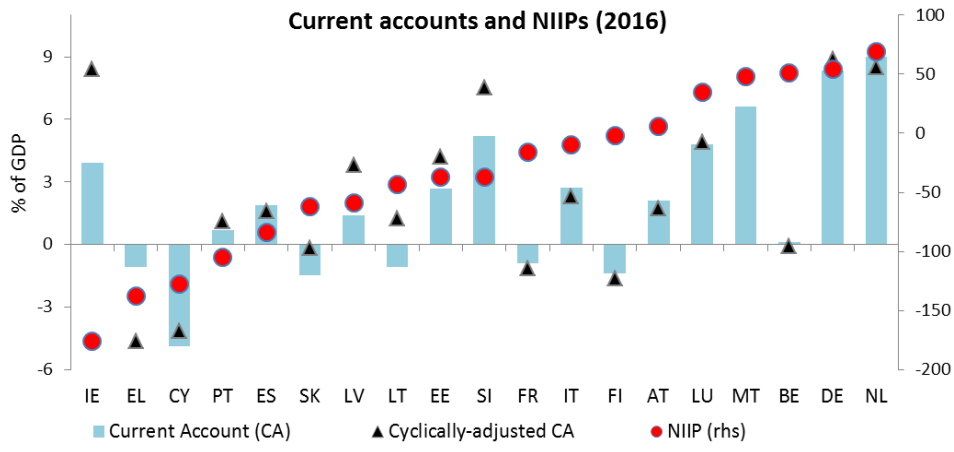
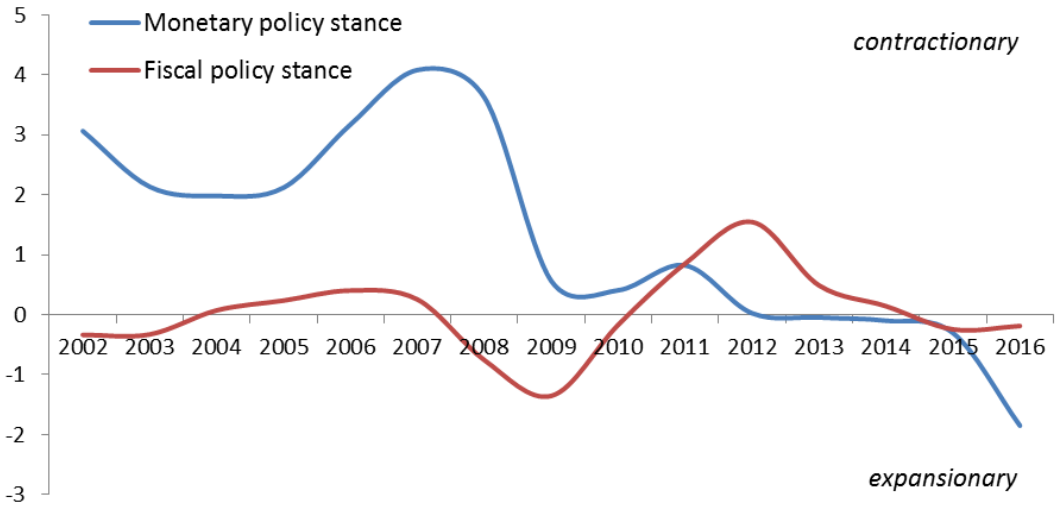


Figure 3: Fiscal and monetary policy stance in the euro area – 2002-2016



Notes: (1) The fiscal stance is defined here as the change in structural primary balance. To extend the series back in time, before 2011, the change in the cyclically adjusted primary balance was corrected for one-off measures. ***(2)*** For the monetary policy stance the "shadow rate" is used here to capture the overall impact of conventional and unconventional monetary policy tools that provide monetary stimulus to the economy (though the shadow rate is only one of the instruments that should be looked at to evaluate the monetary policy stance).[1] The shadow rate should nonetheless be used with a lot of caution because i) its estimated value is subject to model uncertainty; ii) it is based only on information embedded in interest rates and may not fully reflect all quantitative aspects of monetary policy; and iii) there is no proper benchmark for it akin to that for official policy rate. Source: DG ECFIN calculations based on AMECO and ECB data.

The existence of cross-border spillovers is a key reason for the coordination of economic policies in the euro area.

The high degree of economic and financial integration among euro area countries implies that shocks and policies at national level have important spillover effects on the whole area.

Cross-border spillovers from fiscal policy measures can be sizeable. Recent simulations,[2] for instance, show that fiscal multipliers and spillover effects (in terms of impact on other countries' GDP) are much larger when monetary policy operates in a zero lower bound environment, compared with normal times. An increase in public investment in countries with fiscal space would generate significant positive spillovers to the rest of the euro area. Long-term GDP effects would exceed the short-term impact as public investment would raise the productivity of private capital and labour over a sustained period of time. At the same time, failure to reduce public debt and the risk of renewed market pressure on high public debt countries would have negative effects for the whole euro area.

Spillovers from structural reforms are generally found to be positive too, although smaller. The simultaneous implementation of structural reforms throughout the euro area

[1] Data are based on McCoy, E. and U. Clemens (2017), "A Calibration of the Shadow Rate to the Euro Area Using Genetic Algorithms", *European Economy Discussion Paper* 051, July 2017.

[2] In 't Veld, J. (2016), "Public investment stimulus in surplus countries and their euro area spillovers", ECFIN economic briefs 16, August 2016.

would have a bigger effect on output than they would if they were implemented by countries in isolation. This highlights again the benefits of coordinated policy action.

Reforms in one country can also affect policy action in other countries by influencing political constraints. The lack of incentives for implementing difficult reforms might be mitigated when policy action is taken in a coordinated manner across the Member States.

3. Fiscal policy

3.1. The fiscal stance in the euro area

A broadly neutral fiscal stance at aggregate level for the euro area appears appropriate in the light of the current economic recovery characterised by some atypical features, the debt legacy from the crisis and the expected recalibration of asset purchases by the ECB. Striking the right balance between ensuring the long-term sustainability of public finances, depending on country-specific conditions, and supporting the economic recovery is essential.

The overall fiscal stance of the euro area is broadly neutral in 2017. It is expected to remain so in 2018 and in 2019 (under a no-policy change assumption for the latter year) (Figure 4). A broadly neutral fiscal stance for the euro area appears still appropriate in the light of the current economic recovery, which is strengthening but remains atypical and incomplete. This is even more relevant in the context of persistent debt legacy from the crisis.

There are nonetheless considerable differences at national level, with some countries facing the need to consolidate, while others have some fiscal space. A differentiated approach to national fiscal policies is thus needed in order to balance the objectives of stabilising the economy and ensuring the long-term sustainability of public finances.

It is also important to reduce excessive debt levels and re-build fiscal buffers, in order to be able to absorb potentially upcoming shocks. According to the latest Commission economic forecast, the aggregate debt level for the euro area is expected to reach around 89% of GDP at the end of 2017 and decline to around 87% and 85% in 2018 and 2019 respectively. Public debt levels have decreased on average at a slow pace and remain close to their historic peaks in several euro area countries. The strengthening recovery in the euro area and the associated steepening of the yield curve observed since the fourth quarter of 2016 suggest that the opportunity presented by the current low financing cost environment might be slowly fading. Where debt ratios are high, curbing less growth-friendly spending and cutting tax loopholes is important for strengthening the sustainability of public finances.

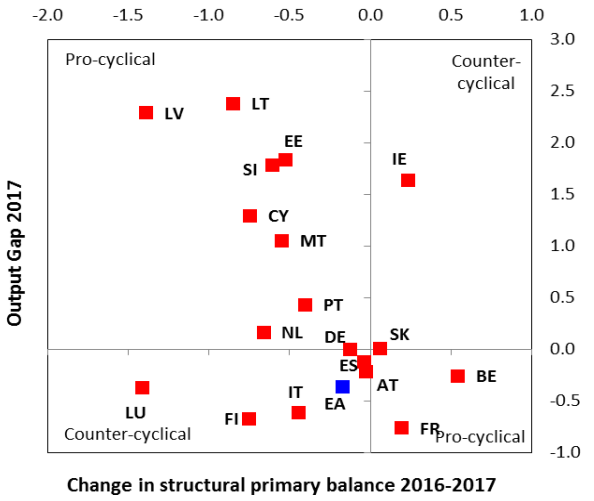
3.2. The quality and composition of public finances

Member States' fiscal policies can contribute to both stabilisation and sustainability by improving the quality, composition and governance of their public finances.

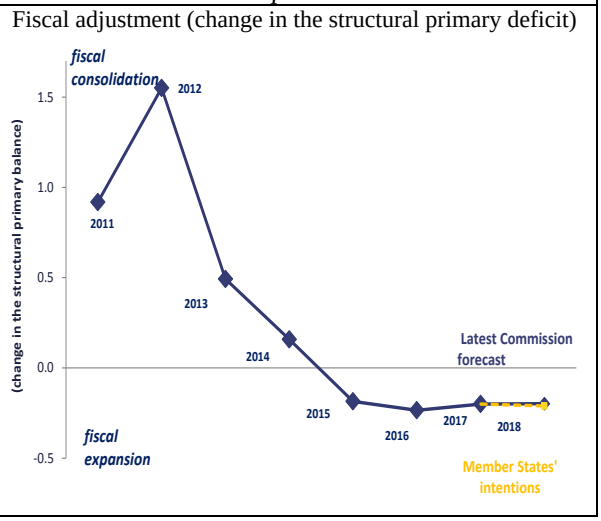
The major part of past consolidations relied on revenue measures (Figure 5). This contrasts with findings[3] that expenditure-based consolidation, in general, tends to weigh less on growth and have more persistent effects on deficit and debt levels.

Figure 4: Fiscal policy and developments in the euro area

Fiscal policy is on average countercyclical in the euro area this year.



The overall fiscal stance for the euro area is broadly neutral in 2017 and is expected to remain so in 2018.



Growth-friendly expenditure, such as investment, has the potential to stimulate aggregate demand in the short term and raise potential growth over the longer term. Public investment has fallen over recent years. There is a need to ensure high-quality public investment to boost knowledge-intensive and sustainable growth, in particular by investing in the quality of education and training. Evidence suggests significant room for improving the efficiency and effectiveness of public spending on education.

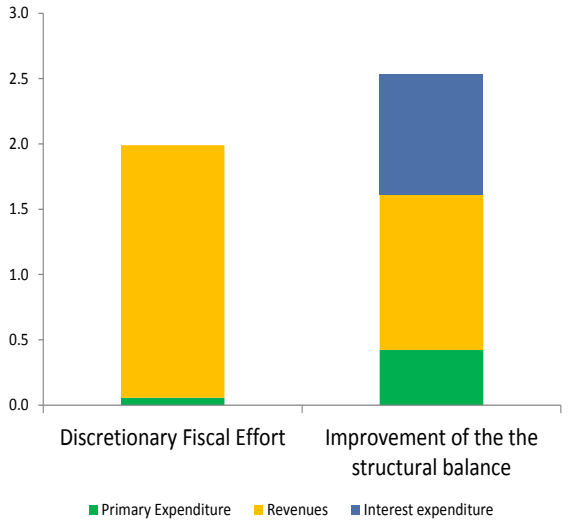
Improvements in the functioning of national fiscal frameworks and well-managed spending reviews can support the pursuit of a credible and growth-friendly fiscal policy.

[3] European Commission (2014), Report on Public Finances in EMU 2014, part IV.

Figure 5: Composition of public finances in the euro area (tax and spending)

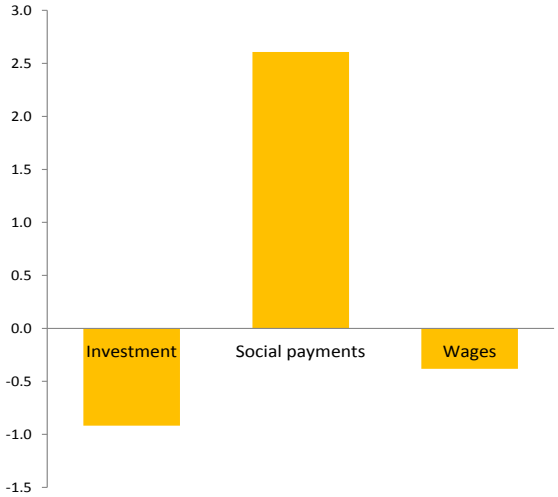
The largest part of the fiscal effort in past years (2011-17) relied on revenue measures and lower interest expenditures.

Composition of fiscal effort, EA (2011-17),% GDP [1]



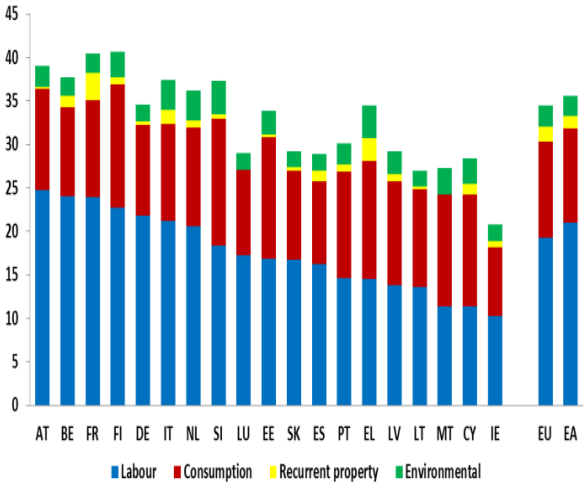
The share of social benefits in total expenditure has increased while the shares of investment and wages have decreased.

Change in the share of total expenditure of selected expenditure items, EA (2011-17), pps.



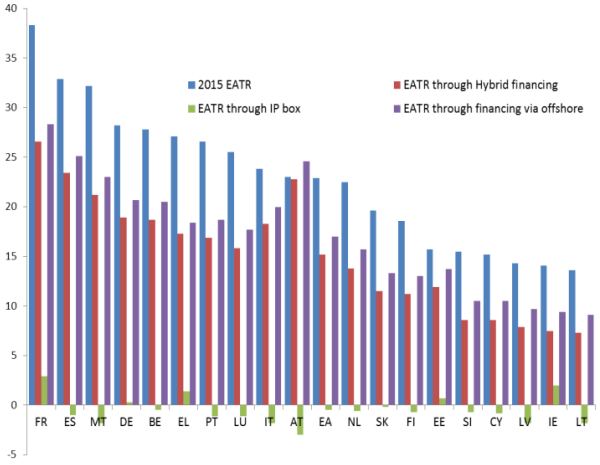
Taxes on labour income are the most important source of tax revenues in the euro area.

Taxes as % of GDP, 2015



ATP impacts on Effective Average Tax Rate in the euro area.

Impact of ATP on the Effective Average Tax Rate (EATR) in the euro area [2]



Notes: (1) The Discretionary Fiscal Effort (DFE) combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. It consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013), "Measuring the fiscal effort", Report on Public Finances in EMU, part 3. ***(2)*** "Hybrid financing" refers to a strategy where firms use mismatch in tax treatment of a financial instrument between two countries to obtain double deduction or no or low taxation; "IP box" refers to a strategy relying on the use of a patent box to obtain lower taxation on IP revenues; "Financing via offshore" relies on debt shifting using a no-tax country (which has concluded tax treaties with euro area countries) to locate financial profits and benefit from interests deduction in high tax countries. Controlled foreign companies rules and thin capitalization rules are disregarded in the calculations of the EATR.

Improving the overall structure and design of taxation can free resources for public investment, education and healthcare and can contribute to supporting investment, employment and improving social fairness.

The overall tax burden in the euro area is high and skewed towards labour (Figure 5). For euro area Member States, the tax burden on labour, as measured by the tax wedge,[4] is among the highest in the world. For low income earners it standed in 2015 at around 41% for the euro area (against around 38% for the EU and around 29% and almost 31% in the US and Japan respectively). Reducing the tax burden on labour, while shifting it to other bases, can support consumption, stimulate labour supply and increase work incentives for low-income earners, beyond improving firms' profitability and cost-competitiveness. The shift should be towards tax bases that are less detrimental to growth, such as, for instance, consumption taxes, recurrent housing taxes and environmental taxes.[5] The distributional effects of a tax shift to alternative bases should be taken into account.

Simplifying tax systems and addressing tax fraud, evasion and avoidance are essential to make tax systems more efficient and fairer. In particular, **measures against aggressive tax planning (ATP)[6]** 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. This is therefore a particularly relevant issue for the euro area. **The Common Consolidated Corporate Tax Base[7]** (CCCTB) would be another powerful tool against tax avoidance, while improving the Single Market for businesses. All measures to tackle tax abuse can also provide additional revenues to support labour tax reductions.

ATP negatively affects government revenues and has clear spillover effects within the euro area. Although the extent of these practices and their impact on total tax revenues is hard to measure with precision**,** losses can be estimated at between EUR 40 and 60 billion.[8] ATP creates a tax-induced redistribution of tax revenues across euro area Member States on top of an overall loss due to lower effective taxation.

ATP distorts the level playing field between firms. A recent study demonstrates potential significant reduction in effective taxation for companies that engage in ATP, using structures that involve at least two euro area countries (Figure 5).[9] It can allow them to gain market

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4 The tax wedge is defined as the sum of personal income taxes and employee and employer social security contributions net of family allowances, expressed as a percentage of total labour costs (the sum of the gross wage and social security contributions paid by the employer).

5 Johansson, Å., Heady, C., Arnold, J., Brys, B. and L. Vartia (2008), "Taxation and economic growth", *OECD Economics Department Working Paper* 620, OECD Publishing.

6 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. In all cases, the strategy consists in artificially increasing expenses in countries with higher taxation and artificially increasing profits in countries with lower taxation.

7 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.

8 Own computations based on Dover, R., Ferrett, B., Gravino, D., Jones, E., and S. Merler (2015), "Bringing transparency, coordination and convergence to corporate tax policies in the European Union", European Parliament Research Centre Study.

9 ZEW, Centre for European Economic Research (2016), "The Impact of Tax Planning on Forward-Looking Effective Tax Rates", *Taxation Papers*, European Commission, working paper no. 64.

shares and raise entry barriers to the detriment of other firms (mostly domestic and/or smaller firms). Evidence has been found of a link between ATP and higher mark-ups and increased industry concentration, which may lead to inefficiencies and high consumer prices.[10]

ATP calls for coordinated action at European level. Due to capital mobility, the fight against ATP can only be truly effective if all countries act in a coordinated fashion at euro area level.

4. Structural reforms, economic resilience and real convergence

Comprehensive and appropriately sequenced product and labour market reforms can improve economic resilience, increase productivity growth and foster real convergence and fairness. In particular, convergence towards resilient economies is fundamental for improving the functioning of EMU as the experience of the past years has shown how lack of resilience in one or several economies of the euro area can have significant and persistent effects not only on the countries concerned but also on other countries and the euro area as a whole.

Structural and institutional features of labour and product markets and a well-functioning state sector are important determinants of economic resilience and real convergence.[11] Resilient economic structures prevent shocks from having significant and long-lasting effects on income and employment. In this way, they reduce economic fluctuations and prevent strong spillover effects of the kind experienced in the euro area during the economic and financial crisis. Strengthening resilience entails acting on: i) reducing the vulnerability of economies to shocks; ii) increasing their shock-absorption capacity; and iii) increasing their ability to recover from the shocks.

Sequencing and packaging of labour and product market reforms are crucial to fully harness the positive effects they can have on investment, growth and employment. Reforms in product markets tended to be associated with an increased likelihood of labour market reforms following suit (based on past data). This is in line with the expectation that reforms in product markets facilitate the entry of new firms, increase overall activity, thereby leading to an expansion in labour demand. Lower rents are also likely to reduce resistance to labour market reforms.[12] The ability of the public administration to deliver efficient services and to implement reforms timely is a key cross-cutting factor in the achievement of economic and social objectives.

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10 OECD (2015), "Measuring and Monitoring BEPS", action 11, 2015 final report, p 181.

11 Economic resilience is defined as the economy's ability to withstand shocks and recover quickly to potential thereafter. Real convergence is convergence in living standards, typically measured by GDP per capita. The two concepts bear a strong relationship in that resilient economies are better able to resume long-term growth and prevent severe negative social consequences of downturns, thus fostering real convergence in the longer run (for example by containing hysteresis risks following a crisis).

12 Da Silva, A.D., Givone, A., and D. Sondermann (2017), "When do countries implement structural reforms?" *ECB Working paper* 2078, June 2017.

Both the short- and long-term effects of various types of structural reforms matter. Some reforms can also have negative short-term effects on aggregate demand, which can be offset, at least partly, by an appropriate sequencing and packaging, to take advantage of their complementarities.[13] Product market reforms strengthen the pass-through of reforms on the labour market to product markets. Increased competition in product markets leads to lower prices that can sustain changes in real wages.[14] In turn, labour market reforms can ensure a smooth reallocation of labour in response to adjustments triggered by product market deregulation. The beneficial effects of reform packaging are also supported by empirical analysis.[15] The simultaneous implementation of labour and product market reforms is estimated to improve growth dynamics in the short run.

The relative contribution of different types of structural reforms to GDP growth changes over the time horizon. In the short run, labour market reforms (increased participation, active labour market policies and benefit reforms), tax reforms (shifting taxation towards indirect taxes) and product market reforms (higher competition in services sector and lower entry costs) have the largest effects. Effects of education/training (or skills enhancing) reforms, as well as of innovation reforms (R&D promoting policies), become sizeable in the medium to long run (Figure 6).[16]

During the crisis euro area countries have made significant reform efforts. Although the pace of reforms has differed across countries, most efforts were in the field of labour market regulations (EPL) and framework for labour contracts, collective bargaining, active labour market policies (ALMP), education, skills and life-long learning, and to some extent access to finance. This helped to increase the adjustment capacity of the economies and improve competitiveness. Conversely, progress was much more limited with regard to the removal of barriers in product markets (Figure 6).

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13 Banerji, A., Crispolti, V., Dabla-Norris, E., Duval, R. A., Ebeke, C. H., Furceri, D., Komatsuzaki, T. and T. Poghosyan (2017), "Labor and Product Market Reforms in Advanced economies: fiscal costs, gains and support", *IMF Staff Discussion Notes* No. 17/03.

14 Blanchard, O. and F. Giavazzi, (2003), "The Macroeconomic Effects of Regulation and Deregulation in Goods and Labor Markets", *The Quarterly Journal of Economics*, Vol. 118, August, pp. 879-907.

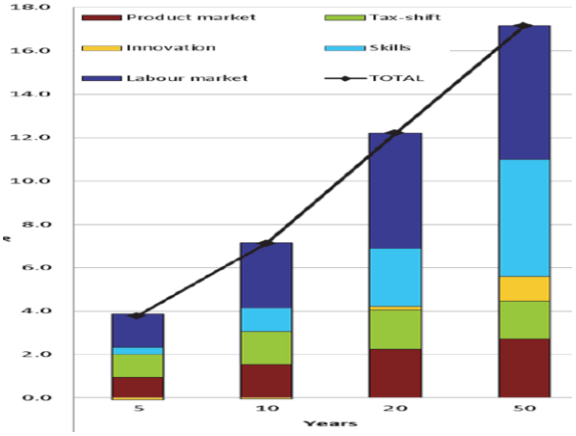
15 Berti, K. and E. Meyermans (2017), "Maximizing the impact of labour and product market reforms in the euro area – sequencing and packaging", *Quarterly Report on the Euro Area* 2017/2.

16 Varga, J. and J. in 't Veld (2014), "The potential growth impact of structural reforms in the EU: a benchmarking exercise ", *European Economy Economic Paper* no. 541.

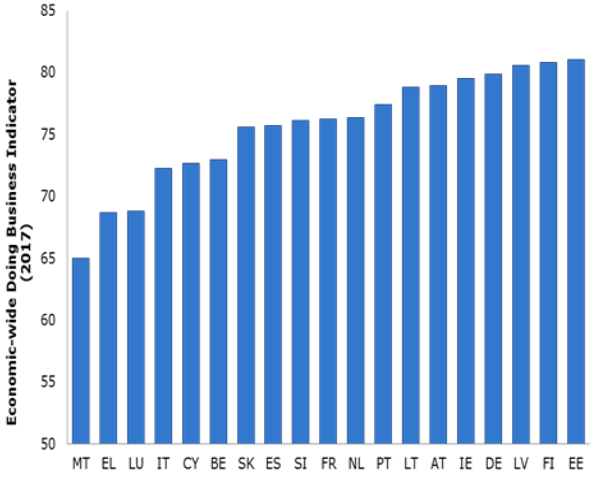
Figure 6: Structural reforms, economic resilience and growth effects

Labour market, tax and product market reforms have largest GDP effects in the short run; education/training have sizeable effects in the medium to long run; innovation and R&D in the very long run.

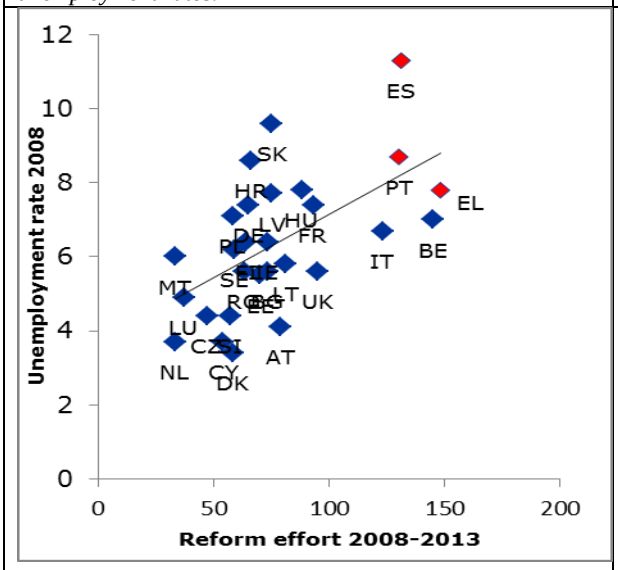
GDP effects after 5, 10, 20, and 50 years, by reform areas (difference from baseline)



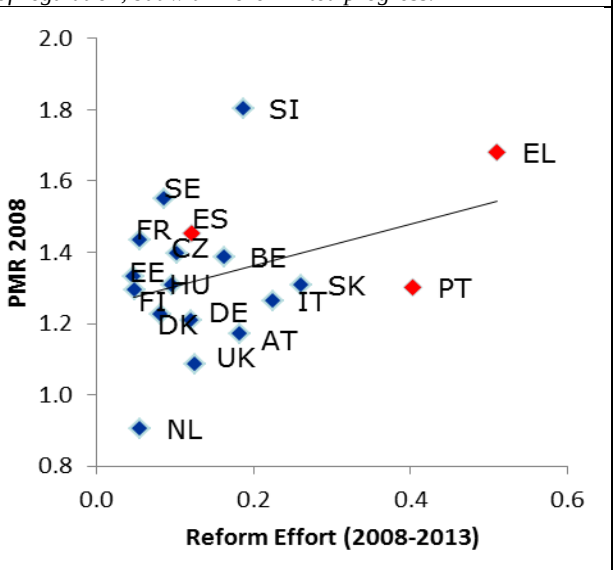
Significant differences still exist in relation to business environment between EA Member States.



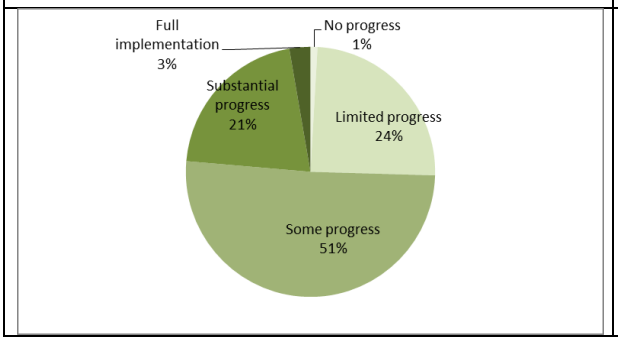
Labour market reform efforts over 2008-13 have tended to be more pronounced in countries with initially higher unemployment rates.[1]



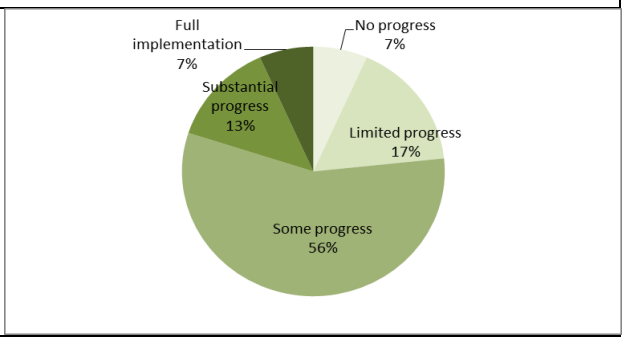
Product market reform efforts over 2008-13 have also tended to be more pronounced in countries with initially higher level of regulation, but with more limited progress.[2]



Implementation of 2011-2016 CSRs linked to active labour market policies in euro area MS to date.



Implementation of 2011-2016 CSRs linked to business environment in euro area MS to date.



Notes: (1) Reform effort in labour market is measured as the number of labour market reform measures by country and year, where pension reforms are excluded (source: LABREF). ***(2)*** Reform effort in product markets is defined as the change in OECD PMR from 2008 to 2013 (positive value means the level of PMR has declined). Data for the PMR in 2008 are missing for Bulgaria, Croatia, Cyprus, Latvia, Lithuania, Malta and Romania.

4.1 Labour market and social protection systems

Well–functioning labour markets and social protection systems play an important role in supporting economic resilience and social fairness in the euro area.

The experience of the crisis highlighted the need for improved policy coordination in the economic and social spheres. The European Pillar of Social Rights aims at progress towards future-proof, fair and well-functioning labour markets and welfare systems. The 20 principles set out in the Pillar fall into 3 broad chapters: 1) equal opportunities and access to the labour market; 2) fair working conditions; and 3) social protection and inclusion. Well-designed active labour market policies support job matching and facilitate job transitions. Active labour market policies and support measures help reducing long-term unemployment[17] by activating jobless people who can participate in the labour market, providing individualised support for job search, training and re-qualification, while contributing to social fairness.

Access to high quality education and training is vital to ensure equal opportunities and address skills mismatches. Adequate investments in human capital through education and training systems that improve lifelong learning and ensure that skills levels match present and future labour market needs play a key role in improving the economy's adjustment capacity and real convergence in the longer run. Investment in skills can also drive innovation and increase productivity and competitiveness, in addition to ensuring social inclusion and mobility. This applies particularly to investment in digital skills that are particularly important to foster the euro area economy's competitive potential.

Well-designed social protection is crucial to ensure adequate income support, promote inclusive labour markets and ensure appropriate social support through access to quality services. Apart from contributing to social inclusion, social protection systems can play a strong role as automatic stabilisers in times of crisis**.** Pension reforms and work-life balance policies also are key to foster labour market participation.

4.2 Product markets and the business environment

Reforms that stimulate innovation and enhance competition in product markets bring important benefits through reduction in prices and availability of better quality goods and services. Product market reforms that increase competition, reforms that improve the business environment and the quality of institutions (including an effective justice system that facilitates contract enforcements) foster economic resilience in euro area Member States by supporting the economy's capacity to cushion a shock and facilitating the swift reallocation of resources following it.

Further integration in the Single Market has proven to be a major engine of growth and convergence between Member States. The Single Market still holds considerable

[17] European Commission (2015), Employment and Social Developments in Europe 2015, chapter II.1.

unexploited potential and significant progress is needed to complete it. The Single Market for services (including financial, digital commerce, energy and transport) remains incomplete. Attention should nonetheless also be focused on the goods markets to avoid potential market segmentation. Completing the legal environment for the Digital Single Market would help speeding up the digitalisation of economic activities as a necessary step to improving the performance of product markets and global competitiveness.

Reforms to improve the quality of institutions and governance as well as the business environment are complementary to product (and labour) market reforms. Such reforms strengthen the positive impact of product market reforms in the markets where they are implemented and in the economy as a whole. Productivity gains in downstream manufacturing sectors resulting from reforms in upstream service sectors are, for instance, conditional to institutional quality.[18]

5. Financial sector developments and policy

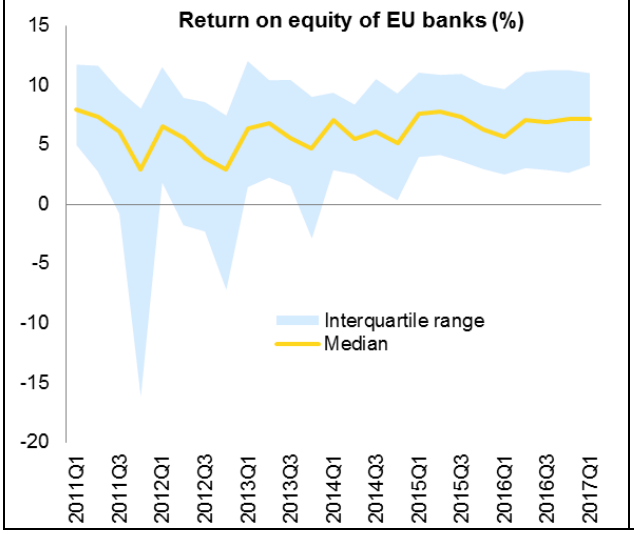
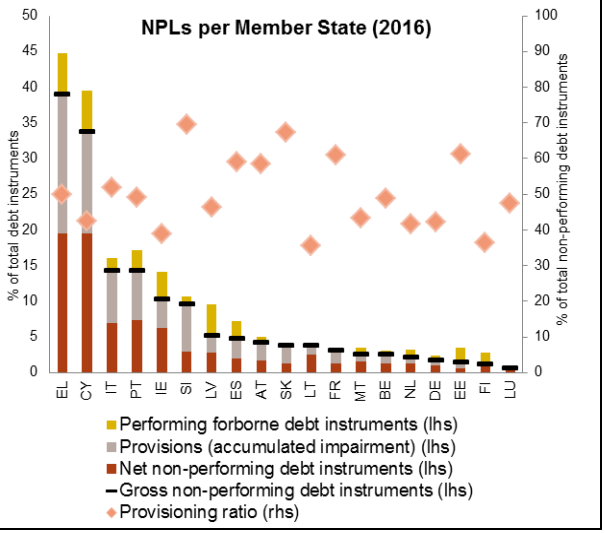
Euro area financial markets showed signs of optimism, the overall resilience of banks continued to improve, as well as lending conditions. Vulnerabilities in the banking sector nonetheless remain and need to be addressed through measures at national and European level.

Euro area financial markets showed signs of optimism over the past year, as reflected in higher stock prices, a gradual increase in long-term interest rates and stable or narrowing sovereign spreads. In terms of credit provision to the real economy, bank lending conditions improved systematically. Interest rates on new corporate loans remain on a downward trend and convergence across Member States continues.

Notwithstanding these positive trends, euro area banks continue to be confronted with low profitability, especially for small and medium-sized institutions. The profitability of the median bank in the euro area remained constrained and often below the cost of capital. The cost of adapting banks' business models, the low interest rate environment, and potential competition from other forms of finance will continue to exert pressure on banks' profitability. Business models may therefore need to further adapt to become sustainable in the long-term. At the same time capital ratios are on an increasing trend as new capital requirements continue to be phased in.

[18] Beverelli, C., Fiorini, M., and Hoekman, B. (2017), "Services trade policy and manufacturing productivity: The role of institutions", *Journal of International Economics*, 104, pp. 166-182.

Figure 7: Banking sector developments in the euro area

Euro area banks continue to be confronted with low profitability, with performance varying significantly across Member States.	*The stock of NPLs continues to decline, but remains elevated in some jurisdictions, while NPL provisioning practices differ across Member States.*
	

The stock of non-performing loans (NPLs) continues to decline across the euro area. In nearly all more affected Member States, NPL ratios have stabilised or are on declining trend, but progress remains slow. High NPL ratios in banks' balance sheets may hinder banks' ability to lend, the transmission of monetary policy as well as economic adjustment capacity (as funding is not directed towards the most productive uses). They are also a source of vulnerability for the banking system as a whole. High NPLs in some jurisdictions have potential spillovers on others within an economically and financially integrated area like EMU. This implies that, although tackling NPLs remains primarily the responsibility of the affected banks and Member States, in some areas action is needed at European level. On the basis of the Action Plan to tackle NPLs that was agreed in the Council in July 2017, and as announced in the Communication on Banking Union of 11 October 2017,[19] the Commission is currently working to deliver a comprehensive package of measures to reduce NPLs in early 2018. This package will consist of actions related to prudential tools, structural reforms, the development of secondary markets and the restructuring of banking systems.

The completion of the Banking Union and further progress on the Capital Markets Union are crucial to strengthening the EMU and fully reaping its benefits.

Strengthening the institutional architecture of EMU requires, as a matter of priority, completing the Banking Union and further progress on the Capital Markets Union, in parallel to reinforcing the euro area banking sector and adopting risk-reduction measures on the financial side. In order to further support banks' efforts to reduce risk and improve risk management, the Commission proposed in November 2016 a comprehensive risk-reduction package, which is currently under discussion in the European Parliament and the Council.

[19] COM(2017) 592.

The Commission's latest Banking Union Communication suggested new measures to reduce non-performing loans and to help banks diversify their investments in sovereign bonds.

Completing the Banking Union would reinforce financial integration by reducing barriers to cross-border banking, reduce the risk of a bank-sovereign feedback loop, as experienced during the crisis, and enhance financial stability. Progress on the Capital Markets Union would foster cross-border private risk sharing, thus strengthening financial stability and resilience of the euro area's economies in case of asymmetric shocks. It would also foster diversification of funding sources for business and support the efficient allocation of capital in the euro area. Additionally, more effective and consistent supervision is essential to eliminate possibilities for regulatory arbitrage between Member States in the way that they supervise financial entities and activities.

A common European Deposit Insurance Scheme (EDIS) is necessary to complete the Banking Union. This would underpin the credibility of the Banking Union in the face of large shocks by ensuring that adequate funding is swiftly available. The current set-up of deposit guarantees is not optimal as national deposit guarantee schemes may be vulnerable to large national shocks, in particular when both sovereign and national banking sector were under stress. For this reason, in November 2015, a gradual approach was proposed by the Commission, consisting of a re-insurance of national Deposit Guarantee Schemes (DGS), moving subsequently to a co-insurance scheme, where EDIS would intervene at the same time as the national Deposit Insurance Scheme but with progressively increasing contribution by EDIS. As a final stage, only EDIS was envisaged as the entity in charge of intervening in case of payout events. In the recent Communication on the completion of the Banking Union, the Commission has confirmed its ambition on this proposal. To revive the discussions, the Commission has presented ideas for the European Parliament and the Council to consider, in the current negotiations, the possible introduction of the European Deposit Insurance Scheme in a more gradual manner, starting only with liquidity support provided by EDIS in the first phase and adding gradually loss coverage to the liquidity coverage in the second phase. At the end of the second phase EDIS would provide full liquidity and loss coverage. The move to the second phase, however, could be commensurate to progress achieved with regard to risk reduction and the tackling of legacy issues that could be measured through an asset quality review.

Finally, the establishment of a common backstop to the Single Resolution Fund is needed to reinforce the credibility of the Single Resolution Mechanism. As indicated in the Commission Reflection Paper on deepening EMU and reiterated in the recent Communication on the Banking Union, for the backstop to be effective it would have to be of an adequate size, would need to be activated in a swift manner, and would be fiscally neutral given that the Single Resolution Mechanism Regulation stipulates that the banking industry repays any potential disbursements from the Single Resolution Fund.