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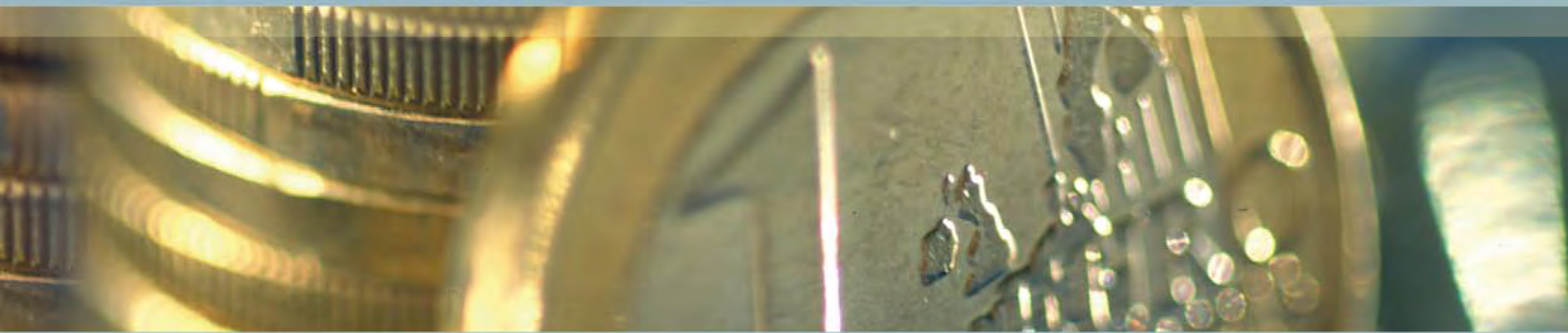

Macro structural bottlenecks to growth in EU Member States

Directorate-General for Economic and Financial Affairs

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FOREWORD AND ACKNOWLEDGEMENTS

In a Communication on 3 March 2010, the Commission outlined a proposal for a Europe-2020 Strategy to help the Union emerge from the crisis and to return growth and public finances to sustainable trajectories, i.e. smart, sustainable and inclusive growth. ([1]) Building upon this Commission's proposal, the ECOFIN Council on 16 March agreed that "… there is a need to start identifying areas that constitute the main bottlenecks, including infrastructure, to growth at EU and national level and designing policies that will provide the right conditions for sustainable and balanced growth and jobs in the future" and it called on the Commission and its Committees to prepare this in time for the ECOFIN Council of 8 June 2010 and the European Council in June. To this end a specific Country Review exercise was carried out involving the Economic Policy Committee and the Economic and Financial Committee. These committees presented the identified bottlenecks to growth in their report "EU macro-structural bottlenecks to growth at the national level". The findings of the report were endorsed by the ECOFIN on 8 June. The report is published on the ECOFIN Council web page. ([2])

The above mentioned country review was based on Commission analysis of each Member State. This analysis encompasses both framework conditions for growth at macro level (fiscal, macro-financial and external imbalances) and growth drivers at macro level (labour utilisation, investment and productivity, and knowledge base). This Occasional Paper publishes, under the responsibility of the Commission services, the country fiches for all Member States. For the sake of completion, this paper includes also the report of the EPC and EFC, which summarises the identified bottlenecks.

The country fiches were prepared in the Directorate-General for Economic and Financial Affairs under the direction of Gert Jan Koopman (Director of Economic Service and Structural Reforms), Jürgen Kröger and Matthias Mors (respectively Director of Economies of the Member States I and Acting Director of Economies of the Member States II). Co-ordination, editing and comments was provided by Declan Costello, Jonas Fischer, Natalie Lubenets, Aino Salomäki and Kristian Orsini. The work also benefited from substantial contributions from Filip Keereman and Lina Bukeviciute on macro-financial issues and Mary McCarthy, Reinhard Felke and Eric Ruscher on competitiveness and euro area issues. Moreover, colleagues in Directorate Economic Service and Structural Reform as well as in other Directorates-General provided comments in particular on labour and product market issues.

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Comments on the report would be gratefully received and should be sent by email to Jonas.Fischer@ec.europa.eu or Kristian.Orsini@ec.europa.eu

([1]) The communication is available at: http://europa.eu/press_room/pdf/complet_en_barroso___007_-_europe_2020_-_en_version.pdf

([2]) The report is published on the Council web page: http://register.consilium.europa.eu/pdf/en/10/st10/st10731.en10.pdf

Part I

EFC and EPC Report on Identifying National Macro-structural Bottlenecks to Growth

1. EU MACRO-STRUCTURAL BOTTLENECKS TO GROWTH AT NATIONAL LEVEL

Report prepared by the Economic Policy Committee and the Economic and Financial Committee:

EU MACRO-STRUCTURAL BOTTLENECKS TO GROWTH AT THE NATIONAL LEVEL

Introduction

- While the recovery from the most severe economic crisis since the 1930s is underway in the EU, it is proving more tentative than in past upturns. In this context, it is imperative that exit strategies include structural reforms to boost potential growth.

- On 3 March 2010, the Commission outlined its proposal for a Europe 2020 strategy to help the Union emerge from the crisis and return to economic growth and public finances to sustainable trajectories. Building on this proposal, the ECOFIN Council recognised on 16 March "a need to start identifying areas that constitute the main bottlenecks, including infrastructure to growth at the EU and national level." The European Council on 25-26 March also highlighted the need to address bottlenecks constraining growth at national and at EU level, including those related infrastructure and to the working of the internal market.

- For each country, the bottlenecks have been identified on the basis of the following approach:

- the focus is on identifying medium to long term challenges in line with the Europe 2020 time horizon and not on detailed policy suggestions;

- as regards the scope/coverage, this exercise identified only macro-structural bottlenecks to growth. This encompasses both framework conditions for growth at macro level (budgetary, macro-financial, external imbalances) and growth drivers at macro level (labour utilisation, investment, productivity): thus, reflecting the more integrated approach to surveillance called for in European Council conclusions. These bottlenecks at the macro-structural level may over time be complemented by more detailed analysis arising under the thematic elements of the Europe 2020 strategy.

- bottlenecks have been identified on a country-specific basis reflecting the most important priorities of the country concerned according to the EPC and EFC. This means that a country may have a bottleneck identified in an area even if performance is above the EU average.

- the euro area dimension is taken into account with respect to competitiveness concerns and macroeconomic imbalances.

- Member States are invited to take these suggestions into account in setting out their bottlenecks in their National Reform Programmes.

Main messages

- Most Member States are experiencing significant fiscal deficits and rising debt ratios which together with the costs of ageing populations, pose a significant challenge for fiscal sustainability and thereby confidence and growth. The challenges outlined below draw upon and are consistent with recent Stability and Convergence Programme assessments.

- Many countries face the challenge of ensuring a stable and well-functioning financial sector that is capable of providing continuous financial intermediation without state support. A sound, well capitalised financial sector along with measures to avoid asset price bubbles and excessive private sector indebtedness would help to ensure the stability of the financial sector.

- Member States with large current account imbalances rooted in a persistent lack of competitiveness ([3]) or due to other reasons should address the underlying causes by acting for example on fiscal policy, on wage developments, on structural reforms relating to product and financial services markets (including the flow of productivity enhancing capital), on labour markets, in line with the employment guidelines, or on any other relevant policy area.

- In this context, Member States should encourage the right framework conditions for wage bargaining systems and labour cost developments consistent with price stability, productivity trends over the medium-term and the need to reduce macroeconomic imbalances.

- Member States with large current account surpluses, especially within the Euro area, ([4]) should pursue measures aimed at implementing structural reforms conducive to strengthening potential growth and underpinning domestic demand.

- Most Member States do not tap their full employment and productivity growth potential because of sectors with low competition, a weak business environment and obstacles to employment and labour reallocation. Appropriate labour market reforms are also needed in a number of countries so as to increase wage flexibility, reduce segmentation and improve incentives to work for all.

- Many Member States also face challenges regarding increasing productivity and facilitating transition towards higher value added production and exports, and in several cases a diversification of the industrial base. This can relate to increasing capital investment, ensuring an efficient regulatory business environment, administrative efficiency as well as promoting a higher degree of competition.

- Finally, most Member States face important challenges regarding the human capital endowment and upgrading of their economies. Together with the synergies from a favourable environment for research and development, a strong human capital base is essential for high growth and international competitiveness.

Identified bottlenecks per country

AUSTRIA

- *Combining fiscal consolidation with a reallocation of public expenditure towards growth-enhancing items while addressing fiscal relations between different layers of government*

  Reducing inefficiencies flowing from the complexity of the inter-governmental fiscal relations would help bringing public finances back on a sustainable path and free up resources for investment in R&D and education.

- *Ensuring a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

  The need to repay the capital injected by the state in the wake of the financial crisis underlines the need to re-establish sound and sustainable financial sector framework conditions. In addition, cross-border activities of Austrian banks need to be monitored.

([3]) In particular within the Euro area, see Eurogroup Terms of Reference, 15 March 2010.
([4]) See Eurogroup Terms of Reference, 15 March 2010.

- *Strengthening of the sources of domestic demand*

  A policy framework aimed at strengthening structural measures, encouraging private investment and consumption, will be key to raising the economy's growth potential over the longer term.

- *Further increasing labour market participation*

  Further improving the employability of older workers remains an important challenge for Austria. Moreover, additional labour supply would come from the activation of workers facing disincentives to take up work.

- *Ensuring a stronger contribution of the educational system to human capital formation and promoting innovation capacity to support investment*

  Reforming of the educational system at all levels and raising the number of science and engineering graduates would help Austria to translate its relatively high spending on R&D into upgrading of the production structure of the economy towards high-tech goods and services.

BELGIUM

- *Ensuring the long-term sustainability of public finances in view of the high government debt level and population ageing*

  Belgium’s debt is high and rising and the long-term budgetary impact of aging is clearly higher than the EU average, prompting the need to consolidate public finances and reform the social security system.

- *Ensuring a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

  The financial situation of the banking sector remains fragile, which, given its size in the economy, underlines the importance of re-establishing a sound and sustainable financial sector framework.

- *Improving incentives to labour supply and demand by addressing the benefit system and the tax-wedge.*

  Given structural problems stemming from large financial disincentives to take up work, a challenge will be to reduce further the tax wedge on labour and reform the unemployment benefit system.

- *Improving the functioning of the labour market notably by addressing the high differences in labour market performance across regions and age groups*

  It will be a challenge to tackle the low employment rates of older workers, the coexistence of high and low employment areas in Belgium, a high number of job vacancies and low labour mobility (notably across regions). Addressing rigidities in the wage setting mechanism which depress labour demand especially for workers with a lower productivity would help in facilitating wage moderation.

- *Addressing the weaknesses in the business environment, notably by improving the regulatory framework and promoting competition notably in professional services and network industries but also further reforms in the retail sector.*

Belgium’s competition and business environment is characterized by a high administrative burden at all levels of administrations and weaknesses in the competition framework making improvements of the regulatory framework a challenge.

BULGARIA

- *Improving the efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items*

  Bulgaria's challenge, given the current deficit is to proceed with a frontloaded fiscal consolidation while further deepening health care and pension systems reforms. The reallocation of public expenditure would positively contribute to its growth potential.

- *Ensuring a well functioning and stable financial sector as a precondition for a sustainable development of the economy*

  Although the financial sector remained stable and profitable during the crisis, non-performing loans are still increasing and the losses will have to be absorbed by the build-up of capital buffers. In addition, the relatively low level of financial development highlights the scope for potential growth of the sector, which if sustainable, could be very important for enhancing the catching up-process of the country.

- *Ensuring better and more efficient utilisation of the economy's labour potential*

  Raising participation rates would boost catching-up and potential growth. In the context of the current economic downturn, increasing unemployment risks becoming structural, which should be tackled by enhancing matching in the labour market and upgrading the skills of the labour force. Reducing labour supply resulting from massive emigration has a negative impact on potential growth.

- *Addressing the weaknesses in the business environment and enhancing administrative efficiency*

  Increasing administrative efficiency, transparency of the regulatory framework and strengthening contract enforcement capacity would further improve the business environment. Improvements in this area and higher absorption of EU funds would support entrepreneurship, private investment and public infrastructure development needed to facilitate the transition to diversified and higher value added activities.

- *Improving the quality and efficiency of the education and training systems*

  Completing the educational reform would help raising the skill levels in the work force, upgrading low-skilled workers and achieving better matching with the requirements and needs of the employers.

CYPRUS

- *Reducing the high general government structural deficit and ensuring the long-term sustainability of public finances in view of population ageing*

  Fiscal consolidation including expenditure control is crucial in stabilising the economy. To this end, accelerating pension and healthcare reform with a view of containing population-ageing related expenditure and the implementation of an effective multi-annual budgetary framework would ensure the adherence to the budgetary targets and contain expenditure over the medium-term.

- *Improving efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items including weaknesses in energy and transport infrastructure.*

  Improving quality of public finances could create the space for pursuing growth-friendly policies, while supporting social cohesion, and ensuring a smooth adjustment.

- *Ensuring wage and price adjustment to regain and sustain competitiveness*

  Ensuring that wage developments are in line with productivity would support the country's competitiveness, particularly vis-à-vis its euro area partners, and be conducive in the adjustment of the external imbalance. More competitive price formation in product and service markets would also contribute to this objective. Cyprus' membership of the euro area reinforces the importance of this adjustment channel.

- *Promoting innovation and ICT capacity mainly of the private sector to support investment, diversification of the economy and orientation towards high value-added production and services*

  With Cyprus being a mainly small, services-oriented economy with lack of industrial base, the main drivers of growth are its labour force and productivity. Investing in improving the country's innovation and ICT capacity, infrastructures, productivity and labour would facilitate Cyprus restructuring and transition to diversified and higher value added activities.

- *Restructuring the economy with emphasis on high-skilled jobs and the training of the low skilled and disadvantaged groups*

  Restructuring the economy by shifting emphasis from low to high-skilled jobs and increasing labour productivity is an important challenge requiring investment in new technologies and a more efficient utilization of the highly qualified human capital thereby producing attractive jobs for university graduates.

CZECH REPUBLIC

- *Reducing the high structural deficit and improving long-term sustainability of public finances*

  The structural deficit was persistently high also during good times and it increased further during the crisis. Its reduction, together with healthcare and pension reforms, is important also in the long-term perspective as the country faces a big demographic challenge.

- *Improving the functioning of the labour market by addressing remaining structural weaknesses*

  Despite considerable progress in recent years, several structural problems on the labour market persist, such as low employability of certain groups (low skilled workers, young people and women with children), skills mismatches and low regional mobility. Removing those weaknesses and increasing labour supply represents an important challenge as population ages and labour force turns negative.

- *Addressing the weaknesses in the business environment, including the regulatory environment and efficiency of public administration*

  Businesses face a number of administrative and regulatory hurdles in several areas (tax administration, starting and closing business, access to finance for SMEs, enforceability of contracts, competition in network industries, transparency of public procurement), which hamper investment and growth.

- *Promoting innovation capacity and business R&D to support diversification of the economy and orientation towards high value-added production and services*

  The country should be moving towards high-tech production and more developed services sector. The framework conditions for innovation could be strengthened in order to encourage R&D-intensive investment and increase the high-tech content of production and exports.

- *Continuing to upgrade the quality of human capital to improve labour productivity over the long term*

  It will be important to strengthen the links between tertiary education, research and innovation systems. Upgrading the quality of labour force will also help further reducing skills mismatches.

GERMANY

- *Combining fiscal consolidation with ensuring a reallocation of public expenditure towards growth-enhancing items*

  Shifting government expenditure towards growth-enhancing items (e.g. on education, R&D and gross fixed capital formation) and improving the overall efficiency of public spending, would help reconcile the necessary fiscal consolidation with strengthening potential growth.

- *Ensuring a well functioning and stable financial sector while addressing the structure of the banking sector*

  Further stabilisation of the banking sector and securing access to finance, including adequate bank capitalisation, remains a precondition for a sustainable recovery. Successful restructuring of the Landesbanken and strengthening the regulatory and supervisory framework would not only help ensure a well functioningand competitive financial sector but also contribute to a more efficient allocation of domestic savings.

- *Strengthening domestic sources of demand*

  Stronger domestic demand would also help to broaden the basis for economic growth. Sustaining high employment and real income growth, in particular through more buoyant domestic investment, and lowering regulatory barriers for the service and craft sectors could help the economy.

- *Ensuring full utilisation of the economy's labour potential*

  Sustaining the recent trend of more dynamic employment growth and rising labour market participation would help counter the negative effects of demographic change on labour supply and strengthen domestic demand.

- *Improving the contribution of the education system to human capital formation*

  Given the emerging shortages of high-skilled labour, further improvements of the quality and inclusiveness of the educational system remain central in supporting the employability of workers and maintaining the comparative advantage in technology-advanced products.

DENMARK

- *Ensuring a well functioning and stable financial sector also in light of the high indebtedness in the household sector*

Dealing with risks stemming from high household indebtedness underlines the importance of a sound and sustainable financial sector.

- *Addressing the prolonged trend in decreasing labour productivity*

  Danish labour productivity growth has lagged behind most OECD countries for a decade and a half. Reversing this trend is key to improving competitiveness.

- *Ensuring full utilisation of the economy's labour potential*

  In the face of a decreasing population of working age, increasing labour force participation is a key challenge in order to secure fiscal sustainability and financing of the welfare state.

- *Addressing weak competition in parts of the Danish economy*

  Weak competition, especially in the Danish services sector, is a factor causing relatively high prices and insufficient innovation capacity.

- *Improving the cost-effectiveness of education and increasing the completion rates in education*

  Workers of higher qualification better absorb new technology and are less prone to unemployment and other losses of working time. Increasing the educational level of the work force would thus both increase productivity and increase labour supply.

GREECE

- *Implementing the agreed frontloaded fiscal consolidation and thereafter sustaining a large primary surplus to reduce debt level and improving long-term sustainability of public finances.*

  Greece's most pressing challenge is to ensure a swift reduction of its deficit and stabilise its debt dynamics in line with the EU and the IMF recommendations, while improving the management of its public finances in order to deliver pro-growth and cost effective services for businesses and citizens.

- *Strengthening the efficiency and effectiveness of the public administration, achieving a better control of public finances and improving the quality of public finances*

  Improve administrative efficiency by modernising public administration and increasing transparency so as to achieve a better control of public finances and to deliver cost effective public services for businesses and citizens;

- *Ensuring a well functioning and stable financial sector including the safeguarding of banks' balance sheets*

  Re-integration to global markets would flag the Greek government ability to refinance the public debt. Moreover, the safeguarding of banks' balance sheets and fostering sustainable credit growth would boost domestic demand.

- *Ensuring wage and price adjustments to regain and sustain competitiveness, through wage moderation and productivity- and competition- enhancing reforms*

  The structural nature of external imbalances in Greece implies that, in the medium-to-long term, restoring and sustaining competitiveness is a major challenge within the euro area. Competitiveness could be supported by tackling the rigidities in the product and labour markets and promoting innovation. Appropriate wage adjustment could be facilitated through changes to the wage bargaining system and the introduction of minimum entry level wages for groups at risk such as the young and long term unemployed...

- *Reducing the size of the informal economy by facilitating the full participation of all groups in the formal labour markets and, in tandem, improving tax administration.*

  Reducing the size of the informal economy by facilitating the full participation of all groups in the formal labour markets is an important challenge that will require the implementation of a wide range of actions foreseen in the adjustment programme.

- *Overhauling the educational system in order to improve the quality of the country's human capital.*

  An overhaul of Greece's educational and training system, aiming to improve performance and promote accountability will enhance the country's human capital formation.

- *Improving the business environment including by enhancing competition in services and regulated professions*

  The improvement in the business environment, including the opening up of services and network industries, could make significant contribution to Greece's trend productivity and growth.

ESTONIA

- *Avoiding the recurrence of economic and financial imbalances, including by paying attention to credit flows, asset prices and balance sheets*

  After the credit/real estate bubble of 2005-2007, policy measures are needed to ensure that economic actors deleverage in an orderly fashion and that similar imbalances do not recur once growth resumes.

- *Enhancing competitiveness and productivity, primarily in tradable sectors, by assuring cost competitiveness and continued productive investment*

  In the overheating period, competitiveness was eroded as wage growth outpaced productivity growth; however, current ongoing adjustment in costs is benefitting the competitiveness of the tradables sector. Ensuring more productive investment, in particular in export-oriented industries, could raise productivity and support trend growth while sustaining competitiveness.

- *Avoiding high unemployment from becoming structural and ensuring an adequate supply of skills as well as better matching in the labour market*

  In the past, skill shortages and mismatches fuelled wage inflation, while overly buoyant non-tradable sectors lured labour resources. The challenge now is to facilitate reallocation of labour to expanding sectors, before structural unemployment develops and hampers potential growth.

- *Addressing weak aggregate fixed investment, notably in cross-border and internal infrastructure*

  In view of Estonia's low level of capital-deepening, infrastructure investment oriented towards mobility of goods and factors would contribute to business environment and boosting growth.

- *Increasing business R&D to support diversification of the economy and orientation towards high value-added output*

  Improving framework conditions and strengthening the links between tertiary education, research and innovation could contribute to a higher value-added production and services.

SPAIN

- *Reducing the high structural deficit and improving long-term sustainability of public finances*

  The shift to a less tax rich tax-basis economy requires an adjustment of expenditure in all levels of government to this new situation. Dealing with impacts of ageing including higher health care costs and a significant increase in the ratio of retirees per worker is an important challenge.

- *Putting in place a policy framework to address imbalances in the real estate sector and ensuring a well functioning and stable financial sector in light of these imbalances and the high indebtedness in the household sector.*

  The high concentration of loans on the real state sector is at present the main risk for the stability of financial sector, given also the high indebtedness of the private sector. Policy measures to avoid asset prices bubbles, household as well as non-financial sector indebtedness would ensure that similar imbalances do not recur in the future.

- *Facilitating wage and price adjustments and enhancing productivity to regain and sustain competitiveness*

  This implies fostering a change in the economy's production structure towards higher-value added activities, as well as boosting competitiveness in the economy, notably in the non-tradables sector, and enhancing export-oriented activities and the spectrum of exporters. To this end, a challenge is to ensure wage and price adjustment in particular in non-export sectors.

- *Improving the functioning of the labour market in particular as regards labour market segmentation and wage bargaining*

  The low activity rate, mainly among women, limits potential growth while the present high level of unemployment increases the risk of expanding structural unemployment, which would further reduce potential growth. Appropriate reform in the labour market, including inter alia a reduction of segmentation through changes in employment protection legislation, is essential to confront these risks.

- *Ensuring a stronger contribution of the educational system at all levels to human capital formation*

  Low educational achievements and high rates of early school leaving undermine the quality of human capital. The challenge is to solve the educational problems of quality (at secondary and tertiary levels of education) and quantity (at the secondary level), as well as to improve the attractiveness of vocational training.

FINLAND

- *Ensuring the long-term sustainability of public finances particularly in view of population ageing, while boosting productivity in public services*

Productivity advances in the provision of public services, which to a large extent fall under the responsibility of local governments, have been lagging in recent years. Boosting productivity would become increasingly crucial as the imminent population ageing raises demand for related public services and could help ensure supply of labour for the private sector.

- *Addressing vulnerabilities arising from a concentrated industry structure*

  A relatively concentrated industry structure and highly specialized exports renders the economy vulnerable to sector- specific shifts. Diversification could be promoted by enhancing the diffusion of technologies and incentives for resource reallocation, including a wage formation system that would better reflect productivity differentials between companies and industries.

- *Ensuring full utilisation of the economy's labour potential*

  Some segments of the population have traditionally shown a weaker labour market attachment, notably youth, migrants and low-skilled workers. Furthermore, there is scope for extending the length of working careers and for decreasing regional, sectoral and skills mismatches' weight on structural unemployment.

- *Improving competition in services including retail and wholesale trade*

  The lack of competitive pressure in the domestic market, with highly concentrated business structures, is reflected in a relatively high price level. This has adverse consequences for consumers' purchasing power, and crucially also for productivity in the sheltered sectors.

FRANCE

- *Reducing the high general government structural deficit and the high government debt level*

  The sustained increase in the debt-to-GDP ratio following a prolonged period of insufficient consolidation and a significant deterioration in the context of the financial crisis brings about the need for fiscal consolidation. If addressed, a lower interest service could allow for more productive public and private investment, particularly necessary to support growth and boost confidence and allow a decline in the high current saving rate of households.

- *Enhancing external competitiveness and fostering export-oriented activities also by improving the technology positioning of French exports*

  Since 2000, the current account balance is on a deteriorating trend and has implied that net exports have been hampering growth. Improving notably non-price competitiveness will be key to boosting growth so that the French economy relies less heavily on domestic sources.

- *Improving labour market functioning focusing on higher employment rates for different age groups*

  The low employment rate, which reflects the weak activity rate and a persistently high unemployment rate, impacts negatively on potential growth. Improving labour market functioning and employment creation, especially at both ends of the age spectrum and for vulnerable groups and tackling segmentation is a major challenge.

- *Further addressing the weaknesses in the business environment, including the competition framework*

A regulatory framework removing barriers in potentially competitive sectors and being more business-friendly is crucial to raise the economy's growth potential over the longer term and will also reflect in a better external competitiveness.

- *Promoting innovation capacity and business R&D investments as well as strengthening the links between tertiary education, research and innovation system.*

  Evaluating and improving framework to increase business R&D and innovation, especially in small and mid-sized enterprises (SMEs) is a challenge, as well as strengthening the links between tertiary education, research and innovation system. Better targeted private R&D expenditure could stimulate total factor productivity, improve the competitive position of the country and strengthen the labour market.

HUNGARY

- *Reducing the deficit and the high level of government debt while continuing efforts to reallocate public expenditure towards growth-enhancing items.*

  Further steps are needed to reduce the deficit and sustain declining public debt. Moreover, the successful efforts to contain the budget deficit are not fully the result of structural measures and therefore structural reform should be continued.

- *Ensuring a stable and well functioning financial sector by reducing the risk from over-exposure to foreign denominated credit*

  The high level of household debt denominated in foreign currency imposes risks to the solvency of the bank sector, constrains the room for manoeuvre of monetary policy and thus may limit growth opportunities.

- *Ensuring full utilisation of the economy's labour potential, in particular through raising the participation and employment rates*

  Addressing the obstacles that currently persist both on the demand and supply side of the labour market is important in order to boost potential growth and ensure economic convergence.

- *Improving business environment to facilitate the development of a more viable SME sector, and to promote favourable conditions for R&D and innovation activities*

  SMEs have been hindered both by a high level of administrative burden and limited accountability and transparency in public administration and in business. Developing a dynamic business environment could enable Hungary to profit from the potential business opportunities and know-how transfer provided by the large international companies.

- *Improving the contribution of the education system to human capital formation.*

  Improving the quality of the education system, including through better vocational and language training would support growth through a higher employment rate and inclusion of disadvantaged groups notably the Roma minority.

IRELAND

- *Reducing the high general government structural deficit and improving long-term sustainability of public finances*

  As the crisis brought about a double-digit deficit ratio and soaring public debt, continuing to pursue fiscal consolidation would help to boost market confidence, which is a prerequisite for a return to sustainable growth. Together with measures to address the increase in ageing-related expenditure, this would also create room for more productive public expenditure.

- *Ensuring a well functioning and stable financial sector in light of the high indebtedness in the household sector.*

  The high exposure of the financial sector to the collapse of the property development segment and the relatively high share of Irish output accounted for by this sector underline the importance of re-establishing its soundness and well functioning so as to ensure an adequate supply of credit. Facilitating an orderly deleveraging also in the household and non-financial corporate sector in the aftermath of the property bubble would help to limit the dampening effect of deleveraging on domestic demand while avoiding negative feedback effects on credit supply.

- *Ensuring wage and price adjustment to restore and sustain competitiveness*

  Promoting competitiveness will be important to support the return to and sustainability of export-led growth, also in view of the likely subdued domestic demand developments during the adjustment process. At the same time, Ireland's membership in the euro area reinforces the importance e of this adjustment channel.

- *Ensuring full utilisation of the economy's labour potential*

  While there is scope for female participation rates to increase, uncertainty about future migration flows following the downsizing of the construction sector means that insufficient labour supply could become an impediment to growth in the medium term.

- *Supporting the sectoral reallocation of resources towards higher value-added production and services*

  Intensified re-skilling and up-skilling efforts should help to avoid the flow of the large pool of newly unemployed into long-term unemployment and inactivity. Investing for the knowledge-based economy, including in the areas of R&D, ICT and education, while further upgrading physical infrastructure, would support the sectoral shift towards higher value-added activities.

ITALY

- *Consolidating public finances so as to reduce the high government debt*

  The very high government debt highlights the importance of the committed fiscal consolidation. Even though the budgetary impact of ageing in Italy is lower than the EU average, pursuing a durable fiscal consolidation and firmly putting the government debt ratio on a steadily declining path remains nevertheless a key challenge.

- *Ensuring better alignment of wage and productivity developments while increasing productivity so as to restore and sustain competitiveness*

In order to allow wages to better reflect productivity developments, which has been very subdued since the end of the 1990s, there is scope for better balancing wage co-ordination at the national level with appropriate wage adjustment at the decentralized level, including in the public sector. This would also help to address regional imbalances in the labour market.

- *Ensuring full utilisation of the economy's labour potential, by continuing to increase the employment rates of the youth, women and older workers, also with a view to reducing regional disparities*

  Despite considerable progress since the mid 1990s, employment and activity rates of women, youth and older workers remain significantly lower than the euro area average, with large regional disparities.

- *Addressing the weaknesses in the business environment, including the further opening up of services and network industries, and improving administrative efficiency*

  Remaining weaknesses in Italy's business environment and competition policy framework may hamper business activity and entrepreneurship. The regulatory framework still entails lengthy and costly procedures for enforcing contracts, dealing with licences and starting a business; the overall administrative burden on firms is high and the degree of competition in services remains relatively low.

- *Enhancing human capital, also by improving the link between education and the labour market, and promoting innovation capacity to support investment and orientation towards high value-added production and services*

  Encouraging a higher level of expenditure on R&D in the private sector would help to enhance the innovative capacity of firms and ensure the development of high-technology activities. At the same time, addressing the current weaknesses in the education system, including significant regional disparities in outcomes, would provide the skills and human capital that are needed for such move.

LITHUANIA

- *Reducing the high general government structural deficit and improving long-term sustainability of public finances*

  The currently high general government deficit requires considerable consolidation efforts. Moreover, given the Lithuanian demographics and due to the projected increase in pension expenditure, ensuring the longer-term sustainability of public finances is also a challenge.

- *Avoiding the recurrence of economic and financial imbalances, paying attention to credit flows, asset prices and balance sheets*

  After the credit/real estate bubble of 2005-2007, policy measures are needed to ensure that economic actors deleverage in an orderly fashion and that similar imbalances do not recur once the economic growth resumes.

- *Promoting rebalancing of the economy towards the tradable sector and high value-added activities including services, and raising productivity levels*

  Rebalancing the economy towards the tradable sectors will require increases in productivity through higher levels of investment in physical and human capital.

- *Avoiding high unemployment from becoming structural and ensuring better matching in the labour market*

  High unemployment as a consequence of the severe recession reinforces the risks of raising skill gaps vis-à-vis labour demand. The challenge now is to facilitate reallocation of labour to expanding sectors before structural unemployment develops and hampers potential growth.

- *Addressing the weaknesses in the business environment, ensuring adequate access to finance for companies with a view to favour productive investment and adequate inter-connected energy grids.*

  Fostering a dynamic and competitive business environment could provide an important boost to trend growth including through adequate credit access for viable businesses, with the support of EU structural funds, underpinning the necessary rebalancing of the economy.

LUXEMBOURG

- *Reforming the pension system in order to ensure the long-term sustainability of public finances in view of the population ageing*

  The increase in age-related public expenditure in Luxembourg up to 2050 is projected to be the strongest in the EU and will essentially be the result of the generosity of the pension system. Reforming the pension system is thus a major challenge for sustaining potential growth in the longer term.

- *Ensuring a well functioning and stable financial sector, in particular through enhanced European and international cooperation in regulation and monitoring*

  The financial sector has played a very important role in sustaining high growth rates and it will be important to ensure its well functioning and stability while also identifying other sources of growth. One aspect that could be useful in this process is to enhance international cooperation in regulation and monitoring.

- *Ensuring full utilisation of the economy's labour potential, in particular among the unemployed, the young and older workers*

  The employment rate of residents is low at both ends of the age spectrum because youth unemployment is higher than the EU average and the pension system provides very high replacement rates and often allows workers to retire before the statutory pension age. Raising labour supply could have important contribution to potential growth and public finance sustainability in the medium term.

- *Improve the contribution of the education system to human capital formation*

  Addressing weaknesses in the educational system will remove an important handicap for residents in the quest for jobs.

LATVIA

- *Reducing the high general government structural deficit.*

  As a condition for receiving Balance of Payments assistance, Latvia has committed itself to achieving the Maastricht budget deficit target by 2012. The authorities' commitment to reach this goal will be crucial for Latvia to regain and maintain access to international financing at reasonable rates and avoid a further accumulation of debt.

- *Ensuring a well functioning and stable financial sector in the light of the ongoing deleveraging of the private sector.*

  After the very marked lending boom, the household and corporate sectors are indebted, which puts a drag on consumer spending and the investment needed to kick-start growth, while representing a risk to the banking sector. Moreover, avoiding a recurrence of asset price bubbles would ensure a sustainable price level convergence.

- *Promoting rebalancing the economy towards the tradable sectors and raising productivity levels*

  In the boom years the tradable sector was largely neglected, losing much of its competitiveness. For Latvia to be able to gain new export markets and produce more innovative products, productivity and skill levels need to be raised significantly.

- *Avoiding high unemployment from becoming structural and ensuring better matching in the labour market*

  Latvia has the highest unemployment rate in the EU. Long-term structural unemployment could damage the skills and motivation of the labour force resulting in further emigration.

- *Addressing the weaknesses in the business environment, ensuring efficient use of EU structural funds and adequate access to finance for companies with a view of favouring productive investment*

  The banking system experienced severe losses and asset impairments in the downturn, and current lending practices are extremely cautious. Fostering dynamic business environment could provide an important boost to trend growth.

MALTA

- *Ensuring the long-term sustainability of public finances in view of ageing of population*

  The impact of demographic ageing in Malta on age-related expenditure is projected to be one of the most significant in the EU, both in health care and pensions. This challenge is amplified by low employment rate of older workers.

- *Ensuring the alignment of wages and productivity growth to sustain competitiveness*

  Protecting competitiveness is important for a very small and very open economy like Malta's. A more efficient and flexible wage setting process could contribute to competitiveness allowing better alignment of wage and productivity developments including in the public sector. Malta's membership of the euro area reinforces the importance of this adjustment channel.

- *Support the diversification of the economy and a further move to higher value-added activities by raising investment in new areas of growth*

  Encouraging further diversification of Malta's economic base towards the high value-added segment of production would help Malta reduce its reliance on tourism and manufacturing of electronics. Investing further in renewable energy sources as a new area of growth would offer the additional benefit of reducing Malta's high dependency on imported oil for energy.

- *Ensuring better utilisation of the economy's labour potential, in particular that of women and older workers, and improving the skills base of labour force*

  Malta's low employment rate stems from very low female and older worker participation rates, which in turn may reflect a wide range of institutional features, such as childcare provision, education and training policies and retirement arrangements. Improving labour supply and the skills base of the labour force, particularly targeting the skills required to boost R&D and innovation and facilitate a further shift towards higher value-added sectors, is important for boosting potential growth.

- *Addressing the weaknesses in the business environment and enhancing competition*

  The small size of Malta's economy lends itself to market imperfections, leading to high mark-ups in certain sectors and calling for an enhanced role of the competition authority. Lowering administrative and regulatory burdens could also make Malta a more attractive investment location.

THE NETHERLANDS

- *Ensuring the long-term sustainability of public finances in view of population ageing*

  The impact of the ageing population is significantly above the EU average, due to relatively high increases in both pension and long-term care expenditure, leading to high risks to the sustainability of public finances.

- *Ensure a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy*

  The relatively large and open Dutch financial sector was hit hard by the crisis, triggering a wide range of government interventions. The risks to the stability of the financial sector have not fully disappeared and require close monitoring of cross border activities and the supply of credit.

- *Strengthen the sources of domestic demand*

  Structural reforms promoting private investment and consumption would help raising the economy's growth potential over the longer term.

- *Ensuring full utilisation of the economy's labour potential*

  The total amount of hours worked in the Netherlands is one of the lowest in the EU, partly resulting from financial disincentives to work more hours.

- *Promoting innovation capacity to support investment and orientation towards high value-added production and services*

  Private Dutch R&D and innovation expenditures are relatively low. The underperformance of the Netherlands in this area may negatively affect future economic growth and the competitiveness of the Dutch economy. Addressing this challenge will trigger positive spillovers throughout the economy.

POLAND

- *Reducing the high general government structural deficit and ensuring a reallocation of public expenditure towards growth-enhancing items including infrastructure*

The structural deficit was high also during good times and it increased during the crisis. Reducing it, including through reforms to enhance the quality of government spending, is a major challenge for the short and medium run.

- *Addressing weak aggregate fixed investment, including in the transport and energy infrastructure*

  The underdeveloped transport infrastructure is a key obstacle to investment. Invigoration of physical infrastructure would help reducing regional disparities ensuring territorial cohesion and boost potential growth. The existing energy network is outdated and inefficient.

- *Addressing high regulatory and administrative burden and accelerating financial deepening in order to further improve the business environment*

  The inefficient and burdensome public administration, including procedures for starting businesses, and underdeveloped financial sector, in particular corporate debt market, undermine growth and competitiveness.

- *Further improving the functioning of the labour market notably by addressing the low participation rate*

  Labour force participation is low, especially on both ends of the working age distribution. In view of unfavourable demographic developments, improving labour market participation and performance is a priority for the coming decade. It will also be important to improve mobility of labour across regions and sectors.

- *Promoting innovation capacity to support investment, diversification of the economy and orientation towards higher value-added production and services by strengthening the links between tertiary education, research and innovation system*

  Insufficient links between businesses and public research institutes and skill mismatches hamper the innovation capacity of the economy. Strengthening the knowledge triangle is therefore an important challenge.

PORTUGAL

- *Reducing the high government structural deficit in line with fiscal commitments in the context of the Stability and Growth Pact while ensuring a reallocation of public expenditure towards growth-enhancing items*

  Following the rapid decline in tax revenues and increase in public spending as a share of GDP brought about by the current crisis, rebalancing the government budget is a challenge both for the immediate and longer term. Expenditure developments call for particular attention in order to ensure their sustainability in a context of low GDP growth over the medium term and of high and rising government debt.

- *Dealing with the risks stemming from the high levels of indebtedness of the non-financial sector and ensuring a stable and well functioning financial sector*

  The negative feedback loop from real economy to the financial sector is another main type of risk to financial stability, which is heightened in the case of Portugal by higher-than-average debt levels and subsequent pressure for deleveraging. Household sector deleveraging is needed and will be an important challenge, especially as interest rates begin to rise.

- *Ensuring wage and price adjustment to regain and sustain competitiveness*

  Promoting competitiveness will be important to support the return to and sustainability of export-led growth, also in view of the likely subdued domestic demand developments during the adjustment process. Cost competitiveness as well as promoting wage moderation and flexibility have an important role to play in this respect.

- *Improving labour market functioning by tackling in particular labour market segmentation and fostering flexibility*

  Labour market functioning can be improved by reducing the duality of the labour market and by allowing for more flexibility in working arrangements to accommodate heterogeneity of production and work specificities.

- *Improving the contribution of the education and training systems to human capital formation with a view to support the restructuring of the economy towards higher value-added production and services*

  To raise productivity growth allowing the catching-up of the Portuguese economy, it is necessary to address weaknesses of a more structural nature, including the relatively low levels of formal education of the labour force and the low educational achievements of current students. This makes the enhancement of the human capital factor by means of improving the efficacy and effectiveness of education and training systems an important challenge.

ROMANIA

- *Reducing the high general government structural deficit while generating a reallocation of public expenditure towards growth-enhancing items including infrastructure and ensuring long-term sustainability of public finances in view of the population ageing*

  The structural deficit was persistently high during good times and increased further during the crisis. Its reduction is important also in a long-term perspective and could be supported by reforms of pension and healthcare systems as the country faces a major demographic challenge. Within the context of the BoP assistance program, Romania has agreed to take further consolidation measures aimed at further sizeable reduction in the structural deficit.

- *Strengthening the efficiency, effectiveness and independence of the public administration, including the absorption capacity of EU structural funds*

  Important reforms are needed in public administration to limit tax evasion, improve absorption of EU structural funds, strengthen the regulatory environment, and increase efficiency of the public sector

- *Ensuring a well functioning and stable financial sector, in particular by continuing to ensuring sufficient buffers in the banking system to face direct and indirect credit risks*

  The Romanian banking sector faced stress at the beginning of 2009, reflecting negative balance sheets effects from the depreciation of the RON given the high share of foreign-denominated loans.

- *Further improving the functioning of the labour market especially as regards wage bargaining*

  The system of collective bargaining at national level, which is regulated by law and sets national minimum pay and conditions applicable to all employees, has been a drag on competitiveness and growth, affecting particularly young and long-term unemployed.

- *Ensuring a stronger contribution of the education system at all levels to human capital formation*

  Romania's performance in terms of primary and secondary education is poor relative to other EU countries, which is slowing the transition of the economy and, more generally, the real convergence process.

SWEDEN

- *Ensuring a well functioning and stable financial sector, facilitating deleveraging of the household sector*

  Strengthening the financial and supervisory framework and dealing with the risks stemming from a high and rising level of household sector indebtedness, which is contributing to rising house prices, are important challenges.

- *Avoiding high unemployment from becoming structural and improving labour market inclusiveness*

  It is important to promote a quick absorption of unemployment in the wake of the recession, which could lead to weakening of human capital and hysteresis effects. In the longer run it is crucial to make use of the full potential of the labour supply by raising the inclusiveness of groups with a currently loose connection to the labour market, such as young persons and immigrants.

- *Addressing weaknesses in the business environment, including by increasing competition*

  Challenges stemming from shortcomings in the level of competition in some areas, such as markets where private and public companies compete with each other and in public procurement, are important and could be addressed by effectively making use of the new powers granted the Competition Authority.

- *Promoting innovation capacity by strengthening the links between tertiary education, research and the corporate sector*

  Addressing the issues concerning converting large investments in R&D into growth-enhancing productive innovations, including by improving the attitude towards entrepreneurship, could help boost potential growth in the long run.

SLOVENIA

- *Reducing the general government structural deficit and ensuring the long-term sustainability of public finances, particularly given population ageing in particular through reforming the pension system.*

  The old-age dependency ratio and consequently pension expenditure are projected to increase significantly over the coming decades, posing a risk for the long-term sustainability of public finances, especially given the currently low employment rate of older workers. The high general government deficit in 2009 compounds the budgetary impact of population ageing on the long-term sustainability challenge.

- *Enhancing flexibility while tackling segmentation in order to improve labour market functioning and ensuring a better alignment of wages and productivity.*

  Employment protection for workers with permanent contracts is higher than for workers with fixed-term contracts. In addition, "student work" constitutes a largely unregulated labour market.

- *Increasing competition in the service sector and addressing other weaknesses in the business environment*

  A range of difficulties in the business environment gives rise to inefficiencies and elevated business costs, particularly for SMEs. This includes high mark-ups and high concentration in certain services sectors, impediments to getting credit and registering property and gaps in transport infrastructure.

- *Promoting innovation capacity and increasing overall R&D investments*

  R&D expenditure in Slovenia still lags behind the EU level and is relatively inefficient while employment in high-tech sectors and the share of innovative SMEs remain low.

- *Refocusing human capital investment, especially in tertiary education, on higher value-added activities*

  Tertiary education is insufficiently oriented towards emerging labour market needs and the restructuring of the economy. Furthermore, it operates with relatively low staff/student ratios.

SLOVAKIA

- *Reducing the high general government structural deficit and ensuring long-term sustainability of public finances in view of the population ageing*

  The significant structural deficit persisted during good times and increased further during the crisis, also taking into account some uncertainty regarding potential output. Expected growth of age-related expenditure, especially in the health sector, poses an additional challenge in the longer term.

- *Ensuring reallocation of public spending towards growth-enhancing items, including education, R&D and infrastructure*

  The share of spending in growth enhancing items, in particular R&D, education and capital expenditure is low in Slovakia compared to its peers. Increasing their share would support real convergence of the economy, given diminishing scope for technological catch-up.

- *Implementing the necessary reforms to ensure better quality of public spending and in particular that the additional expenditure for education and R&D are used efficiently*

  There are inefficiencies in Slovakia's education and R&D systems. Addressing them, in particular by strengthening links between research and business sectors, and refocusing education towards labour market needs would support potential output.

- *Ensuring wage and price adjustment to sustain competitiveness, while improving the business environment*

  The rapid appreciation of the Slovak REER over the recent years points to a need for careful monitoring of relative prices and costs vis-à-vis Slovakia's competitors. Improvements in the business environment would help maintain competitiveness.

- *Ensuring full utilisation of the economy's labour potential, by tackling the long-term unemployed and marginalised groups*

Unemployment, including long-term unemployment, remained high even during the economic boom. Structural problems on the labour market need to be addressed.

UNITED KINGDOM

- *Reducing significantly the high general government deficit*

  Following the rapid decline in tax revenues and increase in public spending as a share of GDP brought about by the financial crisis, rebalancing the general government budget is a challenge both for the immediate and longer term.

- *Ensuring a well functioning e and stable financial sector capable of meeting the financial intermediation needs of the real economy*

  Both the relatively high share of UK output accounted for by the financial sector and the large capital flows required to fund a rebound in private investment underline the importance of re-establishing a sound and sustainable financial sector framework.

- *Ensuring that constraints on growth posed by household and government sector indebtedness are countered by a rebalancing towards net exports*

  Household sector deleveraging and fiscal consolidation are likely to limit growth in the short to medium term, but sterling's depreciation since 2007 should be conducive to minimising the resulting output loss by both reducing import growth and boosting UK exports.

- *Facilitating an increase in aggregate fixed private investment*

  In view of the UK's typically low rates of capital deepening, a lasting reinvigoration of fixed capital accumulation could provide an important boost to trend growth.

- *Improving the contribution of the education system to human capital formation including through a broader skills base*

- Weaknesses in the lower and intermediate skilled segment of the labour force make the broadening of access to opportunities to develop such skills an important challenge.Combining fiscal consolidation with a reallocation of public expenditure towards growth-enhancing items while addressing fiscal relations between different layers of government.

Part II

Commission Country Fiches on National Bottlenecks to Growth

1. BELGIUM

1.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Belgium has been hit hard by the global crisis: the fall in world trade had a strong impact on the country's small open economy, while the financial crisis and the problems in the banking system triggered a tightening of lending conditions and a fall in confidence and financial wealth, which depressed domestic demand. The government responded to the crisis with a fiscal package that was relatively limited in view of the limited fiscal space. In addition, sizeable banking sector rescue measures were adopted.

The evolution of world trade will be important for Belgium's economic recovery in the medium term, given the importance of exports in the economy. Domestic demand is foreseen to recover from the second half of 2010, in the wake of the improvement in the labour market. In this context, GDP is projected by the Commission services Spring 2010 forecast to expand by 1.3% in 2010 and by 1.6% in 2011. In the long term, Belgium's GDP growth potential is projected to decrease to 2.3% in 2015 and 1.9% in 2020 from 2.5% in 2007 in the wake of the slower increase of employment. In view of the relatively smaller contribution from labour to potential growth in the pre-crisis decade in Belgium, policies aiming at increasing the employment rate at both ends of the age spectrum as well as increasing the average hours worked will be essential. The contribution of total factor productivity and especially labour productivity to potential growth was smaller than in the EU as a whole, which suggests that a challenge will be to promote innovation and education. In the very long term to 2060, potential growth in Belgium is projected to remain at the level of 1.7% p.a., higher than in the EU as a whole, owing mainly to population growth. ([5])

([5]) European Commission, (2009), *The 2009 Ageing Report*, European Economy, 2.

1.2. MACROECONOMIC FRAMEWORK CONDITIONS

1.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, in the late 1990s the fiscal stance was restrictive and thereafter it was geared towards attaining a balanced budget, mainly with a view to decreasing the very high government debt level. As a result, the debt-to-GDP ratio declined from 134% in 1995 to less than 85% in 2007. This impressive decrease was reversed as the global financial and economic crisis began to take its toll on the Belgian public finances, with the budget deficit deteriorating rapidly to 6% of GDP in 2009, partly due to the operation of automatic stabilisers but to a lesser extent also the implementation of the ½% of GDP fiscal stimulus package as well as strong primary expenditure growth. Moreover, the debt ratio increased sharply to almost 97% of GDP as a consequence of the significant government operations to stabilise financial markets. A swift reaction from the government, leading to the implementation of a consolidation package, together with an improved economic outlook, should lower the deficit to 5% of GDP in 2010 and, without further measures, the deficit is expected to stabilise at that level in 2011, whereas the debt ratio is foreseen to surpass the 100% again in that year. Such a high debt ratio is problematic, not only for the sustainability of public finances, but also for growth dynamics.

For the medium term, it is important for Belgium to ensure an adequate budgetary consolidation strategy, which will lead to the correction of the excessive deficit in 2012. This would also contribute to put the gross debt ratio on a downward path. Furthermore, the quality of public finances would benefit from the adoption of a more stringent budgetary framework, encompassing the creation of enforceable, multi-annual expenditure ceilings. For the longer term, ensuring the long-term sustainability of public finances in view of the high government debt level and population ageing is essential, since the long-term budgetary impact of ageing is clearly higher than the EU average, mainly as a result of the relatively high increase in pension expenditure expected over the coming decades. Reforms in the pension system could reduce its cost and also support labour supply through an increase in the effective retirement age. In addition, further consolidation of public finances and reform of the social security system would help to address this challenge.

1.2.2. Macro-financial stability

Regarding macro-financial stability, the Belgian banking sector is highly concentrated, with the four largest banks having a market share of over 80% in most market segments. These banks are also very active abroad and their balance sheets are big compared to Belgium's GDP (over 300%). In response to the global crisis, the Belgian government provided very significant help to the sector, through capital injections and other support, amounting to around 6% of GDP. There is also a guarantee, in return for a fee, of certain types of debt issued by large banks and part of future losses these banks may potentially incur on their portfolios of risky assets, which represents 9.3% of GDP. The problems in the banking sector have depressed domestic demand chiefly through confidence and wealth effects and through a tightening of lending conditions.

The recapitalization of banks and the improvement of balance sheets are still ongoing. The risk of a weak recovery due to insufficient credit warrants a close monitoring of the situation. A critical moment will be the exit from government support schemes, as adverse effects on credit could materialise. Ensuring a viable and stable financial sector capable of meeting the financial intermediation needs of the real economy is crucial for the Belgian economy. The financial situation of the banking sector remains fragile, which given its size in the economy, underlines the importance of re-establishing a sound and sustainable financial sector framework.

Another challenge is related to Belgium's relatively high exposure to sovereign debt, both mature Western and Central-Eastern European markets. To enhance risk monitoring and prevention, the ongoing reorganisation of the Belgian supervisory authority is important. Housing prices have increased significantly in recent years and may be somewhat overvalued relative to average incomes.

1.2.3. Current account and competitiveness position

Turning to issues related to the current account and competitiveness, external demand addressed to Belgium has expanded considerably less than world trade over the past years. This has resulted in a structural loss of market share for Belgian exports.([6]) These developments mainly concentrated in the goods balance, which evolved from a 4.8% of GDP surplus in 2002 to a 1.6% of GDP deficit in 2008. Based on this performance, it is uncertain whether the country will be able to fully benefit from the rebound in world trade.

The performance of exports suggests a challenge concerning geographical and sectoral specialisation. Belgian exports are mainly oriented towards other euro area countries, whose import growth has been considerably lower than world trade growth in recent years, and they show a specialisation in medium-technology goods that are easy to imitate, such as chemicals and steel. In addition, relatively high unit labour costs have a negative impact on exports; these are prompted by strong increases in wages, notably as a consequence of the wage bargaining system and its outcome. Efforts in innovation and R&D will be key for the country's competitiveness, especially in relation to the pressure from low-cost countries. Export growth would be supported by facilitating technological upgrading and specialisation in products and services with a higher technological content through focussing on key sectors such as biotechnology and health care and improving R&D intensity, as well as improving the business environment.

1.3. GROWTH DRIVERS

1.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. After having

([6]) The current account balance improved between 1981 and 1994, reaching a record surplus of 5.6% of GDP in the latter year. After a period of fluctuations around 5% of GDP, the current account balance started to deteriorate from 2003 onwards, with the surplus shrinking to 0.5% of GDP in 2009 (after a deficit of 2.9% in 2008). Note that these numbers follow the Balance of Payments approach, i.e. looking at cash-flows.

been on a decreasing trend for several years, the unemployment rate began increasing again in the third quarter of 2008. It is now at 8.1%, i.e., 1¼ pp. above its lowest point, and expected to continue rising in 2010 (up to 8.8%). Employment fell in 2009, in a context of a broadly stable inactivity rate. The negative impact of the labour market deterioration on gross disposable income was cushioned through benefits payments acting as an automatic stabiliser, but such transfers are unlikely to grow further in the current situation of a continuing deterioration of the labour market.

Despite a number of reforms in the last decade, the long-term unemployment rate is among the highest in the EU, reflecting structural problems stemming from large financial disincentives to take up work, a high tax wedge on labour, the virtually unlimited unemployment benefit duration, a wage setting mechanism producing high degree of real wage rigidities and low job mobility. Therefore, further progress with wage moderation and incentives to labour supply and demand by addressing the benefit system and the tax-wedge would contribute to higher potential output. Additional measures should aim at improving the functioning of the labour market notably by addressing the high differences in labour market performances across regions, age groups, and ethnic/national status. One of the peculiarities of the Belgian labour market is indeed the coexistence of high and low employment areas in Belgium, important employment and unemployment rate gaps between EU born and non-EU born or with a migration background, a high number of job vacancies and low labour mobility (notably across regions), wage rigidities which depress labour demand especially for workers with a lower productivity. Early retirement schemes remain pervasive and implicit taxes on continued work are high driving down the employment rates of the elderly people. Enabling older workers to remain active is crucial to support the economic recovery and to preserve the long-term sustainability of public finances. The top-down determination of wages, with a prominent role of wage indexation and the "wage norm", limits the response of wages to local labour market developments. In addition, the high statutory or conventional minimum wage (with no differentiation by region) depresses labour demand especially for low-skilled and new entrants in the labour market (despite some differentiation in the minimum wage by age and by sector).

1.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Belgium's competition and business environment seems to be broadly in line with the EU average ;([7]) however, it is characterized by a high administrative burden at all levels of administrations and weaknesses in the competition framework. In particular, there remains room for addressing the weaknesses in the business environment by improving the regulatory framework and promoting competition, notably in retail, network industries and professional services. According to the OECD, aligning sectoral regulation in retail trade, electricity and gas and professional services with international best practice would boost labour productivity in the entire economy by 16%.([8]) Moreover, the resources of the competition authority are low compared to other small economies. Public investment in infrastructure (notably transport and energy infrastructures) is important for increasing productivity and attracting foreign investments and has been low in recent years. Lastly, the consolidation of public debt will be helpful in view of avoiding crowding out of private investment.

1.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. The level of R&D spending as a percentage of GDP has been on a decreasing trend since 2001 (2.1%), reaching 1.9% in 2008, mainly due to developments of business investment. Conversely the share of public expenditure on education is relatively high compared to the EU average. The

([7]) See for instance The International Bank for Reconstruction and Development / The World Bank (2010), Doing Business 2010, and European Commission (2008), *The LIME assessment framework (LAF): A methodological tool to compare, in the context of the Lisbon Strategy, the performance of EU Member States in terms of GDP and in terms of twenty policy areas affecting growth*, European Economy. Occasional Papers. 41.

([8]) Belgium's figure is the highest in the 9 countries included in the study. Since the OECD survey, a number of reforms have been implemented in the Belgian retail sector. OECD (2009), *Belgium*, Economic Surveys, 12.

Belgian education system is characterised by a high share of people leaving the education system with at least a secondary qualification; still, the quality of secondary education seems to have deteriorated as witnessed by the declining average PISA scores, whereas the EU15 has increased. Moreover regional differences are noticeable and entail diverging trends in the quality of the educational system.

Underperformance in R&D and education coincides with insufficient total factor productivity. Over the last years, the latter even contributed negatively to GDP growth. It is therefore important for Belgium over the next years to increase the overall level of the spending in R&D as a percentage of GDP in order to foster innovation. Given the strong public finance constraints, the focus will be on promoting an environment favourable to innovation in which private R&D is encouraged by non-fiscal incentives. Moreover, while the devolution of the Belgian R&D to sub-federal level of government has the advantage to better adjust policy to the local needs, it implies risks that a critical mass is not met. In addition, as more than half of the business R&D expenditure is under control of foreign firms,([9]) the reinforcement of factors that could better attract foreign FDI will be a challenge. In this respect, an increase in the efficiency of the educational system could play an important role.

([9]) Peter Teirlinck (2009), Foreign direct investment in business R&D in Belgium in comparison with other EU Member States: statistical overview and policy making, R&D and Innovation in Belgium Research Series, 10.

2. BULGARIA

2.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Bulgaria entered a recession in the first quarter of 2009, following a decade of strong economic growth exceeding 5% on average, macroeconomic stability and high FDI inflows. However, the rapid expansion was accompanied by a sharp rise in the current account deficit, increasing inflation and growing private sector indebtedness. Fiscal policy was counter-cyclical for most of the pre-crisis decade, contributing to an average cyclically-adjusted general government balance of +0.1% between 2003 and 2008.

Going forward, the economy is expected to recover slowly and gradually, under the impact of the international cycle. Output is expected to stagnate in 2010 and to pick up only gradually to an annual rate of 2.7% in 2011. While the magnitude of the recovery might be slightly higher than in other EU countries, growth in the medium term is expected to remain well below the pre-crisis average, thus temporarily slowing the catching-up process.

In the long run, at around 2% during the period 2010-2020, the economy's growth potential is projected to be weaker than its 2000-2008 average of 2.4%. Looking beyond the year 2020, long-term potential growth in Bulgaria is expected to be lower than the EU27 average and to fall below 1% p.a., mainly as a result of a projected decline in the size of the labour force.([10])

2.2. MACROECONOMIC FRAMEWORK CONDITIONS

2.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Bulgaria has consistently achieved high budget surpluses during the past economic good times and accumulated large fiscal reserves, reflecting buoyant economic growth and considerable revenue windfalls. There was a decline in the government expenditure-to-GDP ratio as well as an expenditure restructuring towards more growth enhancing items, such as capital outlays. As a result of the downturn the budgetary balance swung from a surplus of 1.8% of GDP at the end of 2008 to a deficit of 3.9% of GDP on an accrual basis at the end of 2009.

In the medium-term the budgetary strategy should aim at correcting the excessive general government budget deficit by 2011, while preserving and enhancing the longer-term growth potential of the economy. The achievement of the fiscal targets would require considerable and frontloaded fiscal consolidation. However, given the pressing need to improve the public infrastructure, it would be important to sustain public sector investment. In the longer term, the budgetary strategy implies that the debt-to-GDP ratio would decrease enough to allow reaching a net asset position by 2020, while the budgetary impact of an ageing population is below the EU average. In order to ensure the long-run sustainability of public finances and increase the efficiency of government spending, the reforms in the pension and health care systems need to be further addressed, also in view the current deficits of the systems. All in all, improving the efficiency of public spending and ensuring a reallocation of public expenditure towards growth-enhancing items will secure favourable macroeconomic framework conditions for sustainable growth.

2.2.2. Macro-financial stability

Regarding macro-financial stability, the Bulgarian banking system is competitive, with a strong foreign presence. The five biggest banks have a market share totalling 58%, with the first bank alone representing 15% of the domestic market. Foreign ownership is above 80%, with Greek, Austrian and Hungarian owned banks having the highest market shares. Banks are dominating the credit market, where leasing companies and non-monetary credit granting companies provide around 10% of total credit. During the crisis the financial sector remained rather stable but the credit expansion decelerated markedly. Banks' loan portfolios are slowly but progressively deteriorating, mostly with respect to consumer

([10]) European Commission (2009), op. cit.

loans to households and other purposes. Mortgage loans continued to increase in 2010 with relatively low rates of non-performance as most of them were given to first time buyers. After the outbreak of the crisis, banks have proceeded with recapitalisations that resulted in an increase of the capital adequacy ratio to more than 17% at the end of 2009.

In long term, it would be important to ensure that the financial sector remains viable and stable as a precondition for a sustainable development of the economy. Although the sector remained profitable during the crisis, non-performing loans are still increasing and the build-up capital buffers might be needed to absorb the losses. In addition, the relatively low level of financial development highlights the scope for potential growth of the sector, which if sustainable, could be very important for enhancing the catching up-process of the country. Its good functioning and efficiency could be enhanced by further development of the capital markets and a more market-based and trade-oriented financial intermediation (i.e. by developing further the export insurance schemes) as well as by continuing the implementation of strict banking supervision, proactive and countercyclical measures and ensuring competitive bank behaviour.

2.2.3. Current account and competitiveness position

Turning to issues related to the current account and competitiveness, Bulgaria, as a small open catching-up economy, was characterised by high ratios of imports and exports to GDP and large external deficits in the pre-crisis period, reflecting a gap between low savings rates on the one hand and large investment opportunities (and needs), on the other. The current account deteriorated and the deficit reached 26.8% of GDP in 2007. This largely reflects the progressive worsening of the balance of trade in goods, whereas the services balance has maintained a small surplus over the past decade. The overall increase reflects uneven developments in exports and imports. While in the pre-crisis period exports increased on average by 10% per year, imports rose even faster, reflecting buoyant and sustained domestic demand and strong FDI-driven investment. Since the mid-1990s, the share of services in both exports and imports has been on a declining path, partly reflecting the more moderate contribution of the tourism industry.

The unwinding of the external imbalances that started as a result of the crisis is projected to continue and the current account deficit is expected to decline further. While in 2009 these dynamics were driven by imports declining faster than exports, in the medium-term the correction would be a result of exports picking up faster and earlier than imports. After a sustained rise in 2000-2005, the trend of market share expansion was temporarily reversed in 2006 and 2007. This might be partially explained by the acceleration in wage growth and the corresponding deterioration in the economy's cost competitiveness. In addition, the economy's relatively high degree of specialisation in low-to-medium technological goods (such as metals, chemical products, clothes and textiles), which experience strong international competition, makes Bulgarian exports particularly sensitive to price-induced changes in external demand. Over a longer horizon, the further rebalancing of the external accounts and the sustainability of the improvements could largely depend on the economy's price and cost competitiveness and its ability to shift from the non-tradable towards the tradable sector.

2.3. GROWTH DRIVERS

2.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. In the decade leading up to the crisis Bulgaria witnessed strong employment growth of above cumulated 15%, albeit most of it was directed towards the non-tradable and services sectors (i.e. construction, financial intermediation, real estate and retails). Agriculture and forestry recorded big declines of wage and salary earners. However, this was more than compensated by a massive increase in the employed persons in construction and services (by almost 90% and 22%, respectively, between 1999 and 2008. Moreover reductions in labour supply resulting from massive emigration have had a negative impact on potential growth. The recession-driven fall in employment was due to a large extent to structural factors and the decline in the construction and real estate sectors. After the end of the crisis shortages of skilled workers in the services and industry sectors are likely to emerge again, especially with respect to new skills and technologies following the changing economic structure, despite the satisfactory level of educational attainment. Furthermore, opportunities for increasing youth participation in the labour market and combining education and work should be further developed and expanded as the youth activity rate remains far below the EU average. Given the importance of labour market developments, stepping up of structural reforms could raise labour productivity, labour participation and skills to levels that better match labour market needs.

In the longer run, with one of the lowest productivity levels in the EU 27, Bulgaria faces the challenge of ensuring better and more efficient utilisation of the economy's labour potential, while further increasing its quality. Raising participation rates would boost catching-up and potential growth. In the context of the current economic downturn, there is a pronounced risk that increasing unemployment becomes structural. The risk of hysteresis could be tackled by enhancing matching in the labour market and further upgrading the skills of the labour force.

A further challenge is also the significant share of the informal economy. Undeclared work is estimated to account for 22-30% of the GDP and to employs one-fifth to one-quarter of all employees. This is due to a large extent to various administrative and regulatory rigidities which hinder labour market adjustments and job creation. The lack of flexibility is likely to further contribute to high labour market segmentation as rigid transitions and inflexible work opportunities reduce incentives to take up regular employment.

2.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Despite certain progress in improving the business environment and start-up conditions, Bulgaria is still lagging behind the best performers in an EU and world comparison.([11]) There still remains scope for progress to cut red tape which would help in further improving the business environment and effectively fighting against corruption. The effectiveness and efficiency of public administration remain key bottlenecks to growth in Bulgaria. Improvements in this area could lead to better investment environment and higher absorption of EU funds, thus improving the growth outlook. In particular, the efficiency and effectiveness of public administration could be strengthened further by focusing on key government functions, including the competition, supervisory and regulatory authorities, as well as the judiciary, while continuing taking all necessary measures to ensure effective financial controls and sound management of structural funds. At the same time, the authorities should abstain from restructuring the public administration without basing such decisions on a thorough and independent functional analysis of the administrative structures.

Despite some improvement, public infrastructure needs further development, so that it does not become a bottleneck to growth. In the period 2006-2009 public investment was consistently maintained above 4% of GDP, despite a tendency in the past to cut public capital expenditure and spending on operations and maintenance at the expense of rationalisation in other more rigid budget areas when fiscal tightening has been necessary. Such cuts could potentially lead to serious deterioration in the quality of basic public infrastructure, which could become detrimental to the growth prospects of the country. Financing through the EU structural funds could support boosting public investments even in a phase of fiscal consolidation. Historically low levels of capital endowments and total factor productivity are the main explanatory factors for the low per-capita incomes in Bulgaria, and their considerable improvement is the factor that contributed the most to the above average growth performance before the crisis.

([11]) See for instance World Bank (2010), op. cit and European Commission (2008), op. cit.

2.3.3. Knowledge Base (R&D, innovation and education)

Major drivers of total factor productivity growth are also policies in the area of R&D, innovation and education which support the knowledge base. The performance of Bulgaria in generating investment in R&D and fostering innovation has been weak in the pre-crisis decade and the country has been behind other Member States with respect to almost all indicators. The level of public spending on R&D is considerably below the EU average. Most public R&D expenditure is allocated for salaries and social security contributions, while only 10% of them are invested in capital goods and R&D equipment. The financial crisis has negatively impacted on the level of R&D investments, although less so than that of tangible investment. In the medium-term, it could be useful to direct policies towards recovering the pre-crisis R&D intensity and improving the effective allocation of public spending on R&D, including through increasing the share of funding based on competition.

With respect to education and training, secondary school dropout rates are relatively high, while tertiary education participation rates tend to be relatively low. Major problems with educational mismatches in the labour market also highlight that the education and training system is insufficiently aligned with labour market needs. This supports the usefulness of an educational reform and a strategy of increasing the knowledge base, in which greater educational inclusion and an upgraded skills strategy go hand in hand. Given the potential of the human capital to help shift Bulgaria's pattern of comparative advantage from primarily low value added and labour intensive industries to those with higher value added and contribute thus to real convergence, there is a challenge to ensure that the education system contributes more to human capital formation.

3. CZECH REPUBLIC

3.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Following several years of buoyant growth, the highly open and strongly integrated Czech economy, was hit by the global crisis, with the dramatic collapse in trade playing a major role. This has translated into a deep recession of the manufacturing sector. The automotive industry, which accounts for around 16% of Czech total exports, was particularly affected. The slump in economic activity of 4.2% of GDP in 2009 forced labour market adjustments. The economy started to recover from the recession in the third quarter of 2009 supported by the stimulus measures implemented internally and abroad. Due to the temporary nature of a number of measures implemented in Europe (i.e. car scrapping schemes), the path of the recovery will largely depend on sustained growth in foreign demand.

Strong fundamentals such as sound macroeconomic and structural policies have helped the Czech economy to weather the global crisis, although a large loss of output could not be avoided. In the medium term, drop in economic activity might translate into an extended period of higher unemployment affecting the growth potential of the economy through hysteresis and losses in human capital. The potential growth of the Czech Republic is estimated at above 3.5% on average by 2020, and it is projected to diminish substantially to around 1% by 2060. Although the Czech Republic still lags behind the EU average regarding labour productivity, catching up has been very dynamic. Total factor productivity and capital deepening remain the main drivers of growth, with the role of capital deepening expected to fall with the economy further upgrading its production structure. On the contrary, population ageing, as discussed below, is expected to have an increasingly adverse impact on labour supply and economic growth in a long-term perspective.

3.2. MACROECONOMIC FRAMEWORK CONDITIONS

3.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Czech public finances have been constantly in deficit since 1995. Over the last 10 years, the average general government deficit stood at around 4% of GDP and the 3% of GDP Treaty criterion was fulfilled only between 2006 and 2008. On the whole, the structural deficit remained high and good times, in particular the period 2004-2007 when GDP growth averaged 6%, were not used to the full extent for reducing the deficit and debt levels. The crisis put an additional strain on the budget: discretionary stimulus measures in combination with the operation of automatic stabilisers resulted in a sharp deterioration of public finances with the general government deficit reaching 5.9% of GDP in 2009.

The high level of the general government deficit appears to be the most pressing problem for the country in the short- to medium-term. The debt level is currently relatively low (around 40% of GDP) but it is increasing rapidly with debt servicing costs crowding out productive investment. Building on the consolidation measures enacted in 2010, additional measures to correct the excessive deficit will need to be taken from 2011 onward, in particular on the expenditure side (revenue ratio was 40.3% of GDP in 2009 while expenditure ratio shot up to 46.2% of GDP). Revenue base has been partly eroded during the crisis. In the post-crisis lower-growth environment, it could be important to shift to less volatile sources of revenue, but containing public expenditure could play an even more important role. Measures to increase the efficiency of public spending would allow getting a better return from public investment, education and R&D spending.

Keeping public finances in check could be even more important in the long-term perspective. The Czech Republic belongs among countries facing a significant demographic challenge in the long-term. According to the recent projections, almost a third of the population is estimated to be in retirement age (65+) by 2060. The consequences on public finances are expected to be profound: age-related expenditure is projected to increase by 6.3% of GDP over 2010-2060 if no action is taken. Further reforms of the pension and healthcare systems could therefore be essential to bring the public finances on a more sustainable path. Consequently, one of the most pressing challenges is the reduction of the high structural deficit and improvement of the long-term sustainability of public finances.

3.2.2. Macro-financial stability

Regarding macro-financial stability, despite the large shock to the real economy, the financial sector has remained rather stable, mainly due to a strong domestic deposit base and low exposure to toxic assets. Overall, financial market in the Czech Republic is highly dominated by the banking sector. This is mainly due to an extensive usage of banks as a source of corporate financing. The banking sector is highly concentrated and foreign-owned. However, the share of FX loans to businesses is below 20% and external indebtedness of households is virtually non-existing. The stability of the banking sector was promoted by the prevalence of standard banking operations and granting of the credits was mostly based on deposits from domestic clients without being strongly connected to their foreign mothers. These characteristics of the banking sector have contributed to the overall rather good shape of the financial sector during the global crisis marked by high exchange rate volatility. The share of non-performing loans is currently around 6%.

Despite these encouraging signs of resilience of the financial markets, the significant decrease in growth of loans granted to the private sector observed since 2008 could weigh on private investment in the coming years, and slow down potential growth, calling for an attentive monitoring of access to credit.

3.2.3. Current account and competitiveness position

Turning to issues related to the current account and competitiveness, the degree of openness of the Czech economy has been rising rapidly over the last two decades, placing the country in the group of the most open EU Member States. This development has been positive and external trade has been contributing significantly to growth. The growing openness ratio has not given rise to any significant macroeconomic imbalances. Although the current account balance had been constantly in deficit until 2009, it had remained at a readily financeable level. Since EU accession, it has hovered in a range from 2% to 4% of GDP, falling to 1% during the crisis.

Despite the real appreciation trend of the koruna since 2000, reflecting developments in the nominal exchange rate and an increase of the unit labour costs, the Czech Republic has significantly increased its export market share in the world market. This trend has been supported by non-cost competitiveness factors and quality up-grading, notably sustained by FDI. While the share of labour-intensive goods in total exports has decreased substantially, the proportion of technology-intensive goods (mostly in the "easy-to-imitate" category) in Czech exports has more than doubled over the last decade. In order to preserve these positive developments in the medium-term, it could be important to address challenges in the business environment, the labour market and in the education system.

The future of the real convergence process may depend, inter alia, on the capacity of the Czech economy to continue its successful integration in the international production process. While a relative advantage in labour-intensive goods still exists, it is diminishing over time given the increasing competition from lower-wage EU members and from non-EU countries. Therefore, the long-term strategy could focus on measures that foster competitiveness of the economy, including measures supporting labour supply, human-capital building, as well as measures that attract investment and support innovation. Domestic technology development could be seen as a priority in this context in order to reduce the reliance on FDI-related technology transfers in longer-term. This is likely, at the same time, to support the on-going reorientation of the production structure toward high-value-added products, support diversification of the export structure, stimulate external competitiveness, and boost the potential growth of the economy.

3.3. GROWTH DRIVERS

3.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Labour market in the Czech Republic had shown encouraging developments prior to the crisis. Unemployment rate decreased from around 8% in 2000 to 4.4% in 2008. Employment rate was relatively high in 2008 (66.6%) and participation rate was slightly lower than the EU average. Long-term unemployment had been on a declining path although it still remains comparatively high.

Despite these positive signs, the economic downturn marked a rapid increase in unemployment to 6.7% in 2009. The crisis accentuated the fact that despite recent progress, the labour market still faces several structural challenges as shown by relatively low employability of certain groups (notably low educated workers, young people and mothers with small children), skills mismatches and a high share of long-term unemployment. Furthermore, regional disparities in unemployment rates are significant and persistent. Removal of barriers to geographical mobility (e.g. by reducing rigidities on the housing market) could help tackle persisting regional disparities in unemployment rates. While labour market's response to the crisis suggests that labour market is reasonably flexible, there could still be scope for examining the remaining rigidities, notably those related to notice periods, severance pay and fixed-term contracts. Furthermore, evidence shows that the tax wedge remains still relatively high, in particular for low-income workers.

Looking further ahead, it appears to be important that the steep increase in unemployment rate associated with the crisis does not turn into a long-term reduction in labour-supply and a rise in structural unemployment. Improving the functioning of the labour market by addressing remaining structural weaknesses could be crucial in this respect. Increasing labour supply over the long-term represents an important challenge in the face of population ageing, and this could be supported by addressing the issue of incentives to work, in particular for women with young children, low skilled and older workers. In addition, improving the quality of labour force through education and increased participation in life-long learning would facilitate the ongoing shift in the trade specialisation away from labour-intensive towards technology-intensive goods.

3.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The Czech Republic experienced an investment boom in the last decade. Capital deepening was supported by strong FDI inflows which brought an important technology and knowledge transfer, in particular in the manufacturing sector (and more specifically in the car industry). The crisis has to a certain extent changed the picture with a significant drop in investment and low capacity utilisation. Investment activity is expected to resume slowly and with a certain lag.

Despite the fact that the Czech Republic has so far continued to successfully attract FDI, the business environment has shown several weaknesses. Past reforms have led to some progress but the regulatory environment for businesses still appears to be burdensome. A number of surveys indicate that starting and closing business is relatively lengthy and costly, access to finance is limited, in particular for smaller enterprises, enforceability of contracts is low and the tax administration and collection is particularly complex. Some business surveys also indicated that a lack of stable and predictable legal environment and inefficiencies of the public sector remain important issues. In this context, weaknesses in public procurement procedures coupled with a lack of their transparency generate inefficiencies in the use of public resources and negatively impinge on overall total factor productivity. Furthermore, despite recent liberalisation process, there are persisting competition issues in network industries, in particular in electricity and telecoms where prices remain relatively high in international comparison. Going forward, it could be important to improve the attractiveness of the country for new investment in a situation where it competes not only with its regional neighbours but also with other lower-cost countries further to the East.

Ensuring favourable business environment, with less administrative/regulatory hurdles and an efficient public sector would help create conditions for further encouraging business activity and boosting total factor productivity growth.

3.3.3. Knowledge Base (R&D, innovation and education)

Major drivers of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. The Czech economy is well advanced in the convergence process. In this context, innovation capacity plays a major role. With a ratio of R&D expenditure to GDP at around 1.5% in 2008, the Czech Republic has been making steady progress in closing the gap with the more advanced knowledge economies, but is still below the EU average. However, the Czech Republic is the third EU Member State (after Austria and Estonia) that has achieved the most substantial progress towards its R&D target in recent years. On the contrary, the effectiveness of the R&D spending remains a challenge and presents a case for a strengthening of the framework conditions for innovation. The performance in terms of registered patents and scientific publications is relatively low which might be linked to high patenting costs, administrative difficulties and lack of awareness. Promoting innovation capacity and business R&D to support diversification of the economy and orientation towards high value-added production could significantly help boost total factor productivity and growth potential, helping the country move towards high-tech production and more developed services sector.

The functioning of the educational system plays a vital role in a knowledge based society. Although spending on education remains lower than the EU-average (around 4% of GDP), it has been growing rapidly. The percentage of population having attained upper secondary education is significantly higher than the EU-average. With regard to tertiary education, the total attainment levels, despite a growth in recent years, are still significantly below the EU-average. Also the level of participation in lifelong learning, especially among the low-skilled and older workers, is still bellow the EU average, despite a considerable raise in 2008. As for the number of graduates in maths, science and technology, it has increased impressively, almost 3 times faster than in the EU on average. Overall, further improvements in the quality of human capital and innovation capacity are key factors in fostering labour productivity and competitiveness over the long term. In this respect, it will be important to strengthen the links between tertiary education, research and innovation systems. Upgrading the quality of labour force will also help reduce the persisting skills mismatches in the labour market.

4. DENMARK

4.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Apart from a three-year slump following the bursting of the IT-bubble in 2001, Denmark has experienced robust growth for the past 15 years, with unemployment falling since 2003 to historically low levels in 2008 and a stabile monetary framework with a fixed exchange rate vis-à-vis the euro. The Danish economy slowed down before the onset of the financial crisis, brought about by the bursting of a real estate bubble and an overheating economy. The budget surplus turned into a deficit in 2009 due to the effects of the crisis and the fiscal stimulus measures taken to mitigate its impact.

Looking ahead, the economic recovery is projected to be moderate and based on domestic demand. On the back of increased private consumption and expansionary fiscal policy, output growth is expected to reach 1.6% in 2010. By 2011, when fiscal consolidation takes hold, the recovery is expected to be self sustaining with business investments and private consumption as the main drivers of growth. In the next decade, the Danish economy's growth potential is projected to be at around 1.6% p.a. and beyond, until 2060, yearly growth is projected to average 1.7%. A declining work force until 2018 could pose challenges to the Danish labour market and external competitiveness may come under pressure unless productivity growth can be increased or real wage growth contained.

4.2. MACROECONOMIC FRAMEWORK CONDITIONS

4.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Denmark has run budget surpluses since 1997 and structural surpluses since 1998. This was part of the government's strategy to reduce debt set forth in successive Convergence Programmes and gross debt has come down from 68% of GDP in 1996 to 33.4% of GDP in 2008. As the crisis struck and automatic stabilisers, stimulus measures and tax cuts came into play, the budget balance turned negative in 2009 and so did the structural balance in 2010. The general government deficit is expected to reach -5.3% of GDP in 2010 before gradually moving towards budget balance in 2015. Revenues are expected to be boosted as the financing elements of the 2009 tax reform are phased in from 2010 to 2019 while expenditure will come down as the fiscal stimulus measures introduced during the crisis are phased out from 2011. The debt-to-GDP level is expected to stabilise by 2020 also owing to the long-term budgetary impact of an ageing population that is below the EU average. These projections nevertheless assume that Denmark will implement reforms to increase labour supply and contain public consumption expenditure, something that historically has been difficult to achieve.

4.2.2. Macro-financial stability

Regarding macro-financial stability, the Danish financial sector was hard hit during the international financial crisis, which apart from the drying out of the money markets following the collapse of Lehman Brothers also had to deal with the bursting of a domestic real-estate bubble. On top of this, the two largest Danish banks were heavily engaged in Ireland and the Baltic States, both of which also experienced significant real estate corrections leading to further impairment of these institutions' assets. The government response comprised a series of structural and temporary measures to support the resilience of the banking sector. Lending standards were nevertheless tightened, which induced companies that were already suffering from falling demand due to the collapse in global trade, to cut back on investment and lay off people. On the back of a stabilising macroeconomic environment and government support measures the financial system gradually returns to normal functioning. Defaults on loans are still expected to be high in the coming years which will pressure banks balance sheets, but stress tests carried out by the Central Bank suggest that the banks are expected to be able to manage without further aid.

Furthermore, seen in a European context, Danish households are heavily indebted. The high level of household debt in Denmark is partly related to high private pension savings (amounting to some 140 percent of GDP). Overall financial wealth is therefore high among Danish households relative to most other countries, but pension savings are illiquid, and high debt relative to disposable income may thus cause households to be more sensitive or responsive to interest rate changes. Relatively high gross indebtedness should also be seen in the light of Denmark’s sophisticated and highly developed mortgage market, which enables low income households access to the same variety of mortgage products, and at the same terms, as high income households. The composition of outstanding mortgages has changed significantly during the past decade. While fixed rate mortgages was the predominant mortgage type ten years ago, adjustable rate mortgages now account for more than 65% of outstanding mortgages. The high level of debt and, with about 80% of outstanding household debt in the form of mortgages, the shift towards adjustable rate mortgages make households more vulnerable to interest rate shifts as higher interest rates result in a higher debt servicing burden. Against this background, it would be important to control risks stemming from high household indebtedness, underlining the importance of a viable and stable sustainable financial sector.

4.2.3. Current account and competitiveness position

Turning to issues related to the current account and competitiveness, although Denmark has run a current account surplus since 1999, the underlying competitiveness of the economy has weakened. Danish labour productivity growth has lagged behind most OECD countries for a decade and a half. Reversing this trend is key to sustaining growth. Labour costs have increased more than in the main trading partner countries and productivity growth has been lagging, leading to a deterioration of the competitive position, particularly accentuated in the years after 2004. Labour shortages led to significant wage increases and forced companies to hire people of below average productivity, thus dampening productivity advances for the whole economy. Additionally, it takes time for the capital stock to adjust to a higher level of labour supply and additional capital may be required to complement the extra labour in use. Another reason for the weak productivity growth was shifts in employment towards labour-intensive sectors.

The global economic crisis has forced companies around the world to reassess their supply chains. Because of their loss of competitiveness in the last decade, Danish companies may find themselves in an increasingly difficult situation vis-à-vis their foreign competitors. While the crisis and rising unemployment has led to wage moderation, this is also the case for many countries. It is therefore questionable whether wage moderation in Denmark will be enough to restore the economy's global competitiveness. Danish exports have traditionally been less sensitive to the business cycle due to its high content of pharmaceuticals, agricultural products and "green technology" products, which also helped cushion the fall in exports as global trade collapsed during the crisis. However, the Danish export product mix and the loss of competitiveness experienced during the last decade suggest that exporters may not be able to reap the full benefit of the global recovery in trade. In recent years, the goods trade balance has turned negative, while the service balance has shown a more or less constant surplus. In the case productivity increases, the decline in the goods trade balance could be reversed. In this context, improving the general level of educational attainment would make a positive contribution.

4.3. GROWTH DRIVERS

4.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The high degree of flexibility exhibited by the Danish labour market contributed to the strong employment growth since 2003, but the impact of the current crisis risk reversing this trend. To some extent, the rise in actual unemployment caused by the crisis risk turning structural in the case hysteresis effects take place (through for example the loss of skills, stigmatisation and lower regional labour mobility). However, estimates of the effect of actual unemployment on long term unemployment, which is a key transmission channel through which actual unemployment can lead to higher structural unemployment, show Denmark as being among the countries in OECD where this effect is lowest.

In the medium to long term, Denmark is faced with an ageing population. From 2009 the number of people of working age has been decreasing and the number of older people (older than 64 years) is increasing, with the number of very old people (older than 79 years) expected to more than double by 2040. The number of children (younger than 15 years) is expected to fall slightly until 2020. Within the labour force there will be a shift towards more people below 30 or above 50 and an increasing share of immigrants. As both younger and older workers as well as immigrants have a lower employment rate than the 30 to 50 years old, Denmark is facing a situation where the number of people in the labour force with high employment rate is set to decrease while the number of people with low employment rate is set to increase. As public expenditures historically have been higher for older people, especially for the very old, the changing demographics and the composition of the labour force are going to create a situation where fewer workers with historically lower employment rates are going to finance a larger and more expensive share of the population. Therefore, increasing labour force participation is a key challenge in order to secure fiscal sustainability and financing of public expenditures.

4.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Denmark is an open economy with a strong competition policy framework and a business friendly environment, as evidenced by a number of surveys and assessments.([12]) Start-up conditions and the regulatory framework are favourable in an EU comparison. However, despite the growth-friendly business environment, there are concerns about the relatively limited innovation capacity and relatively high price levels, especially in the service sector and most likely in the sectors not exposed to international competition. According to the Danish Competition Authority, this is partly due to insufficient competition which may inhibit the uptake of new technologies and productivity. Therefore, it would appear that weak competition, especially in the Danish services sector, is a factor causing relatively high prices and insufficient innovation capacity and tackling this is an important challenge. International surveys in general place Danish infrastructure among the best in the world, but there are still areas which could be improved. In particular the Danish transport infrastructure will face serious congestion problems, especially in the Copenhagen area and around the major urban areas in Jutland.

4.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Denmark already has a well-established knowledge potential with overall innovation performance well above the EU average. Public spending on R&D is close to 1% of GDP and private spending close to 2% of GDP, which put Denmark in line with EU targets. Denmark has an excellent broadband network, and ICT uptake by government, enterprises and households is among the highest in the EU. In the medium term, further expansion of R&D is at risk of being limited by increased scarcity of science and technology graduates, while in the longer term labour shortages in the educational sector could make it more difficult to reach the government's educational targets of increasing the completion rates on secondary and tertiary educations to 95% and 50% respectively of a youth cohort by 2015, and improving primary and secondary education outcomes. The government has implemented a range of measures to reform education in order to increase quality, but cost-effectiveness remains an issue as spending does not appear to fully yield the intended results. Reducing delays in the average study time in tertiary education could be one relevant focus area. The targets to increase the number of students with upper secondary and tertiary education should be seen in conjunction with the future skills needs and possible labour shortages, as these shortages are expected to be most severe among workers with higher skill levels. Workers of higher qualification better absorb new technology and are less prone to

([12]) See World Economic Forum (2009), The Global Competitiveness Report 2009-2010.

unemployment and other losses of working time. Improving the cost-effectiveness of education and increasing the completion rates on secondary and tertiary education would help boost labour market performance and growth.

5. GERMANY

5.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Germany went through major structural adjustments in the 2000s, involving wage moderation to restore cost competitiveness, labour market reforms to address high structural unemployment, a correction of the post-unification construction boom, fiscal consolidation, and a strengthening of household and corporate balance sheets. As a result, economic growth averaged only 1% p.a. in the first half of the 2000s. Both potential growth and productivity followed a downward trend, reflecting inter alia low public and private investment. From 2006, economic growth picked up as structural reforms started to bear fruit and strong external demand provided an important boost. However, total domestic demand remained muted and, given its strong export orientation, Germany was severely hit by the slump in world trade in the wake of the global financial crisis.

On the back of expansionary fiscal and monetary policy and higher exports, the German economy rebounded in mid-2009, but the recovery temporarily lost momentum again around the turn of 2009/10. Looking ahead, overall sound economic fundamentals should favour an early exit from the crisis. With its costs competitiveness intact and its specialisation in investment goods, Germany appears well placed to benefit from the pick-up in world trade, notably in emerging markets. However, weaker demand from some of its traditional trading partners and still fragile financing conditions could weigh on the strength of the recovery. According to the Commission services' spring 2010 forecast, real GDP growth is therefore projected to accelerate only moderately from 1.2% in 2010 to 1.6% in 2011.

Potential growth is projected to increase to around 1½% p.a. in the period 2010-2014, compared with just around 1% p.a. in the period 2000-2008. This upward shift mainly reflects the positive impact of past labour market reforms on structural unemployment and participation rates. Negative demographic trends, weak capital accumulation and sluggish productivity growth imply, however, that potential growth remains moderate.

5.2. MACROECONOMIC FRAMEWORK CONDITIONS

5.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, as a consequence of the crisis, Germany's general government budget swung from a balanced position in 2007 and 2008 to a deficit of 3.1% of GDP in 2009. This was the result of fully operating automatic stabilisers as well as discretionary measures adopted in line with the EERP to counter the downturn and to stabilise financial markets. The deficit is forecast to widen to 5% of GDP in 2010 on the back of further fiscal stimulus and to edge down in 2011 to 4¾% of GDP with the economic recovery and the expiry of certain stimulus measures. High deficits and financial market stabilisation measures fuel gross public debt which is set to increase to 81½% of GDP in 2011.

Given that only a part of the fiscal stimulus measures was temporary, the budgetary situation following the recession is complicated by revenue shortfalls and higher expenditure. The new constitutional budgetary rule, which prescribes a structural deficit ceiling of 0.35% of GDP for the Federal government from 2016 onwards and balanced structural budgets for the Länder as of 2020, provides an important anchor for a credible consolidation path, but plans for retrenchment are not yet supported in detail by concrete measures. A stronger focus on growth-enhancing expenditure, e.g. on education and gross fixed capital formation, would be conducive to potential growth. A further review of the tax-benefit system could potentially increase incentives for job creation and labour force participation (see section 3.1), but would have to be compatible with consolidation requirements. The long-term budgetary impact of ageing is close to the EU average. However, in the context of mounting public debt, the achievement of rising primary surpluses over the medium term, by preserving the fiscal gains of past pension reforms and further reforms to the social security system, including the public health-care system, designed to curb the increase in age-related expenditures, could reduce risks to long-term sustainability. The main challenge in this regards will be to reconcile the necessary fiscal adjustment to ensure the long-term sustainability of public finances, particularly in view of population ageing, with strengthening the economy's long-term growth potential. A reallocation of public expenditure towards growth-enhancing items such as education, R&D and physical infrastructure and greater efficiency of public spending would be conducive to higher potential growth.

5.2.2. Macro-financial stability

Regarding macro-financial stability, Germany did not experience any pronounced asset or house price boom prior to the crisis. The indebtedness of households and non-financial corporations remains moderate. After a temporary drop following unification, private households partially restored their saving rate, albeit without reaching pre-unification levels. Improving profitability and lower domestic investment implied that the corporate sector as a whole has become a net financial lender since 2002. Throughout the 2000s, these high private sector savings were channelled abroad both via corporate foreign direct investment and via higher portfolio and other investment intermediated by the banking sector. As a result, parts of the German banking sector were heavily exposed to investments in mortgage-backed securities and suffered severe losses since the onset of the financial crisis.

Comprehensive government rescue measures contributed to a stabilisation of the banking system. However, bank balance sheets have been considerably weakened by the losses incurred during the crisis. Concerns remain that recession-related credit defaults could further erode the capital base of banks, potentially impairing their capacity to provide financing to households and companies. Further stabilisation of the banking sector and securing access to finance for companies, including adequate bank capitalisation, remains a precondition for a successful exit from the crisis and for sustained longer term growth. From a long-term perspective, the German banking sector has traditionally been characterised by low profitability and a weak capital base. Some Landesbanken, in particular, have suffered from the lack of a viable business model. Especially since the withdrawal of implicit state guarantees, they played a particularly active role in investing in structured assets and real estate markets abroad and would now seem to be in need of restructuring. A successful restructuring of the Landesbanken and strengthening the regulatory and supervisory framework would not only help ensure a well-functioning and competitive financial sector, but also contribute to a more efficient allocation of domestic savings.

5.2.3. Current account and competitive position

Turning to issues related to the current account position and competitiveness issues, since 2001, the current account surplus has widened considerably, peaking at almost 8% of GDP in 2007, driven by a strong expansion of merchandise exports. The slump of world trade in the wake of the crisis slashed the current account surplus markedly by almost 3 pps. until 2009. Germany's cost and price competitiveness vis-à-vis the euro area has been restored to its pre-reunification level by sustained wage moderation and low inflation after 1995. However, price competitiveness actually weakened relative to major non-euro area trading partners, with euro appreciation offsetting the steady reduction in relative unit labour cost.

In the medium term, the German export sector is expected to benefit from the recovery of global trade especially in emerging market economies. However, given the need for household and corporate balance sheet repair in some of its traditional trading partners, German exports might not return to pre-crisis levels in the near future. Hence, the German economy could be faced with considerable adjustment needs, including a re-allocation of resources from the tradeables to the non-tradeables sector, putting increasing demands on the flexibility of product and factor markets. Stronger domestic demand could also help to broaden the basis for economic growth. Sustaining high employment and real income growth, in particular through more buoyant domestic investment, and lowering regulatory barriers for the service and craft sectors could help the economy.

In the long term, price competitiveness and improvements in structural competitiveness have to go hand in hand to preserve a competitive edge, as dynamically-growing emerging markets begin to diversify into more capital and knowledge-intensive industries. Therefore, sustained efforts to move up the value added chain, improve the quality and variety of products and services will become ever more important.

5.3. GROWTH DRIVERS

5.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The German labour market was characterised by sluggish employment growth and high and rising unemployment rates for most of the 1990s and 2000s. Following a series of labour market reforms in the early 2000s and a prolonged period of wage moderation, unemployment started to decline since 2005 and – helped by improving cyclical conditions – employment growth accelerated since 2006. Remarkably, this positive trend was halted, but not reversed during the economic crisis in 2008/09. Sustaining the recent trend of more dynamic employment growth and rising labour market participation would help counter the negative effects of demographic change on labour supply and to strengthen domestic demand. Despite the recent reduction in the unemployment rate, long-term unemployment and high unemployment among low-skilled workers, particularly migrants, remain a problem. Better integration of disadvantaged groups into the labour market will therefore be crucial to further reduce structural unemployment. Moreover, the tax wedge in Germany remains the second-highest in the EU, mainly because of high social security contribution rates. Apart from lowering incentives for job creation and labour force participation, this also implies that wage increases are only partly translated into higher disposable incomes and domestic demand. In the long run, a shrinking population will put an increasing premium on raising participation rates – including especially of older workers – and boosting productivity to strengthen potential growth. Further improving the quality of education and training systems is required to address emerging shortages of skilled labour force, and reverse the trend of declining productivity growth.

5.3.2. Business environment, entrepreneurship and investment

Germany exhibits a business-friendly environment performing above EU average in various international surveys. The country has a largely effective competition framework and has strengthened competition in the electricity networks. Despite some progress, entry and regulatory barriers in the area of professional services and especially crafts remain high, and the growth potential could benefit from further lowering of regulatory barriers in these areas (see section 2.3). Envisaged progress in the area of public procurement has been delayed. Start-up conditions for companies have improved recently, reflecting the improved implementation of single contact points (Services Directive), while the access to innovation finance is hampered by high collateral requirements and still underdeveloped venture capital market.

Capital deepening in Germany is historically high, but both public and private investment as a share of GDP dropped markedly between the early 90s and the mid-2000s. Lower corporate sector investment reflects the correction of overinvestment in housing after the re-unification-induced construction boom, a cyclically driven investment gap in machinery and equipment, efforts to strengthen corporate balance sheets and higher foreign direct investment in the context of intensified off-shoring and outsourcing of business activities. Since the financial sector has come under severe strain from the financial and economic crisis, Germany faces a challenge of restructuring the financial sector to enable a lasting reinvigoration of fixed capital accumulation contributing to long term potential growth (see section 2.2).

5.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth is policies in the area of R&D, innovation and education which support the knowledge base. Germany shows a strong innovation performance, both as measured by innovation inputs (R&D expenditure) and outputs (patenting). However, German innovation tends to be concentrated in large companies in medium- to high-technology manufacturing sectors. After a peak in innovation expenditure in 2008, German companies cut their spending on innovative activities in the wake of the crisis, safeguarding, however, their expenditure on research and development (R&D). Even though there are no prevalent high-skilled-labour shortages, many sectors encountered difficulties to hire high-qualified personnel in the recent upswing, in particular in the areas of engineering, informatics, natural science, technology and mathematics.

The share of 30-34 years olds with tertiary attainment in Germany is below the EU average (EUROSTAT 2008). This is partly explained by the fact that a significant proportion of medium and high skilled labour force is trained in the vocational education system. However, shrinking age cohorts will increasingly constitute a problem in attracting a sufficient number of well-achieving young people to vocational training. Given the increasing pace of technological change and population ageing, a challenge would be to ensure that the education system contributes to the supply of medium and high-skilled workers to bolster total factor productivity growth.

6. ESTONIA

6.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Several years of economic overheating, with financial flows (mostly credits) from abroad concentrating in real estate-related sectors and growth averaging 8.9% in 2005-2007, gave way to a severe economic contraction of nearly 18% in 2008-2009. The growth period had been accompanied by rapidly rising wages and prices, widening external deficits, a real estate bubble and increasing indebtedness of economic actors. The performance of the tradable sectors became insufficient to finance the surge in imports, while a loss of competitiveness hurt in particular the low-skilled and labour-intensive sectors. Although the general government was in surplus, fiscal policy still showed a rather pro-cyclical stance. In late 2007, the bursting of the real estate bubble led to falling domestic demand, macroeconomic rebalancing and made fiscal consolidation packages necessary to contain the fiscal deterioration, with the needs compounded by the effects of the global financial crisis since the end of 2008.

After the large contraction in 2009, the prospects for economic recovery appear relatively favourable, even though major trade partners are only slowly recovering, while, internally, the deleveraging of economic actors will be progressive. Output growth is expected to pick up from an annual rate of 0.9% in 2010 to 3.8% in 2011. This outlook assumes a continuation of the ongoing rebalancing towards tradable activities as well as of the relative price adjustments, which is leading to a recovery in the economy's competitive position. In the long term, Estonia's growth potential is projected to be weaker than its 2000-2007 average of 6%, at around 4% on average in 2010-2020, further declining to around 1½% in the 2020-2060 period.

6.2. MACROECONOMIC FRAMEWORK CONDITIONS

6.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Estonia's budgetary framework, based on an informal general government surplus target, contributed to surpluses of the general government balance over the period 2002-2007 and to the accumulation of sizeable financial assets. However, the fiscal framework could not prevent a surge in spending during the cyclical upturn. Accordingly, in the downturn, revenue shortfalls led to a rapidly worsening fiscal balance. From a more micro-economic angle, the taxation framework was favourable for both reinvested profits and real estate, which likely contributed to the unfolding of the real estate bubble. Overall, the tax base appeared insufficiently diversified and policies directed at fostering growth rather than at stabilising the economy. The limited headline general government deficit at 1.7% of GDP in 2009 was achieved through large consolidation efforts accounting for more than 9% of GDP in 2009, aimed at avoiding an excessive deficit and conforming to the conditions for euro area accession by 2011.

Looking forward, the objective is to return to a budget surplus by 2013. In order to support this prudent strategy, some open issues may need to be addressed including the relatively high total tax wedge on labour, which is a risk in the context of a weak labour market. Moreover, fiscal policy might need to take into account the possible recurrence of imbalances in the real estate sector and to improve the cyclical stance of fiscal policy. As regards government expenditure, ongoing reforms, which mainly target the public wage bill and current expenditure, could be reinforced to align overall expenditure with a prudent medium-term growth forecast. These efforts could be complemented by a strengthening of fiscal institutions, in particular through the adoption of strictly enforced and potentially legally enshrined expenditure ceilings combined with a formal budget balance and/or revenue rule. Furthermore, there might be scope to strengthen the revenue side through environmental and property taxes.

6.2.2. Macro-financial stability

Regarding macro-financial stability, Estonia's financial sector is well integrated in the broader EU financial sector, with five foreign-owned banks holding about 95% of the total assets. Between 2004 and 2009, the role of banks in financial intermediation grew further, driven mainly by construction activity and real estate, while the capitalisation of the stock market and the issuance of corporate bonds remained rather low. Mortgages and loans to real estate business account for about two thirds of total credit to the private sector. While supporting rapid economic convergence, the high degree of financial market integration amplified the impact of the crisis. The share of non-performing loans increased above 6% by the end of 2009, ([13]) compared to very low levels in previous years. After several years of sizeable bank profits, increased loan-loss provisions led, in 2009, to significant bank losses. Banks' capital-adequacy however remained sufficiently high, and overall the banking sector weathered well the financial and economic crisis.

Looking forward, maintaining the stability of the financial sector remains important: the capital adequacy ratio (at 22% as of end 2009) and prudential reserves would need to remain above the required minimum as long as the crisis and boom legacies have not been fully purged. Addressing debt restructurings might prove useful, also in view of the fact that stretched balance sheets are likely to weigh on domestic demand for some time. Loans in foreign currency – mainly the euro – largely dominate, but the envisaged euro adoption would eliminate residual risks in this respect. In the long run, as a new cohort of borrowers will arrive on the market, a return to over-activity in the real estate-related sectors cannot be excluded, reinforcing the challenge to avoid the accumulation of imbalances and crowding-out of corporate investment. Looking ahead, putting in place a policy framework to avoid recurrence of economic and financial imbalances, paying attention to credit flows, asset prices and balance sheets is particularly important.

([13]) Loans overdue for more than 60 days as % of total portfolio of loans to non-financial sector.

After the credit/real estate bubble of 2005-2007, policy measures are needed to ensure that economic actors deleverage in an orderly fashion and that similar imbalances do not recur once economic growth resumes.

6.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Estonia's cost competitiveness deteriorated during the overheating period, contributing to large external deficits. It should be noted that imbalances originated mostly from a too rapid growth of imports, following excessive credit growth in the upper phase of the cycle, and not so much from deterioration in the country's export performance. Nevertheless, wage increases were substantially above productivity growth and amplified imbalances. A significant adjustment in wages is ongoing helping to restore the lost competitiveness of exports. As regards credit flows, deleveraging is ongoing, reducing domestic demand and, thereby, excessive imports. While in 2009 Estonia recorded an external surplus (7.4% of GDP), the improvement is due to a positive impact from international trade recovery and to a large extent cyclical. When domestic demand growth resumes, imports are likely to start increasing again, suggesting a need to strengthen policy framework to avoid recurrence of imbalances.

In the medium run, the expected recovery of global trade and an internal structural adjustment could help underpin a necessary rebalancing of the economy towards a stronger external sector, so as to reduce the reliance on internal demand as an engine for growth and re-equilibrate the trade accounts. Promoting such rebalancing of the economy towards the tradable sectors and raising productivity levels will be an important challenge requiring sustained cost competitiveness and investment in both physical and human capital.

6.3. GROWTH DRIVERS

6.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Estonia's buoyant economic growth before the crisis contributed to very positive labour market outcomes. In the downturn, the unemployment rate surged and employment rates dropped particularly for low-skilled workers. The major problem facing Estonia is the large share (1/3) of adult population without tertiary education, for which the employment rate is low (around 50%). Moreover, in 2009, the percentage of early school-leavers (18-24) was still relatively high compared to the best performing countries. Regional differences in employment rates are also high and persistent. Given that Estonia is among the EU countries with the fastest ageing population, labour supply shortages could become an important constraint to growth.

Looking forward, as soon as recovery is established, skill shortages and mismatches could reappear, mainly in the tradable sectors, pushing up wages again. In this context, avoiding high unemployment from becoming structural is an important challenge which would require better matching in the labour market and facilitating reallocation of labour to expanding sectors. Adult training, in particular professional and vocational training for people with little or no professional education, is a primary concern. Participation in lifelong training programmes has increased in recent years but the positive momentum needs to be continued, as this could also be important to increase workers' employability, bearing in mind demographic developments resulting in insufficient labour supply in the long-term. Enhancing labour market activation policies could lead to resumed employment while addressing the gaps between current skills and forming needs could prevent jobseekers from withdrawing from the labour force and increase productivity.

6.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Estonia's attractiveness for businesses and investment is related to its well-functioning institutions, its sound fiscal policies and its generally favourable climate for business. Moreover, the determined efforts made by Estonia to pursue far-reaching structural reforms also play a positive role. Finally, the progress made towards entry into the euro area is proving to be an important attractive element. Nevertheless, several professional services remain regulated.

The ongoing deleveraging process in credit financing has contributed to a fall in corporate investment. Over time, investment is expected to resume, but access of enterprises to sustainable financing might remain problematic, in particular for SMEs and innovative enterprises. In the longer term, it could be important to support increased capital formation by various forms of financing, in particular long-term risk capital either in the form of inward investment or through domestic equity issuance. Finally, despite high public investment levels (4,9% of GDP in 2009), with a careful prioritisation of productive investment, Estonia has a weak transport infrastructure, hampering accessibility and mobility: in 2007, the level of infrastructure expenditure, both per inhabitant and per km², was respectively 74% and 23% of the weighted EU average. Therefore, addressing a weak aggregate fixed investment especially in cross-border and internal infrastructure is an important challenge, meeting which could contribute to investment and labour mobility and boost growth.

6.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Recently, the share of capital-intensive products and research-intensive exports has been growing rapidly. However, the development of genuine high-tech exports in a broad product range seems to be a longer term prospect. Furthermore, expenditure on innovation in the foreign-owned exporting sector does not necessarily result in the launching of products new to markets, notwithstanding the improved ranking in the European Innovation Scoreboard 2009 (11th in the EU). Public expenditure on R&D and innovation is already high (above 1% of GDP), indicating that further efforts in this area should now come from private businesses. With respect to education, a shortage of science and technology graduates persists and could increase further once economy recovers. Therefore, it is important to improve the contribution of the education system to human capital formation and to strengthen links between tertiary education, research and innovation, also with a view to leveraging the contribution to R&D from the business sector in order to support the diversification of the economy and its orientation towards higher value-added.

7. IRELAND

7.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

After over a decade of strong economic growth that had increasingly been driven by domestic demand, a sharp adjustment from its 2006 peak began in the Irish housing market and subsequently spread to the wider economy. Given the very high degree of openness and the large weight of the financial sector in the economy, the adjustment has been greatly amplified by the global economic and financial crisis. The Irish economy entered recession in 2008 and real GDP fell by nearly 10% in 2008-09. The downturn has also produced a dramatic deterioration in the Irish public finances, with a large general government deficit emerging after the surpluses that had marked the early 2000s and a steep increase in the debt ratio from its low pre-crisis level.

Looking ahead, real GDP should record another moderate fall in 2010 before the economy returns to positive growth in 2011. External demand should lead the recovery as the drawn-out adjustment process the Irish economy is facing weighs on domestic demand. Adjustment needs comprise the sectoral reallocation of resources, the further consolidation of the public finances as well as the adjustment of private sector balance sheets.

Lower investment, constraints in credit availability, increasing structural unemployment and the return to net outward migration are likely to have a lasting impact on potential growth, reducing it relative to its high pre-crisis level. To counteract this, it could be important to ensure that the newly unemployed can quickly go back to work, restore the stability of the financial sector and promote investment.

7.2. MACROECONOMIC FRAMEWORK CONDITIONS

7.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the average growth of public expenditure in 2001-2006 was above that of nominal GDP, and was increasingly financed by property-related taxes. The sharp housing market adjustment after 2006 and the subsequent wider economic crisis have quickly eroded tax revenue, while it is taking some time to bring expenditure in line with revenue developments, also in view of the increase in social spending and debt-servicing costs. Despite the implementation of significant consolidation packages since mid-2008, the government balance deteriorated from a balanced position in 2007 to a double-digit deficit-to-GDP ratio in 2009. At the same time, government gross debt soared from 25% of GDP in 2007 to 64% of GDP in 2009. Financial rescue operations to safeguard the stability of the financial system contributed to the deterioration of the public finances, while bank guarantees have increased the contingent liabilities of the government.

Against this background, reducing the high general government structural deficit poses a considerable challenge. Risks from financial sector support measures, including the above-mentioned bank guarantees and possible further capital injections, reinforce the need for fiscal adjustment. A broad-based medium-term deficit reduction strategy could usefully combine savings resulting from expenditure restraint and efficiency gains with measures to broaden the narrow tax base, embedded in a strengthened budgetary framework with for instance provisions enforcing a counter-cyclical stance. In turn, a credible fiscal consolidation strategy would, by bolstering confidence, foster the return to sustainable growth. Reducing the structural deficits and improving the long-term sustainability of public finances is a major challenge and could create fiscal space for manoeuvre in case of shocks and for funding new growth-enhancing priorities and could be particularly useful given the a projected significant increase in age-related expenditure due to an ageing population. Implementing further pension reforms would allow the projected sustainability gap to be addressed.

7.2.2. Macro-financial stability

Regarding macro-financial stability, the financial sector is highly exposed to real estate and has suffered heavily from the collapse of the property development segment. The government has stepped in, inter alia by providing guarantees to the banking sector, establishing a 'bad bank' (NAMA) to cleanse bank balance sheets of bad loans and injecting public capital into the banking system. The share in GDP of the implemented financial sector rescue measures is the highest in the EU. Repairing the financial sector's balance sheet is a precondition for ensuring adequate credit supply once the economy recovers. The operations of NAMA will be important in this respect; at the same time, their size implies that NAMA will be an important player in the property market, potentially influencing the speed and efficiency of adjustment over the next decade. Furthermore, strengthening the supervisory framework and reviewing tax policy incentives can help to avoid repeating over-investment in the property market and facilitate more productive investment.

The household sector has also come under pressure given its high level of indebtedness, the worsening labour market situation and ongoing house price adjustment. In particular, the ratio of non-performing loans to households has increased of late and the share of households in negative equity might increase further as the house price adjustment continues while mortgage interest rates start to increase. While the government is trying to restrict house repossessions, the high degree of indebtedness underscores the need to facilitate household sector deleveraging, notably through increased saving and paying down existing debt. The indebtedness of the Irish non-financial corporate sector has also increased significantly, with the debt-to-earnings ratio rising to the second highest in the EU in 2009. Ensuring a viable and stable financial sector and facilitating deleveraging of the household sector, as well as the non-financial corporate sector is of paramount importance given the size of the problem and the inter-linkages between the sectors.

7.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Ireland's competitive position weakened since the early 2000s in the context of the housing boom. High price and wage inflation and tight labour market conditions were only partly relieved by increasing migration inflows. Furthermore, overinvestment in non-productive housing led to a marked decline in productivity growth. These factors and the appreciation of the euro since 2002 led to a significant appreciation of the real effective exchange rate (ULC-based) vis-à-vis industrial countries and, after 2004, a widening external deficit. From its peak at just above 5% of GDP in 2007, the deficit has since narrowed to some 3% of GDP in 2009, mainly due to a strong decline of imports given the sharp fall in domestic demand.

In the medium term, a return to export-led growth would be contingent on restoring and sustaining competitiveness through adequate adjustment of wages and prices, including of relative prices so as to facilitate the sectoral reallocation of resources. Allowing these adjustment channels to work is particularly important for Ireland as a member of the euro area. Consumer prices and nominal wages already fell in 2009 and the sharp sustained falls in house prices point to some adjustment of relative prices taking place. To bring about a more lasting improvement in the current account, a productivity-oriented wage setting framework conducive to wage moderation and enhanced sectoral and regional flexibility could be important, along with strengthened competition. Competitiveness developments are also influenced by productivity growth, notably through the impact of changes in the skills base and investment, as discussed below. Regarding longer term developments, since the turn of the century, there has been a gradual shift in Ireland's export base from manufacturing to human capital-intensive services. This move might continue and would be beneficial to the current account position to the extent that the terms of trade for services continue to be more favourable than those for goods. Building on Ireland's comparative advantage vis-à-vis the euro area in the medium- to high-technology sectors, especially in ICT, this shift could also imply a further move up the value-added chain.

7.3. GROWTH DRIVERS

7.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. In the context of the strong economic growth in the decade to 2007, employment increased by more than 50%, while the unemployment rate declined to only 4.6%. The crisis has led to a significant deterioration in the labour market. Employment fell by more than 9% between 2007 and 2009 and, while the decline was broad-based, construction was most badly hit (-40%). The return to net outward migration, after a decade of strong net inflows, and a marked decline in participation stemmed the increase in the unemployment rate, but the latter still rose to almost 12% in 2009. The recent pick-up in the long-term unemployment share highlights the difficulties faced by the newly unemployed to return into employment. This underscores the importance of ensuring adequate job-search assistance and supporting the re- and up-skilling of the unemployed, which need to go hand in hand with careful targeting of resources and prioritisation in view of budgetary constraints. Boosting the economy's skill base also seems crucial given the massive need for sectoral reallocation of resources in the aftermath of the construction boom and the fact that the increase in unemployment and inactivity has been strongest among the low qualified and young people. Further improving the supply of adequate skills for the needs of higher-productivity sectors would also help to support competitiveness in a euro-area context. After a decline in nominal wages in 2009 followed the rapid wage growth in the context of the housing market boom, ensuring adequate wage developments in all sectors of the economy will also remain important in a medium-run perspective. Finally, while there is scope for the Irish female participation rate to increase, uncertainty about future migration flows implies that insufficient labour supply could become an impediment to growth in the medium term. Ensuring full utilisation of the economy's labour potential could necessitate measures to enhance labour force participation and improve pathways from education to employment.

7.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The very open Irish economy offers a well-integrated market and a favourable business environment. ([14]) Relative to EU peers, the regulatory framework does not seem to pose major barriers to setting up new businesses and to entrepreneurship, and the administrative burden is relatively light. However, while the competition policy framework seems generally adequate, relatively high prices point to weak competition especially in some sheltered sectors, such as telecommunications, energy and professional services, which add to the cost of doing business. On the other hand, the ongoing downward adjustment in property-related costs could benefit business. Regarding access to finance, the ongoing adjustment in the financial sector may help ensure adequate credit flows as the economy recovers, especially towards the indigenous sector which is more dependent on domestic financing sources.

Prior to the current crisis, which saw investment plummet by over 40% in real terms between 2007 and 2009, gross fixed capital formation exceeded the euro-area average and capital deepening contributed positively to GDP growth. However, a capital-intensity gap vis-à-vis the EU15 persists ([15]) and the overall quality of the infrastructure continues to be perceived as being below that of peer countries.([16]) Moreover, nearly two thirds of the 67% increase in the net capital stock in the decade to 2008 went into dwellings, while the net stock of intangible fixed assets increased by less than 27%.([17])

Going forward, it could be important to support the sectoral reallocation of resources towards higher value-added activities by directing investment, both public and private, towards the needs of the knowledge-based economy while further upgrading physical infrastructure. Budgetary constraints underline the need to do so by reprioritising public infrastructure projects and incentives for private sector investment.

([14]) See for instance World Bank (2010), op. cit. and European Commission (2008), op. cit.
([15]) In level terms, as indicated by the updated LAF database (the EU15 benchmark refers to the European Union member states prior to the accession of ten candidate countries on 1 May 2004).
([16]) OECD (2009), *Ireland*, Economic Surveys.
([17]) According to data on the increase in the net capital stock at constant market prices by asset. Central Statistical Office (2009), Estimates of the Capital Stock of Fixed Assets 2008, Dublin, Stationery Office.

7.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Ireland's performance in the area of R&D and innovation is better than the EU-15 average, notably as regards the number of science and technology graduates and the share of high-tech sectors in total employment. ([18]) However, the economy has been relatively less successful in generating investment in R&D and fostering innovation. Despite recent significant improvements, the level of gross R&D expenditure (GERD) remains below the EU average, as does the number of patent applications. Furthermore, expenditure on information technology and other ICT-related indicators show a below-average (and worsening) performance. Although public expenditure on education relative to GDP is below the EU-15 average, the education sector's performance is good, except for the relatively weak participation in life-long learning. In the medium run, sectoral change towards higher-value added activities would be supported by higher R&D intensity and ICT investment.

([18]) Although the trend regarding both indicators is negative. See European Commission (2008), op. cit., also for indicators discussed in the remainder of this paragraph

8. GREECE

8.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Greece's current difficulties are rooted in the accumulation of vulnerabilities over the past decade. Growth was high, but based on unsustainable drivers and it went together with significant losses in external competitiveness and increases in macro imbalances. The 2009 recession was accompanied with a very significant deterioration in the size of the deficit of the general government to a 13.6% of GDP at end 2009 from an initial 2% of GDP in the 2009 budget, and 3.7% of GDP in the January 2009 stability programme. Following the elections in October, the realization that the fiscal deficit and public debt figures for 2008 and 2009 were significantly worse than had been reported by the previous government caused confidence to drop, financing costs to increase, and growth and employment to suffer.

With the deteriorating fiscal results came downgrades of government bonds by rating agencies, and investors started backing out of Greek bonds, driving up their yields. Furthermore, it is clear that the deep macroeconomic and structural problems combined with unavoidable strong fiscal adjustment over the medium term are likely to weigh on activity for some time.

The severity of recession in 2010 will depend significantly on private consumption, as well as in the behaviour of exports, as the latter should substitute the former and become the medium-term engine of growth. The economic program ([19]) assumes negative growth of 4 percent in 2010 and 2½ percent in 2011. While fiscal consolidation is bound to weigh on economic activity at first, it is expected that confidence effects from the front-loaded fiscal measures and the strong medium-term economic program, in combination with comprehensive structural reforms will create the conditions for a return to growth from 2012 onward. Inflation needs to be reduced significantly below the euro area average for Greece to regain swiftly price competitiveness. Domestic demand tightening, both through fiscal adjustment and efforts to moderate wages and pensions, together with cost-cutting measures in the economy, will be essential to bring inflation down in a meaningful way. In this regard, addressing oligopolistic structures to reduce high markups in some sectors will also be important. The external deficit is projected to decline gradually over the medium term as domestic demand and inflation moderate and the economy responds to structural reforms to improve the supply of exports and reduces the dependence on imports. This process will naturally take several years, while the interest costs on the substantial external debt will pressure the current account for some time.

8.2. MACROECONOMIC FRAMEWORK CONDITIONS

8.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Greece entered the downturn with very large external and public deficits. The crisis exposed the weak fiscal position, while the external imbalance remained at unsustainable levels in spite of the contraction in internal demand. The fiscal deficit of 5.1 percent of GDP in 2007, at the top of the cycle, shows that Greece entered the downturn with a large underlying public deficit. With weak revenue policies and poor tax administration, especially leading up to the 2009 elections and aggravated by the recession, revenues declined notably. Spending, meanwhile, increased significantly, especially on wages and entitlements, reflecting weak spending discipline and monitoring and control, which also led to new arrears. The monitoring and control deficiencies delayed the implementation of corrective fiscal policies.

The fiscal strategy in the economic adjustment program is anchored in placing the debt-GDP ratio on a declining path from 2013 onward and reducing the general government deficit to well below 3 percent of GDP by 2014. To avoid reform

([19]) The Memorandum of Economic and Financial Policies (MEFP), agreed between the Greek authorities and the joint mission of the European Commission, ECB and IMF on 3 May 2010, outlines Greece's policy programme which is supported by bilateral financial assistance from euro area Member States and the IMF.

fatigue and boost market confidence, the government's strategy is strongly to frontload the fiscal adjustment and identifies virtually all fiscal consolidation measures until end 2012. The main upfront measures are an immediate cut in the public sector wage bill, and in pension outlays, and further increases in the VAT and selected excises. This will assure that the deficit, notwithstanding the recession, drops from an estimated 13.6 percent of GDP in 2009 to 8 percent of GDP in 2010. The challenge facing Greece is to implemented the agreed frontloaded fiscal consolidation programme and thereafter sustain a large primary surplus over the very long run to reduce debt level. In addition, it is important for Greece to implement the planned pension reform so as to contribute to the sustainability of public finances.

To ensure that the planned fiscal consolidation is sustained over the medium and long run, a key challenge is to strengthen the efficiency and effectiveness of the public administration, achieve a better control of public finances and improve the quality of public finances so as to deliver cost effective public services for businesses and citizens. To this end, the Greek authorities have already adopted a new income tax law and are inter alia implementing a modernization of the tax administration, more stringent budgetary planning and surveillance mechanisms, an overhaul of public procedures (especially in the health care system) and an overhaul of the recruitment procedures and employment condition of civil servants at all level of government. A major streamlining of sub-central government is planned which should be matched by a functional review of the public administration at central level.

8.2.2. Macro-financial stability

Regarding macro-financial stability the Greek banking system is facing challenges. With the deteriorating fiscal results, the subsequent downgrades of government bonds by rating agencies, and rising investor aversion to holding Greek bonds, yields have been on the rise. Furthermore, the deep macroeconomic and structural problems combined with unavoidable strong fiscal adjustment over the medium term are likely to weigh on activity for some time. This combination of factors affects negatively the banking system, which is exposed to both liquidity and credit risk. In the general context of the turbulence affecting the debt markets for the Greek government, the Greek banks have lost wholesale market access to fund their operations since end-2009. Maturing interbank liabilities have not been renewed, or only at high costs. As a result, the banks have increasingly relied on Eurosystem credit operations.

As risks to the Greek financial system have been emerging, a focus on strengthening the financial and supervisory framework and closer coordination with home and host country supervisors within the EU framework for cross-border bank supervision can help maintain a viable and stable financial sector. This is particularly important in view of the ongoing recession and the government's stringent fiscal consolidation programme, as credit extension to the private sector can support productive investment over the medium term. At the same time, corporate and personal debt restructuring legislation should ensure that credit discipline is maintained, that creditor and consumer rights are protected, and that relevant information concerning borrowers' track record is preserved. Since the risks to the financial sector in Greece are currently very much related to the negative feedback-loop from the real economy to the financial sector, the outcome of the government's ambitious programme to consolidate public finances and restructure the economy will determine the sector's long-term prospects, overall ensuring a viable and stable financial sector including re-integration to global markets and sound lending practices. The safeguarding of banks' balance sheets is an important challenge to fostering sustainable credit growth that would support domestic demand, and the rhe reintegration of Greek banks to global markets would flag the Greek government ability to refinance the public debt.

8.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the degree of openness has been rising over the last 15 years, but Greece remains a relatively closed economy. Linked with buoyant and sustained domestic demand and a steady worsening of competitiveness, import penetration rose by 10 percentage points, from around 26% of GDP in 1995 to nearly 36% in 2008, while the share of total exports in GDP increased by around 7 percentage points from 17% to 24% over the same period. As a result, the external balance of the Greek economy deteriorated rapidly from 1997 onwards

In the medium term, the build-up of external imbalances carries with it a risk of lower growth. The patterns of sector and geographical trade specialisation show that Greece not only exports too little, but its exports of goods are mainly concentrated in low-technology and slow-growing demand products. Imports are mainly made up of consumer goods, while equipment and investment goods account for a relatively smaller share. While FDI inflows are relatively small, the growing external imbalance is being financed mostly through portfolio investment and, reflecting the public-sector origin of the current account deficit, through government bonds. The rapid rise observed in wage costs and mark-ups in excess of productivity growth has led to the deterioration in competitiveness over the last ten years as reflected in the sizeable appreciation of the real effective exchange rates. In view of Greece's weakened competitiveness in the euro area and its persistent current account deficit, adjustment in the context of the euro area is a major challenge that would be facilitated by relative price and cost adjustments and a shift of resources from the non-tradable to the tradable sector. In line with the lowering of public sector wages, private sector wages should become more flexible to allow cost moderation for an extended period of time.

In addition, reforms to bolster productivity growth and increase competition in closed markets (see below) could also contribute to improving price and non-price competitiveness. The structural nature of external imbalances in Greece implies that, in the medium-to-long term, the emphasis should be put on policies aimed at tackling the rigidities in the product and labour markets and promoting innovation. Although labour productivity growth has been relatively high, unit labour costs have been increasing at a faster pace than in Greece's main trade partners in the euro area, thus worsening the competitive position of the country. A recovery of competitiveness can be supported by: improving product and services market functioning to allow for a more active role for competition in the allocation of resources; fostering wage behaviour that takes due account of productivity developments; ensuring that tax and benefit systems make work pay; and improving the functioning of the public administration and public resources management, which could be channelled towards investment in knowledge and in human and physical capital. The economic adjustment programme aims at strengthening structural policies in order to boost competitiveness and emerge from the crisis quickly. In the medium-long term, these policies will enhance the flexibility and productive capacity of the economy to ensure that wage and price developments restore and then sustain international competitiveness, and also progressively alter the economy's structure towards a more investment and export-led growth model.

8.3. GROWTH DRIVERS

8.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Reducing the size of the informal economy by facilitating the full participation of all groups in the formal labour markets is an important challenge that will require the implementation of a wide range of actions foreseen in the adjustment programme. Following consultation with social partners and within the frame of EU law, the government should reform the legal framework for wage bargaining in the private sector, including by eliminating asymmetries in arbitration. The government should adopt legislation for minimum entry level wages in order to promote employment creation for groups at risk such as the young and long-term unemployed. In parallel, the government should implement the new control system for undeclared work and modernize labour market institutions, including by improving the job-matching capacity of the Public Employment Services and on well targeted activation polices. Employment protection legislation will be revised, including provisions to extend probationary periods, recalibrate rules governing collective dismissals, and facilitate greater use of part-time work. The scope for improvements in the targeting of social expenditures will also be revised in order to enhance the social safety net for the most vulnerable.

8.3.2. BUSINESS ENVIRONMENT, ENTREPRENEURSHIP AND INVESTMENT

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. A key challenge is therefore to implement the economic adjustment programme as regards specific measures to improve the business environment and open up competition in services and regulated professions. The government will shortly adopt legislation establishing one-stop shops for starting new enterprises to cut procedures, costs and delays. Legislation will be introduced to cut licensing and other costs for industry. The government will fully implement key steps of the EU Services Directive in 2010, especially in priority areas such as tourism, education and retail. Over the course of next year, restricted professions will be opened by reducing fixed tariffs and other restrictions in the legal, pharmacy, notary, engineering, architect, road haulage, and auditing professions. The role of the Hellenic Competition Commission (HCC) will also be strengthened. Network industries will be progressively liberalized, especially in the transport and energy sectors while strengthening regulators in these sectors in line with EU policies. A specific challenge in the Greek business environment pertains to managing and divesting state enterprises. These need to be subject to greater transparency to increase efficiency and reduce losses. As a first step, 2009 financial statements audited by chartered accountants of the ten largest loss makers will be published on the internet. A time-table and action plan for improving the financial performance of main loss-makers, most notably in the railway and public transportation companies will be produced. This action plan will include concrete steps to reduce costs, including by streamlining the networks serviced and increasing tariffs. The government will review the role for divesting state assets, including of land owned by public enterprises or the government. The government will further review the scope for improving corporate governance, and enhancing oversight of state-ownership.

8.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are the policies in the area of R&D, innovation and education which support the knowledge base. The Greek government has pledged to carry out in-depth evaluation of all R&D and innovation actions, including in various Operational Programmes, in order to adjust the national strategy. Moreover, the government will create an external advisory council financed through the 7th R&D programme, to consider how to foster innovation, how to strengthen links between public research and Greek industries and the development of regional industrial clusters.

To promote FDI and investment in strategic sectors, the government will take measures to facilitate FDI and investment in innovation in strategic sectors (green industries, ICT, etc.), through a revision of the Investment Law, the implementation of an action to fast-track large FDI projects, as well as measures to strengthen export promotion policy. It would also be useful to strengthen the contribution of all levels of education to human capital formation, including tertiary education where there is scope for a better match with labour market needs.

9. SPAIN

9.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

For more than a decade before the onset of the current crisis, the Spanish economy recorded growth rates above the euro area average and in excess of potential GDP. This GDP growth record was accompanied by strong job creation and fast population growth, thanks to large immigration flows, but also by the accumulation of imbalances in the economy. The combination of low real interest rates and dynamic demographics resulted in a significant increase in the economy's indebtedness and stimulated a sizeable asset boom, especially in housing. In addition, the Spanish current account deficit widened rapidly, reflecting a rising trade balance deficit and the primary income deficit. The severe economic contraction in Spain since the second half of 2008 has led to significant corrections in some of those imbalances. Mostly cyclical factors led to a reduction of the external deficit, which still remains sizable and has resulted in a high interest burden, due to the accumulation of external net liabilities. The downturn took a heavy toll on both jobs, especially in low-productivity sectors, and public finances, which may result in high long-term unemployment and a sharp worsening of the sustainability of public finances.

The short to medium-term outlook for the Spanish economy is characterised by the expected correction of those imbalances. Households' balance-sheet ratios might be restored by the quick increase of savings, which will have nonetheless an impact on internal demand. The construction sector is expected to face a shrinking demand, driven by the less dynamic economic and demographic developments, as well as by the considerable excess supply stemming from the stock accumulated in the housing sector. As far as the net borrowing needs are concerned, they are foreseen to record a limited reduction, despite the expected contraction of activity in 2010. However, the insufficiency of domestic savings and a weak competitiveness position may lead to a new widening of external imbalances over the medium-term. For 2010 as a whole, real GDP is forecast to contract further dragged down by domestic demand, reversing to subdued growth in 2011. Moreover, the potential growth of the economy will remain relatively low, hampered inter alia by lower population growth, which had been a key driver of the previous economic expansion.

9.2. MACROECONOMIC FRAMEWORK CONDITIONS

9.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Spain needs to pursue strong fiscal consolidation in the short and medium run, as well as to ensure the long-term sustainability of public finances, notably by tackling ageing-related expenditure. The economic downturn has severely affected public finances. Both rapidly falling revenue-to-GDP and rising expenditure-to-GDP ratios, driven by significant increases in social protection needs and discretionary measures to face up to the crisis, have resulted in a sharp deterioration in the public accounts, which have registered a deficit of 11.2% of GDP in 2009. In addition, the move away from the highly tax-rich growth composition associated with the fading out of the asset boom has led to a permanent reduction of tax burden. This creates a more structural challenge for Spanish public finances, which will need to address a permanent fall of revenues. In this context, a reduction of the informal economy would help to boost tax revenue, as well as mitigating distortions in the functioning of the economy.

The deterioration in the government budget balance has been sharp, but picked already in 2009. As from 2010, Spain has embarked in an ambitious process of fiscal consolidation. The long-term budgetary impact of ageing is also a challenge as it is clearly higher than the EU average, mainly as a result of a very high increase in pension expenditure as a share of GDP over the coming decades. As a result, the risks to the sustainability of public finances were assessed in the Commission 2009 Sustainability Report as high. Therefore, achieving primary surpluses in the medium term together with structural reforms would contribute to reducing further the risks to the sustainability of public finances. In order to face in particular the aging challenge, assets have been accumulated in the Pension Reserve Fund in order to pre-fund part of future pension expenditure and the government has proposed on 29 January 2010 a pension reform to the 'Toledo Pact' with improvements on this front. The shift to a less tax rich tax-basis economy points to the need for an adjustment of expenditure in all levels of government to this new situation. Dealing with impacts of ageing including higher health care costs and a significant increase in the ratio of retirees per worker is particularly important to bring this about.

9.2.2. Macro-financial stability

Regarding macro-financial stability, the direct impact of the global financial crisis on the domestic financial system has been relatively contained, despite the significant foreign borrowing needs and relatively high debt levels, thanks to a sound system of dynamic provisions set by Banco de España. For the moment only one minor financial institution, 'Caja Castilla La Mancha', has required intervention from the government. However, the housing bubble undermines the soundness of the financial system in a context of high unemployment, despite the traditionally high solvency of Spanish banks. Against this background, credit defaults have risen steeply and represent a potential source of risk. Similarly, the profitability of the banking sector has fallen, but has so far remained on positive territory. A decline in real estate prices dampened private consumption expenditure via negative wealth effects. Finally, credit growth has decelerated continuously following the tightening credit supply standards and has been the main source of transmission of the financial shock into the real economy.

Some measures were implemented to support a restructuring of the financial sector, which is important to render the financial sector viable and stable. The weak economic growth prospects, high unemployment rates and a structural adjustment of residential sector remain a risk in this context. In any case, restructuring the smallest saving banks seems crucial. Its low size and high concentration on mortgages and loans to real state companies imply a very high exposure to further increases of default rates. Some steps have been taken to foster concentrations in order to achieve larger financial entities, but the pace of this process is for the moment slow. In view of this, the high concentration of loans on the real state sector is at present the main risk for the stability of financial sector, given also the high indebtedness of the private sector. Although some steps have been announced in this respect - such as the partial removing of the housing investment deduction in the income tax and the renting market actions- policy measures to avoid asset prices bubbles and excessive private sector indebtedness would ensure that similar imbalances do not recur in the future.

9.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the Spanish current account deficit widened rapidly over the last decade, reaching a peak of 10% in 2007 of GDP, and only slightly moderating in 2008. Cyclical factors, reflecting strong economic growth in excess of its main trading partners, and structural, associated with persistent inflation differentials between Spain and the euro area, low productivity growth and the concomitant deterioration in competitiveness, are behind the increase of current account deficit. More recently, net outflows of primary incomes, linked particularly to the debt burden, and immigrants' transfers abroad (until 2007), have also contributed to the current account deficit. The actual crisis pushed to an important correction of this disequilibrium, reducing this deficit to 5.4% in 2009 and even lower in 2010, mainly by a narrowing of imports according to a weak internal demand and, to a less extent, by the growth of exports.

The tradable sector has been able to maintain and even increase its market shares, thanks partly to a diversification of their markets and a differentiation of their products as well as to an improvement in the cost competitiveness relative to their partners and the effect of the car scrapping schemes introduced by Member States and non-EU countries. Currently, a significant adjustment of the current account is taking place, in particular via a strong contraction of domestic demand, which has allowed imports to decline sufficiently to substantially reduce the trade deficit. Significant further reductions are hard to achieve. Spain is a relatively closed economy, so there is a larger share of resources in sectors other than the export sector. In this context, the Spanish economy needs to boost competitiveness in the economy, notably in the non-tradables sector, and enhance export-oriented activities.

The key issue for the Spanish economy in order to structurally improve its competitiveness stems from the shortcoming in productivity. Productivity growth in Spain has been sluggish during the last decade, partly as a result of a high allocation of investment to the construction sector and low-productivity services. Although measured productivity increased in 2009 above the euro-area average, this was mainly due to the sharp contraction of the above-mentioned activities rather than improvements in the structural drivers of total factor productivity. Consequently, in the medium term, once the adjustment of these low-productivity sectors is over, productivity gains might be more limited. Therefore, the challenge is to increase total productivity factor through enhancing innovation, investment by firms, training, and encouraging competition. A sustained increase in productivity, ideally accompanied by an increase in the activity rate, would lift potential GDP growth and foster the desired change in the economy's production structure towards higher-value added activities, as well as boosting competitiveness in the economy, notably in the non-tradables sector, and enhancing export-oriented activities and the spectrum of exporters. To this end, it will be important to ensure the necessary wage and price adjustments in particular in non-export sectors.

There are also challenges on the horizon linked to the insufficiency of domestic savings, particularly in the public sector, and the weak competitiveness position may lead again to the widening of the external imbalance over the medium-term. The servicing of the external liabilities will continue to absorb a non-negligible share of income over the medium term, mirrored in the deficit in the primary income balance. Indeed, a high external debt requires a lower equilibrium real exchange rate and a surplus in goods and services to finance it. The process of private deleveraging may weigh on growth, but will contribute to the external rebalancing.

9.3. GROWTH DRIVERS

9.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Spain needs to improve the labour market functioning, including fostering employment creation, reducing unemployment and reducing segmentation. The economic and financial crisis has taken a heavy toll on the labour market, especially in low-productivity sectors. The high employment creation in the Spanish economy in the decade prior to this crisis was characterised by a significant increase in construction-related jobs, which grew twice as fast as in the manufacturing sector. However, a third of those jobs were temporary contracts, remaining highly vulnerable to an adverse economic scenario. The current economic crisis has led to a process of significant job destruction, affecting especially temporary jobs. Given the likely negative impact of the crisis on potential growth and the associated rise in long-term unemployment, promoting a swift transition into employment, while still reining in public expenditures and ensuring social cohesion, poses a challenge for the social protection system. A successful transition into employment and thus a sustained increase in the activity rate would contribute to lift potential GDP growth.

The high segmentation in the job market is also aggravating the still-subdued employment prospects and high unemployment rates, for young people in particular, thus preventing a faster recovery of the economy and reducing the potential growth rate of the Spanish economy. Tackling the segmentation of the labour market would imply lower levels of job protection for permanent contracts and some more job security for the rest. Other challenges in the labour market include the rigid wage bargaining and indexation systems, which undermine competitiveness. The semi-automatic extension of collective wage agreements to all firms of a sector dents the profitability of firms and drives some of them out of business. Possible revisions of wage bargaining systems and social consensus for wage restraint over the coming years would be important with a view to ensure that wage developments reflect specific labour market conditions, in particular productivity developments. The low activity rate, mainly among women, limits potential growth while the present high level of unemployment increases the risk of expanding structural unemployment, which would further reduce potential growth. Reforms in the labour market, including inter alia a reduction of segmentation through changes in employment protection legislation, would help confront these risks.

9.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The institutional environment in Spain has not been very favourable to firms. Various surveys and assessments ([20]) indicate that Spain holds an intermediate position in the international rankings of this category. Continue improving the conditions for the creation of new companies is a key challenge in the current context of change in the productive structure of the Spanish economy. Moreover, professional services need to keep on moving away from the traditional anti-competitive regulation in particular removing a number of prior administrative authorisations to deliver certain services and restrictions to the joint exercise of professional activities and barriers which artificially segment the market. Retail also needs to continue efforts to avoid restrictive regulations, which have resulted on higher prices for consumers and limited productivity increases.

With a view to improving the business environment and increase competition in professional services, the Spanish authorities implemented the ambitious "Omnibus" and Umbrella Laws, which are a partial transposition of the Services Directive and include inter alia certain measures to reduce the administrative burden for start-ups. In addition, the draft law on Sustainable Economy of March 2010 included additional measures in this field such as a further reduction in time and administrative costs for in setting up businesses.

9.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Spain needs to improve education, in particular reducing the early school leaving rate and increasing upper secondary attainment, by fostering vocational education and training. The Spanish education system has problems in quality (at secondary and tertiary levels of education) and quantity (at the secondary level). As regards quality, the number of low achievers in the Spanish education system has increased since 2000. Moreover, Spain still has progress to make in the effective implementation of reforms in higher education, particularly those linked to the Bologna process, but also to the modernisation of its higher education by making it more suitable to the needs of the knowledge society, as well as in increasing efficiency in educational spending. Regarding quantity, the rates of early school leaving are extremely high and continue to increase. Certainly this phenomenon has been fuelled before the crisis by a highly dynamic job market that could offer youngsters a job, but it has its roots in the low performance of the education system. Moreover, participation in adult education, which benefits most those with lower qualifications, remains limited.

Spain also has a relevant shortcoming in terms of R&D. Despite substantial increases in both public and private investments in R&D in the recent years, business R&D expenditure amounts only to 0.74%, well below the EU average (1.23%). A key challenge in this context is the weak innovation performance and the lack of interplay between formal inputs (R&D) and innovative outputs. Spain has to continue efforts to absorb knowledge spill-over from other countries and connect to the expanding European research system, as well as expand the human resources available for research. According to international comparisons, ([21]) compared with other OECD countries Spain has a very low percentage of PhDs, who are proved to be the largest contributors to R&D and innovation. Furthermore, Spain still has room for improvement as regards the reform of the vocational training

([20]) See for instance World Bank (2010), op. cit and European Commission (2008), op. cit.

([21]) OECD (2009), Education at Glance 2009: OECD Indicators.

system in order to meet the changing needs of the labour market, favour labour transitions and upgrade skills to avoid long term unemployment. It will be important for Spain to ensure a stronger contribution of the educational system at all levels to human capital formation.

10. FRANCE

10.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

After a decade of continued economic growth supported by domestic demand, the free fall in net trade and the financial crisis dragged the French economy into a sharp recession, from mid-2008 to the beginning of 2009. However, France was relatively less affected by the crisis than its neighbours. This was mainly due to the importance of economic stabilizers, the recovery plan and the social policy framework, combined with a relative low degree of openness of the economy and limited size of the manufacturing sector, in particular compared to Germany. In addition, the absence of major imbalances compared to other large member states turned out to be an advantage during the crisis. The French economy came out of the recession in the second quarter of 2009 thanks both to a rebound in exports and to a better domestic consumption as the recovery plan got underway.

Economic activity is projected to recover softly in 2010, and gain momentum in 2011, with GDP growing respectively by 1.3% and 1.5% according to the Commission services' spring 2010 forecast. Nevertheless, the recent upturn in global demand is only giving little support to growth as France is not a strong export-oriented economy, while private consumption, the main engine of growth, is set to be weak in line with the slowdown in disposable income and the phasing out of the recovery package. As French potential growth is projected to be somewhat weaker than its 2000-2008 average, at 1¼% at the current juncture, the output gap is expected to close only gradually. In view of the relatively limited contribution to potential growth from labour in the pre-crisis decade, policies aiming at both increasing the participation rate and fighting unemployment would be essential to raise long-term output. Looking beyond 2020, long-term potential growth is set to be around 1.8% p.a. higher than in the EU27, owing mainly to continued projected increases in labour productivity per hour. ([22])

10.2. MACROECONOMIC FRAMEWORK CONDITIONS

10.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the general government deficit reached 7.5% of GDP in 2009, after 3.3% in 2008. This sharp deterioration is mainly due to the drop in economic activity and its large budgetary impact, especially on the revenue side, as well as to the recovery measures adopted by the French authorities following the EERP. Nevertheless, the excessive deficit is also linked to the fact that France did not make sufficient progress with structural consolidation of public finances, leaving it with little fiscal space at the onset of the crisis. The deficit is foreseen to increase further in 2010: while the balance of discretionary measures is expected to be neutral, the strong increase in social benefits linked to the still deteriorated situation on the labour market, as well as the increase in interest payments related to the rise in public debt would worsen the budgetary situation. According to the Commission services' spring 2010 forecast, the deficit would improve by around ½ pp. of GDP in 2011, as a result of the positive impact of discretionary measures (including the complete phasing out of recovery measures in line with the EERP).

For the medium term, the fiscal consolidation should be strong enough to lower the debt-to-GDP ratio, which increased considerably during the crisis. The increase of the debt ratio is mostly related to an increase in the deficit ratio, and to a slight extent to several government operations including those to stabilise the financial system. In total, the debt ratio is expected to come close to 90% in 2011. Reducing the high general government structural deficit and the high debt level will contribute positively to the long term growth perspectives. If addressed, a lower interest service could allow for more productive public and

([22]) European Commission (2009), op. cit.

private investment, particularly necessary to support growth and boost confidence and allow a decline in the high current saving rate of households.

The long-term budgetary impact of ageing is lower than the EU average, with pension expenditure showing a more limited increase, as a result of the previous pension reforms and thanks to a relatively favourable demography. Ensuring primary surpluses over the medium term would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as medium. Specifically, further reforms to the social security system aimed at curbing the increase in age-related expenditures are important. In this context, the government intends to present in the summer a legislative proposal for further reforming the pension system, which would also help put the public finances onto a more sustainable path.

10.2.2. Macro-financial stability

Regarding macro-financial stability, France has a large financial system which accounts for 10% of the global banking system. ([23]) Domestic banks dominate retail banking but foreign banks are increasingly present in wholesale banking and securities trading. The French banking system is highly consolidated, the nine largest banks accounting for 3/4 of total banking assets. The global financial crisis put the French financial sector under strain and various government measures were taken to support the sector. The financial crisis led to a tightening of lending conditions, especially for businesses, but these supply constraints were slightly less important than in the euro area as a whole. Even if difficult to asses, this tightening might have resulted in a pro-cyclical effect of lending which might have amplified the fall in investment. French banks have started to come back to normal refinancing conditions in the markets, also engaging early into exit strategies from support schemes. However, in order to avoid liquidity bottlenecks, especially for SMEs, restoring confidence in the financial sector is of paramount importance. In addition, as the level of French households' indebtedness is relatively low, an improvement of the financial environment could also indirectly lead them to reduce their precautionary savings and support economic activity. Furthermore, improving the viability and stability of the financial system would lessen the need for government intervention.

10.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, France has been on a deteriorating trend since 2000 and net exports have been hampering growth. The French economy is slightly less open than other large euro area countries, and considerably so relative to Germany. ([24]) Exports may be defined as “generalist” The decomposition of French exports clearly points to the medium-high technology positioning of French products, which, together with relatively low investment in R&D and underperformances in education system places the country in a situation of innovation follower in some products. The large share of low-medium technology intensity products exposes France to competition from both industrialised and emerging economies.

Consequently, France's share of exports of goods in world trade decreased on average more than for its main trading partners (Germany, Italy, Spain, UK). The geographic specialisation of exports also is not favourable in the current context: 70% of its exports go to Europe, which is expected to grow at a much slower pace than emerging economies and Asia. The disappointing export performance of the country can also be explained on the basis of a series of supply side factors, such as the aforementioned weaknesses in innovation and the size and the number of exporting firms. Improving notably non-price competitiveness and fostering export-oriented activities, also by improving the technology positioning of French exports would boost growth and reduce somewhat the heavy reliance on domestic sources of growth.

([23]) Yingbin Xiao (2009), *French banks amid the global financial crisis*, IMF Working Paper, 201.

([24]) As measured by the share of (volumes of) exports and imports of goods and services in GDP, openness stood at 62.1% in 2008 (6 pps. higher than in 2000), much lower than the euro area average (almost 90% in 2008) and that Germany's openness (95.1% in 2008).

10.3. GROWTH DRIVERS

10.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. As a result of the strong deterioration in economic activity, the French labour market adjusted rather sharply. The recession has exacerbated the insufficient utilisation of labour in France and the imperfect labour market functioning. The youth unemployment rate, which has been structurally high, has surged during the crisis to almost 25%, increasing twice as much as the total unemployment rate. At the same time, temporary employment was the most badly hit, accounting for more than one third of total job losses, as a consequence of the important labour market segmentation between employment contracts. In view of the fact that previous recessions have resulted in higher structural unemployment in France, combating withdrawal from the labour force and fostering employment creation, with a focus on young and older workers as well as on vulnerable groups would be important. Specifically, tax cuts on overtime hours may incite employers to favour overtime over new recruitment when the recovery is back and thus delay job creation. A successful response would avoid a permanent destruction in human capital and a durable rise in long-term unemployment. In addition, a budgetary neutral reduction of the high tax wedge on labour could stimulate labour demand. Moreover, future increases in the minimum wage could also factor in the need to ensure wage differentiation at the lower end of the wage scale.

In a medium to longer term perspective, the low employment rate, which reflects the weak activity rate and a persistently high unemployment rate, is negatively affects potential output. Improving labour market functioning and employment creation, including by tackling segmentation, is therefore important especially at both ends of the age spectrum and for vulnerable groups. This would necessitate continuing to modernize employment protection legislation, as well as taking measures to reduce structural unemployment. More flexicurity and mobility in the labour market, together with better activation policies, would support employment in the long run, especially at both ends of the age spectrum and for vulnerable groups, while reducing the segmentation between different types of contracts. This is all the more crucial as low employment rates, in particular for older workers, impact negatively on potential output growth and long-term sustainability of public finances.

10.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. France’s external competitiveness could also significantly benefit from enhanced domestic competition. Addressing the weaknesses in the business environment, including the competition framework, would contribute positively to lifting France's long term growth potential. The development of enterprises is notably hampered by a not flexible enough regulatory environment and a high overall tax rate. In addition, SME growth suffers from difficult access to credit and finance. Enhancing competition in regulated trades and legal professions where regulatory entry barriers are comparatively high as well as further reforming the retail sector is also important. Additionally, the competition framework in the network industries, even if improving is not yet favourable. Increasing domestic competition would also better prepare firms to conquer external markets and improve their competitiveness with a positive impact on potential growth.

10.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Despite the vast reform of the research and innovation system since 2005, and the relatively high share of science and technology graduates as well as of employment in high-technology sectors, France tends to display a relatively weak performance in generating business investment in R&D and fostering innovation. Indeed, the level of R&D expenditure as a percentage of GDP has been on a decreasing trend, mainly due to developments in business investment. This may also be due to a sectoral composition effect where the share of intensive R&D sectors is relatively low. This decline is echoed by negative trends in tertiary graduates in science and technology and in employment in high technology sectors. The performance of France in R&D, higher education and innovation is also reflected in a weak evolution of total factor productivity. Despite one of the highest labour productivity levels per hour, future growth in total factor productivity may well be dampened by the lack of targeted R&D and innovation expenditure.

In the medium run, evaluating and improving the framework to increase business R&D and innovation, especially in small and mid-sized enterprises (SMEs) as well as strengthening the links between tertiary education, research and innovation system Would contribute to a higher growth potential. Better targeted private R&D and innovation expenditure could stimulate total factor productivity, improve the competitive position of the country and strengthen the labour market. In this regard, public policies aiming at fostering R&D and innovation, such as the 2008 reform of the "Crédit Impôt Recherche" could be better assessed and targeted where necessary, also in view of their budgetary impact. Educational performance remains overall positive compared to the EU average. To improve the quality and efficiency of the tertiary education system, boosting private funding for tertiary education could also be helpful.

11. ITALY

11.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The global economic and financial crisis produced a sharp contraction in Italy's real GDP between the second quarter of 2008 and the second quarter of 2009 (by more than 6.5%), as exports and subsequently investment collapsed. However, already existing structural weaknesses had weakened the Italian economy long before the global downturn. Economic growth in Italy was only around 1% on average between 2001 and 2007, i.e. half the euro-area average. Weakening productivity was the key factor dragging down growth, due in particular to a marked slowdown in total factor productivity. Growth was mainly sustained by increases in labour utilisation, especially by a falling unemployment rate and increasing participation of the prime-age group.

Real GDP growth is forecast to be mild in 2010, also because of the negative impulse from 2009, and to gain some strength in 2011. As the crisis did not significantly aggravate existing imbalances or create new ones, the economy does not face major restructuring needs. Hence, the crisis is estimated to have little long-lasting impact on Italy's potential growth. However, at around ¾% per year over the period 2001-2007, the potential growth rate was already relatively low before the crisis. Pushing ahead with structural reforms to achieve a durable recovery in productivity growth is key to raising the country's low potential GDP growth.

11.2. MACROECONOMIC FRAMEWORK CONDITIONS

11.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the very high public debt and the related debt-servicing costs continue to weigh on Italy's public finances. Over the 1990s, the general government deficit declined from a double-digit ratio to below 3% of GDP, allowing Italy to join the euro area from the outset and contributing to putting the very high debt ratio on a declining path. In subsequent years, before the onset of the crisis, fiscal policy did not take advantage of the relatively positive cyclical conditions. Throughout the crisis, in view of Italy's very high public debt in a context of increased risk aversion in the sovereign bond markets, the government pursued a cautious fiscal policy, which contributed to containing the country's fiscal risk. Still, the economic downturn had a significant budgetary impact: the deficit widened to 5.3% of GDP in 2009 from 2.7% in 2008, while the debt ratio climbed by almost 10 pps. in 2009, to 115.8%.

The very high government debt highlights the importance of the committed fiscal consolidation. Even though the budgetary impact of ageing in Italy is lower than the EU average, pursuing a durable fiscal consolidation and firmly putting the government debt ratio on a steadily declining path remains a key challenge. In this context, the design and implementation of appropriate rules governing fiscal federalism with a view to improving the accountability of local governments, ensuring fiscal discipline and fostering efficiency in public spending are set to be key elements of Italy's medium-term fiscal policy.

11.2.2. Macro-financial stability

The low level of household indebtedness in Italy has prevented the formation of large external imbalances. However, the very high level of public debt and the modest growth performance make the country vulnerable to external shocks.

Non-financial corporations' debt as a percentage of GDP has been rising fast since the beginning of the 2000s. As a consequence of the economic downturn, non performing loans increased further in 2009 from already relatively high levels. Credit growth, notably to non-financial corporations, decelerated sharply in 2009, which could be explained by the tightening of supply conditions and the fall in demand due to plunging gross capital formation.

11.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Italy's trade balance and current account gradually moved from surplus during most of the 1990s to deficit in recent years. Since the late 1990s, deteriorating cost and price competitiveness has accompanied Italy's steady loss of market shares and led to relatively weak export growth. The low productivity growth in Italy is a key factor behind the rise in unit labour costs and the consequent unfavourable competitiveness developments. In addition, a breakdown of exports by product category reveals a relative predominance of labour-intensive products and low-technology goods. Such an export mix competes with, rather than being complementary to, that of the emerging economies, making Italy more exposed than other euro-area countries to increasing global competition. As a partial response to these competitive pressures, a restructuring process has been taking place in the tradable sector in recent years, whereby Italy's exports moved up the quality ladder, while maintaining their specialisation in labour-intensive sectors.

Looking forward, the geographical pattern of trade has begun moving towards more dynamic emerging markets (especially towards Asia), but its continued dependence on growth in the euro area prevents Italy from fully reaping the benefits of the ongoing global recovery. This feature further reinforces the need for Italy to ensure better alignment of wage and productivity developments while increasing productivity so as to restore and sustain competitiveness. In order to allow wages to better reflect productivity developments, which have been very subdued since the end of the 1990s, there is scope for better balancing wage co-ordination at the national level with appropriate wage adjustment at the decentralized level, including in the public sector. This would also help to address regional imbalances in the labour market. The proper implementation of the recent wage bargaining reforms could also play a role. In a longer-term perspective, the key challenge for Italy is to enable a durable recovery in productivity growth by tackling the deep-seated structural weaknesses of the Italian economy. As discussed in more detail below, R&D and innovation, the quality of human capital as well as the business environment are key areas to be addressed.

11.3. GROWTH DRIVERS

11.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The 1993 tripartite agreement brought about wage moderation, while the labour market reforms undertaken since 1997 increased the flexibility of work contracts by reducing hiring and firing costs for new entrants. As a result, the performance of the Italian labour market has improved in terms of employment, participation and unemployment rates, although accompanied by weak labour productivity dynamics. The economic crisis has had a relatively limited impact on the labour market, at least in terms of headcount employment, thanks to the extended use of the wage supplementation scheme to compensate the salary loss in the event of a reduction of hours worked. Even so, employment and participation rates of women, youth and older workers still lag significantly behind the euro-area average, while sharp disparities persist between northern and southern regions.

To increase potential growth, ensuring full utilisation of the economy's labour potential, by continuing to increase the employment rates of the youth, women and older workers, also with a view to reducing regional disparities is a crucial challenge. In this context, a more efficient wage setting framework could help to increase labour demand. Enhancing the effectiveness of public and private employment services will play an important role. In the long run, all components of labour productivity, including low total factor productivity and capital deepening, but also weak educational attainment levels, need to be addressed if they are to provide a higher contribution to growth. Indeed, these three factors appear to be strongly interlinked. On the one hand, policies aimed at improving competition and the business environment would also have positive spillover effects on labour productivity. ([25]) On the other

([25]) See the 2008 LIME Assessment Framework (LAF) Country Case Study on Italy.

hand, a broader participation in the labour market would call for appropriate flanking policies in the education, vocational training and life-long learning areas.

11.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Capital accumulation contributed positively to Italian growth over the 2000-2008 period, but has continued to be lower than in the euro area. While labour has become cheaper relative to capital and more flexible as a factor of production, weaknesses in Italy's business environment and competition policy framework may hamper business activity and entrepreneurship. The regulatory framework still entails lengthy and costly procedures for enforcing contracts, dealing with licences and starting a business and, in general, the administrative burden on firms is high. ([26]) The degree of competition in services remains relatively low, especially with regard to local public services, energy markets and financial and professional services. This is reflected in services prices, which have grown more than the euro-area average throughout the last decade and have remained rigid during the economic crisis.

To improve the business environment, Italy has taken steps to enhance the quality of existing regulation and the efficiency of the public administration and make the provision of local public services more competitive. Still, addressing the weaknesses in the business environment, including the further opening up of services and network industries, and improving administrative efficiency could significantly raise productivity. Addressing them would help remove significant bottlenecks to long-term productivity growth and capital accumulation, thus raising potential GDP growth and reinforcing the resilience of the economy.

11.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Expenditure on R&D was just 1.2% of GDP in 2008. The private sector accounted for less than half of the total, reflecting the prevalence of small and medium enterprises and inefficiencies in the capital market, notably with regard to enabling the expansion of companies through third-party capital, including innovation financing through venture capital investments. While public spending on education is only slightly below the euro-area average (4.7% of GDP vs. 4.9% in 2006), a number of weaknesses can be identified: a low share of upper secondary attainment and a low share of tertiary-educated population (even if Italy has had a very strong growth in graduates in mathematics, science and technology), a high number of early school leavers and low participation in vocational training and lifelong learning schemes. The performance on low achievers is below the EU average and has deteriorated. Moreover, Italian students score poorly according to the OECD PISA indicators, even if the national average masks significant regional disparities: performance is in line with or above the euro area average in northern regions but significantly worse in the South.

Encouraging a higher level of expenditure on R&D in the private sector would help to enhance the innovative capacity of firms and ensure the development of high-value added production and services. At the same time, addressing the current weaknesses in the education system, including significant regional disparities in outcomes, inter alia by improving the link between education and the labour market, would provide the skills and human capital that are needed for such move.

([26]) See the World Bank's 'Doing Business' and the LAF indicators.

12. CYPRUS

12.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The crisis hit Cyprus with a lag compared to the rest of the EU. Cyprus entered into recession the second quarter of 2009, after more than a decade of sustained and strong expansion in conditions of low inflation and unemployment. Such an expansionary period appears to be explained by a succession of credit-led impulses, demographics and adjustment processes, such as the convergence on the road to EU accession in 2004 and the macroeconomic-stability policy framework put in place to ensure euro adoption in 2008. Fiscal policy has been countercyclical for most of the past decade.

Looking ahead, the prospects for economic recovery appear mixed, as the domestic and external imbalances need to be redressed. In particular, the crisis has highlighted the accumulation of a high domestic and external imbalance, a particularly oversized housing sector and competitiveness losses. The general government deficit reached 6.1% of GDP in 2009, while the current account deficit, although it halved to 8.5% of GDP due to the economic slowdown, it still remains high. Economic activity is expected to shrink further, although to a lesser extent, in 2010 by almost ½% to be followed by a moderate recovery of 1¼% in 2011. In the long term, the Cypriot economy's growth potential is projected to be somewhat weaker than its 2000-2008 average of 3½%, falling at around 1¾% over 2009-2010. The economic outlook prospects hint strongly to a more modest growth path compared to the performance of the recent past.

12.2. MACROECONOMIC FRAMEWORK CONDITIONS

12.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, in 2008, while Cyprus still enjoyed good economic times with economic activity growing at 3½%, fiscal stance shifted to pro-cyclical, partly driven by the government's attempt to mitigate the negative effects of the adverse external environment. In parallel, hitherto buoyant tax revenues began subsiding in line with the fading away of the asset boom. In 2009, the GDP contracted by 1.7%, the first negative growth rate recorded in the last 35 years. The severity of the recession, the vanishing asset boom, less tax-rich GDP composition, the operation of the automatic stabilisers and a discretionary fiscal stimulus package resulted in a major fiscal deterioration. The 2010 budget law targeted a deficit of 4.5% of GDP, on the basis of an estimated outturn for the deficit in 2009 of about 3%. Given that the final outturn for 2009 was a deficit of 6.1% of GDP, the budget law would imply an even higher deficit. The latest update of the stability programme of Cyprus lists measures which aim to stop further budgetary deterioration, but a number of them are still negotiated with the social partners, and these delays raise risks for budget outcomes in 2010.

Given strong growth in government expenditure, improving public sector efficiency can help create room for expenditure adjustments without compromising the quality of public services. Overall, while controlling current expenditures, it would be important to shift public expenditure to more growth-friendly and production capacity-enhancing structure, while pursuing product market reforms that would promote competition and speed up effective restructuring. Moreover, in the early stages of the recovery consolidation pressures need to be balanced against the risk of choking off a nascent return to growth. Improving quality of public finances through a redirection of public spending to growth-friendly policies could support potential output and social cohesion.

The long-term budgetary impact of ageing is significantly above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades, partly due to the fact that the pension scheme is still in a maturing phase. A pension reform was introduced in April 2009 that is projected to slightly reduce the increase in pension expenditure and, more significantly, increase the social security contribution rates. The reform would improve the long-term balance of the pension system and reduce risks to sustainability, however without having an effect on the overall assessment. The budgetary position in 2009 compounds the budgetary impact of population ageing on the sustainability gap. In view of Cyprus' large external and domestic imbalances, fiscal consolidation including expenditure control could help stabilise the economy. Accelerating pension and healthcare reform with a view of containing population-ageing related expenditure and the implementation of an effective multi-annual budgetary framework would ensure the adherence to the budgetary targets and contain expenditure over the medium-term.

12.2.2. Macro-financial stability

Regarding macro-financial stability, the Cypriot banking and financial services sector is relatively large and highly open. Nevertheless, it has shown marked resilience towards the adverse conditions of the economic crisis. As a result, the Cypriot government has not adopted any specific package to stabilise the financial sector. However, in order to underpin the confidence in the banking system the deposit guarantee level was raised. Moreover, the government issued treasury bills in early January 2009, with maturity December 2009, for refinancing its short-term (cash flow) needs and for increasing the liquidity conditions in the banking system. The main reason behind the resilience exhibited by the Cypriot banking sector is that banks have not relied on wholesale funding but their main source of funding is retail deposits. According to the Central Bank, the Cypriot banks have not been exposed to toxic assets and therefore no write-downs took place.

Having said that, a prolonged period of adverse economic conditions with further contraction of housing investment and negative wealth effects to households coupled with any spill-over effects from the Greek crisis, evidently, could pose risks to the hitherto resilient financial sector. Vigilance is warranted at the current juncture in tandem with efforts to ensure a better regulatory framework in international financial markets.. Moreover, further strengthening the financial and supervisory framework would be conducive to enhancing further Cyprus' role as a safe, dynamic and competitive financial centre. Meanwhile, the household sector has become increasingly burdened with high debt levels while the associated debt-servicing costs remaining at high levels, pushed up by the relatively high deposit rates. Rising interest rates over the medium term are likely to strain household finances and potentially, increase non-performing loans or default rates. This underscores a need to limit the risks from high household indebtedness.

12.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, due to the contraction of economic activity in 2009 there was an important, yet partial, reduction of the current account deficit down to 8½% of GDP from the record high deficit of 17½% in 2008. Following a close-to-balance position in the mid-1990s, the current account balance has deteriorated over time and has been in the red since 2000. The widening of the trade deficit in the recent past reflects also the acceleration and the composition of GDP growth, which was exclusively driven by domestic demand, as well as developments in oil and commodity prices. Cyprus being an isolated energy system with no electricity, oil or gas pipeline interconnections needs to cover all its requirements by inland production of imported raw materials, with a direct impact on the current account. The evolution of the Cypriot current account balance shows large disparities between net trade in goods and services. The persistently very high deficit in goods trade and the very high surplus in services reflect the shift of the Cypriot economy towards the tertiary sector. It also mirrors to a certain extent deterioration of competitiveness, partly due to a weak response of wages in both the public and private sectors to the current recession and to the euro appreciation. The current account deficit is also adversely affected by a particular country-specific feature related to the statistical treatment of profits of foreign-owned firms based in the country. In particular, profits which are recorded as outflows in the income account, which is included in the current account, they are treated as a foreign direct investment (FDI) inflow in the financial account, when reinvested.

Despite the significant reduction of the current account deficit, it still remains relatively high. As a result, the current account imbalance is likely to weigh on economic growth over the medium-term.

High public sector dissavings would need to be financed by either foreign debt or higher domestic private savings. Thus, the adjustment of the current account deficit would require either higher cost of debt-financing or higher savings from the private sector. The latter would imply lower output growth through crowding-out private consumption or investment. Therefore, following prudent fiscal policies is crucial. Also, the efficiency in the use of public resources, through a reallocation towards public investment in knowledge, human and physical capital, could also be improved. This would increase the attractiveness of the country to business activities with higher technological content and added value.

Since Cyprus is mainly a services-oriented economy and the role of the local goods production industry is rather limited, upgrading the range of services exports and its role as a regional hub for goods re-export activity appears promising. In view of Cyprus large domestic and large external imbalances, remedial efforts are needed. Restoring the link of wages to developments in productivity is crucial to support the competitiveness of the Cypriot economy. In this context, there is a need to ensure that labour market institutions do not unduly impede the efficiency of the wage-setting process. Allowing wages to reflect productivity gains would lead not only to competitiveness gains, but also to a more efficient allocation of labour. Also, initiatives to improve the functioning of product and labour markets would enhance the country's competitiveness. Ensuring that wage developments are in line with productivity would be important to support the country's competitiveness, particularly vis-à-vis its euro area partners, and be conducive to the adjustment of the external imbalance. Cyprus' membership of the euro area reinforces the importance of this adjustment channel. While controlling the wage dynamics is of paramount importance, improvements in competitiveness should also come from an acceleration of productivity growth. Increasing the investment by the private sector in business activities with higher technological content and added value plays a key role with positive spill-over effect on the substitution of unskilled immigrant labour with highly skilled domestic labour, thus ensuring a more rational utilisation of domestic resources.

12.3. GROWTH DRIVERS

12.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Cyprus' labour market has been characterised by conditions of almost full employment and has outperformed the EU average on all fronts. Over the last ten years, the unemployment rate averaged at 4¼% with long-term unemployment being less than 1% of the labour force. The employment rate averaged at 69¼%, with the employment rates for males, females, and older workers, all fulfilling the relevant Lisbon targets. While population has been growing at an average annual rate of 1½%, employment has been growing in tandem by 2½%. Due to the tight labour market conditions and shortages, working permits were issued to foreigners, particularly from 2003 onwards, leading to large-scale migratory inflows and bringing the total number of foreign workers to about 20% of the labour force, amongst the highest in the euro area. However, most of the foreign workers are relatively young (20 to 30 years old), low-skilled, thus with lower productivity than the domestic labour force. The large increase in foreign workers played a dampening role on both wages and productivity in the sectors they were employed. In the context of the short-term recovery from the recession, labour market policy must be aimed at ensuring adequate job matching, job search and career guidance services in combination with offering continuous training and education to the unemployed and preventing jobseekers withdrawing from the labour force. Given the overall tight labour supply conditions, an improvement in the participation rates of young, female and older-age workers would increase labour supply. This will require measures addressing the gender segregation in the labour market including measures to reconcile work and family life with emphasis in the provision of facilities for the care of family dependants (children, elderly and disabled). In addition, investing in active labour market policies to improve skills would enhance the economy’s potential and competitiveness, and could focus in particular on the needs of the domestic low skilled and disadvantaged groups. Also efforts to combat illegal and undeclared work will increase measured employment.

12.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Cyprus has developed into an increasingly open economy and a favourable business environment. According to the World Banks' "Doing Business", it ranked 14 amongst the EU Member States in 2010. The competition policy framework fares well and the conditions for enhancing competition in the Cypriot economy showed signs of overall progress, through strengthening the role of the Competition Protection Commission. Progress has also been marked in hitherto regulated sectors. In particular, the electricity and energy sectors dominated by the state monopoly opened to competition while the legal framework for the introduction of energy from Renewable Energy Sources (RES) and of natural gas is at an advanced stage. In parallel, measures are taken to reduce the administrative burden. While investment has contracted due to the crisis and it is expected to continue its adjustment over the medium-term, the envisaged correction is assumed to affect mainly the market for residences, and to a much smaller effect infrastructure or non-residential construction. However, the small size of the national economy in certain cases leads to comparatively limited competition and non-competitive pricing practices in certain sectors. Due to increasing transportation costs, European products enter the Cyprus market at comparatively higher prices depriving it of the benefits of economies of scale and also raising the prices of locally produced commodities. This underlines the need for strong policies to strengthen competition and to improve transport links.

12.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Notwithstanding its relatively high share of highly-skilled persons and youth education attainment level, Cyprus' performance in generating investment in R&D and fostering innovation is relatively weak. In recent years, efforts have been made with satisfactory progress via various initiatives to improve the situation. Nevertheless, R&D expenditure, especially from the private sector, remains low. The lack of critical mass, due to the small size of the country, the lack of industrial base since Cyprus is a services-oriented economy, and the fact that 99% of the companies are SMES, with the bulk tilted towards small to very small size, are all critical handicaps in this respect.

The Cypriot authorities have attached significant weight to actions to improve the innovative capacity of the economy. Nonetheless, private R&D expenditures are not increasing. Moreover, the financial crisis affected negatively its financing. On the positive side, in the field of innovation, according to the European Innovation Scoreboard 2008 (Strengths and Weaknesses Report), Cyprus improved its position considerably, moving from 24th to 13th. Given the size of the economy, concentration of innovation efforts and the creation of clusters of excellence (e.g. renewable energy or production of drinking water) seem a promising way forward. Equally, enhancing educational institutions and research centres as well as fostering an innovation culture would support Cyprus' potential output and long-term prospects. In this context, the new strategy to promote ICT uptake and to improve ICT-infrastructure is an essential step. Regarding education, the overall performance remains positive, with a high share of youth educational attainment, including university graduates. Ensuring a stronger contribution of the educational system at all levels to human capital formation and innovative capacity including by strengthening the links between tertiary education, research and innovation systems, but most importantly, investments in new technologies, in improving the business environment and innovation, would help facilitate the restructuring of the Cypriot economy towards more high-skilled jobs and increased labour productivity.

Cyprus is already experiencing the negative impacts of climate change with severe droughts, extreme temperatures and severe deforestations problems, requiring huge amounts on adaptation measures. Cyprus has one of the lowest water availability per capita ratios in Europe, with its water resources depending almost entirely on rainfall. In an effort to eliminate the dependency on rainfall, the process of desalination is being used, which apart form being very costly, it also causes adverse side effects on the environment such as increased CO_2 emissions. Exploiting new technologies for green jobs and Renewable Energy Sources (RES) is also warranted.

13. LATVIA

13.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The global financial crisis amplified the shock of the reversal of Latvia's overheated domestic lending and real estate market by tightening credit availability and conditions. The concomitant downturn in external markets hit the tradable sector, which added to the competitiveness losses of previous years. Financial markets and the banking sector came under significant pressure from October 2008 onwards, prompting the authorities to seek international financial assistance, which was made conditional on major fiscal consolidation, financial system and other structural reforms.

After an estimated 18% GDP fall in 2009, real GDP is expected to decrease by a further 3.5% in 2010 before growing by 3.3% in 2011. The expected transition to positive growth is led by the external sector, as export markets recover and cost competitiveness improves, and somewhat by fixed investment. Private consumption and domestic demand is projected to contract further and recover more gradually. Weakness in labour market, financial deleveraging and additional fiscal consolidation measures are expected to hold back domestic demand. There is also a risk that banks would provide insufficient funding for the economy to expand, thereby delaying the emergence from recession.

Potential growth in the medium term is likely to be reduced due to lower investment, constraints in credit availability and increased structural unemployment. Moreover, the impact of the economic crisis compounds the negative effects of demographic ageing on potential output and the sustainability of public finances.

13.2. MACROECONOMIC FRAMEWORK CONDITIONS

13.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, following a period of consolidation in the late 1990s, the stance of public finances shifted towards pro-cyclical fiscal loosening during the years preceding the crisis. This compounded the crisis as no fiscal savings were accumulated. The general government deficit in 2009 was 9.0% of GDP and is targeted to decrease to 8.5% of GDP this year.

In the medium term, fiscal policy needs to remain restrictive in order to reduce the high general government structural deficit. Despite the extensive consolidation efforts already undertaken, this poses a significant challenge. Risks pertain to the size of remaining adjustment (ca. 7% of GDP over two years) in the context of a sluggish economy and uncertainty on future revenue trends and possible expenditure slippages.

In view of the recent progress in terms of fiscal consolidation, the government is making increasing recourse to domestic financial markets to finance its borrowing needs. However, the implementation of additional consolidation measures to comply with the conditions for receiving Balance of Payments assistance and achieve the Maastrich deficit criterion by 2012 is crucial for increasing credibility and improving access to international financial markets before the assistance programme ends. In addition, structural reforms could help to ensure a sustainable catching-up process of the economy and to avoid a further accumulation of government debt. In the longer term, the budgetary projections in the 2010 update of the convergence programme imply a stabilisation of debt levels in the medium term at around 60% of GDP, while the long-term budgetary impact of an ageing population is expected to be lower than the EU average, as a result of pension reforms already enacted.

13.2.2. Macro-financial stability

Regarding macro-financial stability, the financial sector in Latvia is relatively large compared to GDP and is characterized by large foreign ownership. The exponential growth in lending to domestic private sector in 2005-2007 contributed to economic overheating with a rapid increase in prices and accumulation of sizable private sector debt, mainly in euro. With the global financial crisis, access to external funding diminished and without parent banks' liquidity being available, domestically-owned banks came under severe liquidity pressures. This was one of the reasons that led to the government's intervention to support Parex bank and request international financial assistance. Credit conditions, abruptly tightened during the crisis, remain strict, leading to significant net loan repayments from the domestic non-bank sector (>8% of estimated annual GDP in 2009). This pro-cyclicality of lending exacerbated the deterioration in domestic demand and could hinder the restructuring of the economy towards the tradable sector.

Ensuring a well-functioning and stable financial sector in light of the ongoing deleveraging of the private sector is an important challenge. After the very marked lending boom, the household and corporate sectors are significantly indebted compared with other new member states, which puts a drag on consumer spending and the investment needed to underpin growth, while representing a challenge to the banking sector. Non-financial firms face subdued internal demand and increased difficulties in securing financing. An appropriate debt resolution framework would support an orderly deleveraging, but the process of amending the Insolvency Law is slow.

Looking forward, it is important to monitor conditions for a safe and competitive financial services sector, including a sound supervisory framework This would also support a stronger credit flow to the private sector, thereby facilitating the restructuring of the economy towards the tradable sector. At the same time, it is important to avoid the pre-crisis situation of the banking sector being heavily exposed to the property and construction markets, including by reviewing the policy framework to avoid a recurrence of asset price bubbles and to ensure sustainable price level convergence.

13.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Latvia, a catching-up economy with a substantial need for imported investment goods and with expectations of higher future income, experienced large current account deficits over the past decade. From 2004, however, the domestic demand boom intensified, imports surged and the country registered current account deficits of over 20% of GDP in 2006-2007. In 2009, the current account balance quickly turned into a large surplus of around 8% of GDP and a surplus is expected to remain into 2011, due to the rapid correction of the trade deficit, the improvement in the services balance and losses registered on FDI, as banks' increase loan loss provisions.

Latvia has performed well in gaining export market shares over the past decade, with some clear improvements in its product composition and geographical diversification and with services exports being particularly important. Future export prospects are supported by an absolute cost advantage relative to other EU countries and by Latvia's geographical position as regards transit trade. On the other hand, the tradable sector remains small compared to the economy. A sharp deterioration in nominal unit labour costs in 2006-2008 caused some setback in the performance of this sector. However, this is rapidly reversing as compensation of employees per head is set to fall further. Similarly, the adjustment in nominal unit labour cost is to continue at an annual pace of over 10% in 2010. These trends should serve to tackle the challenge of rebalancing the economy towards the tradable sector. Also to this end, it is important to increase productivity in the medium term, including by higher investment, which hinges upon a healthy financial sector, as well as to ensure an adequate supply of skilled labour.

The supply side of the economy could be strengthened by wide-ranging structural reforms and by making efficient use of the available EU structural funds. Latvia could benefit from the integration of its relatively cheap local labour force into large international supply chains. An attractive business environment for FDI in the tradable sector could facilitate the adoption of modern technologies and production methods.

13.3. GROWTH DRIVERS

13.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The labour market's high degree of flexibility contributed to strong employment growth in the decade leading up to the crisis. However, as Latvia was hit by the crisis especially hard, according to the labour force survey employment has fallen substantially and unemployment, the highest in the EU, reached a rate of 20.4% in the 15-74 age bracket in the first quarter of 2010. More than a quarter of the unemployment is long-term, particularly among low-skilled groups, implying a risk of persistently high structural unemployment. Although there are some signs of stabilisation of the labour market as from the second quarter of 2010, the recovery is expected to be protracted.

In the medium term, significant employment growth is unlikely, as the economy is expected to return only slowly to its pre-crisis levels. Future development is likely to favour high-end, non-labour-intensive, export-driven sectors. Labour-intensive sectors, which rely more on domestic demand, are likely to experience only sluggish growth. In this context, the challenge is to avoid high unemployment from becoming structural and to ensure better matching in the labour market.

13.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by a favourable business environment that encourages entrepreneurship and investment. Over the past couple of years, there have been continuous incremental improvements to the business environment and further initiatives to this end are planned. Nevertheless, the number of entrepreneurs remains relatively low as various problems in the business environment persist. Since 2004, a large share of FDI was made in the real estate and service sectors, while it remained small in the manufacturing, therefore limiting the role of FDI in increasing export performance. Increasing Latvia's attractiveness as a destination for FDI is important given the macro-financial concerns and competition from other countries in the region.

In view of the severe economic downturn and limited fiscal space for economic stimulus, efficient use of EU structural funds is particularly important to raise productivity growth and stimulate employment growth. Thus, ensuring adequate access to finance for companies, and efficient use of EU structural funds as well as addressing the existing weaknesses in the business environment, particularly with a view of favouring productive investment, will contribute to lifting growth potential in the medium term.

13.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Performance in the policy area of R&D and innovation is still considerably below the EU-15 average and many weaknesses persist. In particular, the level of R&D spending remains very low in an EU-wide comparison (0.6% of GDP in 2008 against 1.9% of GDP in the EU). Public R&D financing has been reduced significantly in 2009-2010 and possible further cuts are expected. As regards private R&D financing, limited availability of bank financing and weakness of demand appear as serious constraints. Improving the contribution of the education system to human capital formation is also important especially as regards capacity for attracting additional researchers and producing a sufficient number of graduates in science and technology-intensive fields. This challenge is amplified by significant net outward migration of qualified workers. The low innovative output (i.e., measured by the number patents or the extent of innovative activity of SMEs), and low employment in high-tech sectors partly explain the weakness of the supply side of the economy and a low-value-added of exports. On the whole, the outlook is challenging as regards anticipating change and responding to new occupational needs: a better performance of the education system is warranted taking into account its role in building a knowledge-based economy.

14. LITHUANIA

14.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Several years of rapid economic convergence, with growth averaging 7.4% between 2001 and 2008, gave way to a deep economic recession in 2009, when output fell by 15%. During the boom increasing structural weaknesses of the economy became evident and the sizeable imbalances accumulated ultimately led to a reversal of the cycle, starting with a contraction in domestic demand. Fiscal policy showed a pro-cyclical stance for most of the pre-crisis decade, and the general government recorded deficits despite the very rapid output growth. Since late 2008 several consolidation packages have been adopted to contain the deterioration in public finances. This change in policy, also involving some structural reforms, contributed to start the adjustment needed in the economy, also thereby supporting the credibility of the currency board arrangement.

Looking ahead, the economic recovery is likely to be slow and output growth is expected to pick up only gradually. The economy's growth potential is projected to be significantly weaker than its 2000-2008 average of 5%, at around 2% over the period 2010-2020. In view of Lithuania's low starting position as regards capital intensity and total factor productivity, capital investment and tackling labour market challenges could be essential to raise long-term productivity and growth.

14.2. MACROECONOMIC FRAMEWORK CONDITIONS

14.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the fiscal stance had been pro-cyclical and expansionary, particularly towards the end of the boom period. Driven by rapid economic growth, additional revenues were usually spent and no reserves were accumulated. Accumulated imbalances and constrained financing conditions left no space for fiscal stimulus to counter the severe downturn and Lithuania has been pursuing fiscal consolidation to contain the deterioration in public finances, as well as to facilitate the reduction of imbalances in the economy. The government adopted in 2009 a restrictive initial budget and two supplementary budgets, in preparation of structural reforms of the social security and healthcare sectors. Against a sharp decline in output and notwithstanding the impact of the fiscal consolidation measures of around 8% of GDP, largely on the expenditure side, the government deficit reached 8.9% of GDP in 2009.

The currently high general government deficit poses a considerable consolidation challenge as the country seeks to reduce the deficit below the 3% threshold by 2012, in line with the EDP deadline. In view of the required sizable adjustment, defining the necessary measures, while at the same time securing the necessary co-financing in order to frontload the absorption of EU structural funds and increase productive investment into economy, could be challenging. Given strong growth in real government expenditure in the previous years, improving public sector efficiency could create room for expenditure adjustments without compromising the quality of public services, while fiscal consolidation could be further supported by structural reforms. Avoiding pro-cyclical fiscal policies in the future and ensuring the sustainability of public finances is also important, given that the current fiscal stance is not sufficient to stabilise debt levels in the medium term, and that the long-term budgetary impact of an ageing population is slightly above the EU average mainly due to the projected increase in pension expenditure.

14.2.2. Macro-financial stability

Regarding macro-financial stability, the Lithuanian financial sector is mostly bank-based and highly open in ownership terms, with foreign-owned banks holding around 85 percent of the banking sector assets. The very high credit growth averaging 37% p.a. in the period 2002-2008 quickly reversed to negative in mid-2009. The deleveraging process deepened the downturn on the property market and caused financing difficulties even for firms with viable business models. Credit constraints hit the corporate sector particularly severely, aggravating the contraction of economic activity. Even though household indebtedness remains very low compared to Western standards, individual borrowers are likely to face liquidity problems, as the economic recession strongly reduced disposable income and increased unemployment. Non-performing loans increased to 19% in 2009 ([27]) and the banking sector incurred large losses. Credit risk could therefore be important for the Lithuanian banking sector. The negative feedback-loop from the real economy to the financial sector has been pronounced in Lithuania due to a severe economic downturn. However, no bank needed to be rescued by the government as the foreign-owned banks have provided the necessary liquidity and capital to their subsidiaries and branches. The financial and supervisory framework was strengthened in 2009 by the adoption of the Financial Stability Law. The credit crunch and the associated downgrades by credit-rating agencies have made access to funding difficult even in the tradable sector, underlining the role of public policy in supporting external competitiveness. With a view to stimulate demand and output, immediate challenges relate to ensuring access to finance for viable businesses, especially for investment activity that would underpin the necessary rebalancing of the economy, and for credit-worthy consumers. Looking ahead, avoiding recurrence of economic and financial imbalances, paying attention to credit flows, asset prices and balance sheets is particularly important. After the credit/real estate bubble of 2005-2007, policy measures are needed to ensure that economic actors deleverage in an orderly fashion and that similar imbalances do not recur once the economic growth resumes.

14.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Lithuania's excessive external imbalances had their roots in the excessive level of imports, which developed on the back of a credit-financed domestic-demand boom and led to the accumulation of large external debt as well as an allocation of resources to non-tradable sectors. At the same time, cost competitiveness deteriorated rapidly: during the period leading up to the economic and financial crisis, Lithuania experienced a continuous real exchange rate appreciation. The REER based on unit labour costs and on HICP appreciated by 16% and around 13%, respectively, between end-2005 and 2008. Between 2000 and 2008 the current account deficit averaged around 8¼% of GDP, due mainly to a rising goods trade deficit dwarfing the surplus in trade in services. However, Lithuania's annual gains in global market shares, close to 6% on average over 2000-2008 outperformed its neighbours. The external deficit peaked in 2007, at around 15% of GDP. The current account reversed quite abruptly to a surplus of close to 4% of GDP in 2009, mainly due to a collapse in trade and positive income balance. As the crisis developed, nominal wages decreased improving cost competitiveness. In the medium run, the expected recovery of global trade and an internal structural adjustment could help underpin a necessary rebalancing of the economy towards a stronger external sector, so as to reduce the reliance on internal demand as an engine for growth and re-equilibrate the trade accounts. Promoting such rebalancing of the economy towards the tradable sectors, and higher value added activities, and raising productivity levels is an important challenge requiring investment in both physical and human capital. In this respect, the use of EU structural funds could support competitiveness and stimulate productivity growth and thereby help improve export performance. By sustaining further re-orientation efforts towards medium and high tech products, Lithuania could improve growth opportunities in the longer run.

14.3. GROWTH DRIVERS

14.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. As In the five years leading up to the crisis, Lithuania's high economic growth led to strong labour demand, strong employment and very low unemployment rates. Capacity constraints emerged due to labour supply issues: high emigration as well as skill

([27]) This high figure is due to a much stricter definition of non-performing loans by the Bank of Lithuania, as it includes non-impaired loans overdue more than 60 days and all the impaired loans.

mismatches and low participation rates. During the crisis the adjustment on the labour market has been very rapid, indicative of very high flexibility not only in wages but also as regards lay-offs, with employment contracting by 7% in 2009 and unemployment reaching nearly 14%. Youth and male unemployment, which already compared rather negatively to EU-15 before the crisis, increased particularly rapidly. Wages adjusted swiftly, falling by nearly 9% in the end of 2009. Due to low levels of payments under the social safety net, the negative impact of the labour market deterioration on gross disposable income was significant, pushing up the activity rates as inactive people started to search for employment. Overall, as the labour market has still to bottom-out, avoiding risks of high unemployment from becoming structural is an important challenge which could require better matching in the labour market and facilitating reallocation of labour to expanding sectors. Enhancing labour market activation policies could lead to resumed employment growth while addressing the gaps between current skills and forming needs could prevent jobseekers from withdrawing from the labour force and increase productivity.

14.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Indicators for the Lithuanian business environment, entrepreneurship and investment, however, show a mixed picture. Lithuania is an open economy and scores well on the openness to trade front. However, it has been relatively slow in attracting FDI, which is rather puzzling given the relatively benevolent tax environment. Therefore, addressing the weaknesses in the business environment, ensuring adequate access to finance for companies with view to favour productive investment and adequate interconnected energy grids, would underpin the necessary rebalancing of the economy. In particular, this could require improving start-up conditions ([28]) and streamlining procedures for licences, permits, and land use planning as well as making public procurement more transparent. Moreover, there are indications that progress with reforms in competition and enterprise policy is relatively low. Given the need to reorient the resources to more export oriented sectors, stronger competition policy enforcement and enhanced control of corruption could be desirable. In the domain of infrastructure investment, energy networks continue to represent a considerable challenge as the Ignalina nuclear power plant closure underlined the lack of robust capacity as well as the linking to alternative energy grids in the neighbouring countries. Capital markets remain very shallow. A number of schemes to improve access to finance, in particular for SMEs, as well as export guarantee schemes have recently been put into place, but are insufficient on their own to reverse the negative credit trends.

14.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. In the long-term, Lithuania could raise productivity by enhancing firm level innovation and attracting investment as well as by improving the performance of the public research system. It is important is to increase innovation capacity, where Lithuania performs significantly below the EU-27 average. ([29]) To this end, creating stronger links between business and research could be crucial. Education reform aiming at matching the labour market needs and increasing the efficiency of expenditure on higher education has been enacted recently and could in the long run reduce skill mismatches and improve the quality of the labour force. A weak overall level of gross R&D expenditure, and in particular private sector R&D expenditure, stands out in an EU comparison. Attracting inward investment into higher value added could improve the very low level of business investments in R&D and innovation.

([28]) World Bank (2010), op. cit.

([29]) UNU-MERIT (2009), European Innovation Scoreboard.

15. LUXEMBOURG

15.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Luxembourg has been severely hit by the recession. Growth had been very strong since the beginning of the country's "success story", which dates back to the first half of the 1980s: from 1983 to 2007, real GDP grew on average by almost 5% a year, a performance second only to that of Ireland inside the EU-15. After a deceleration at the beginning of the current decade as a result of the slowdown in the international economy, strong growth resumed from 2004 onwards, reaching 5.5% per year on average over the period 2004-2007. However, GDP began to contract in the second quarter of 2008 and the decline markedly accelerated towards the end of the year. The first victim of the recession was manufacturing industry which exports almost all its output and is therefore totally dependent on world trade. However, construction and services have not been spared, in particular financial services and services to enterprises. The economy began to recuperate in the second half of 2009, essentially as a result of the recovery in the EU economies. Activity will progressively accelerate in the course of 2010 but even in 2011 growth is expected to remain below the strong rates recorded until 2007. Unemployment will probably continue to increase in 2010 and, to a lesser extent, in 2011. Its increase has been (and will be) limited by the fact that a large share of the workers losing their jobs will be non-residents, who are registered as unemployed in their country of residence.

The exceptional dynamism of Luxembourg during the latest decades has been chiefly made possible by the wave of financial liberalisation that took place all around the world since the 1980s and the ensuing worldwide expansion in financial services. Luxembourg has been able to make use of this expansion to build a large financial industry with worldwide activity, which has constituted its main growth engine in the latest decades. In the coming years, future Luxembourg will have to deal with uncertainties regarding future growth of the financial services sector and its own capacity to take advantage of this despite possible adverse changes in the regulatory environment.

15.2. MACROECONOMIC FRAMEWORK CONDITIONS

15.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the situation of public finance was very favourable before the recession, especially when compared with other Member States. Luxembourg recorded recurrent and sizeable general government surpluses since at least the beginning of the 1990's. Moreover public debt was one of the lowest in the EU-27 (6.6% of GDP in 2007). However, the crisis took its toll on public finance: the general government balance turned from a surplus of 2.9% of GDP in 2008 to a deficit of 0.7% in 2009, which is forecast to be close to 3% of GDP in 2010. This deterioration was for a part the result of the impact of the crisis on revenues and outlays but was also due to the fact that, in response to the crisis and in line with the European Economic Recovery Plan, the government adopted a package of stimulus measures, which amounted to 3% of GDP in 2009. Despite this deterioration, the current situation of public finance remains comparatively sound: at a projected 2.8% of GDP this year, the deficit would still be the lowest in the euro area. Similarly, despite a doubling at the end of 2008, the gross public debt would only amount to 19% of GDP in 2010. Moreover, the government, in particular the social security system, holds sizeable assets, accumulated from the recurrent surpluses of the past. These assets widely exceed the amount of the gross debt (they are estimated at about 40% of GDP), so that the net financial position of the general government is substantially positive.

However, long-term perspectives are far less benign than the short-term situation might suggest: firstly, the recurrent surpluses of the past have been essentially permitted by buoyant revenues generated by the very strong economic growth, the continuation of which, as already mentioned, is far from certain. In addition, due mainly to the generosity of the country's pension system, the increase in public age-related expenditure in the coming decades is projected to reach about 18 percentage points of GDP, the highest in the whole EU (which implies that the increase in age-related government expenditure in Luxembourg would be higher than its current level in most EU countries) and the - though sizeable - government's assets will not be sufficient to cover it. This pleads for a reform of the pension system aimed at limiting the projected increase in age-related expenditure up to 2050 in order to ensure the long-term sustainability of public finances, while a return to budgetary surpluses, setting a more ambitious MTO, which would sufficiently take into account the implicit liabilities related to ageing and continuing the build-up of reserves would also help.

15.2.2. Macro-financial stability

Regarding macro-financial stability, the financial crisis had a strong impact on Luxembourg's financial sector, which, because of its almost all-foreign ownership and its international activity, is heavily dependent on world financial markets. However, the impact, though sizeable, has been smaller than could have been initially feared. Problems in some financial institutions required the intervention of the authorities: direct loans for a total amounting to 7.6% of GDP had to be granted to two large foreign-owned banks as a consequence of problems originating elsewhere. This support explains the doubling of the public debt in 2008. Moreover, the government has considerably extended its contingent liabilities, which exposes its risk to further interventions to stabilise the financial institutions. As already mentioned, the performance recorded by Luxembourg since the 1980's was linked to the worldwide expansion of financial services. The present crisis raises the question of the future of this growth model. A major challenge for Luxembourg's economic performance going forward is to secure a viable and stable financial sector, in particular through enhanced international cooperation in regulation and monitoring. At the same time, efforts could be undertaken at the national level or in cooperation with other Member States.

The large drop in Luxembourg's banks balance sheets (almost 18% from peak to trough on a consolidated basis) was essentially the result of the contraction in cross-border interbank lending and does not reflect a dramatic tightening in the financing of the economy. Such a tightening clearly happened but is seems to have been less pronounced than in many other Member States and the sharp slowdown in the credits granted to non-financial enterprises is probably chiefly the result of a much weaker demand, related to the contraction in activity and the collapse in investment. Credit to households slowed down but did not decline due to the rising stock of mortgages.

15.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Luxembourg is the most open economy in the EU-27 (exports represented 160% of GDP in 2009 and imports 127%). Foreign trade is heavily concentrated in services (80% of exports and 70% of imports in 2009). In the last decades, Luxembourg has posted recurrent and strongly growing surpluses in goods and services; these surpluses have been matched by the balance of net primary income, which has been increasingly negative since the mid-1990's, due essentially to the surge in the number of cross-border workers. Consequently, the current account surplus has fluctuated around 10% of GDP between the early 1990s and 2007 before dropping to about 6% in 2008 and 2009. The cost competitiveness of Luxembourg has considerably deteriorated since the beginning of the decade because wages rose faster than in neighbouring countries and also due to massive labour hoarding during the 2001-2003 downturn and on an even larger scale during the recent recession. As a result, unit labour costs increased significantly faster than in the EU-15 from 2000 to 2009. This worsening in competitiveness is thus as much due to developments in productivity as the result of a surge in wages. However, as developments in productivity are largely outside the reach of the country's authorities and social partners, an action on wages seems the only practical mean to restore cost competitiveness. It thus seems to be opportune to moderate wage increases by taking into account productivity developments in wage setting, for instance by reducing the impact of automatic wage adjustments and the minimum wage.

15.3. GROWTH DRIVERS

15.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. In the latest decades, employment has been extremely dynamic in Luxembourg attracting a growing stock of cross-border workers currently accounting for 40% of total labour force. Unemployment in Luxembourg has an increasingly structural character, even though its surge since the end of 2008 is obviously the result of the recession. The rise in unemployment since the beginning of the crisis has been limited by the fact that a large number of workers losing their jobs were non-residents, who are not recorded as unemployed in Luxembourg but in their country of residence. It was also dampened by an extended recourse to short–time working, which was encouraged by the government in order to limit lay-offs. However, taking into account the precedent of the latest decade, unemployment is unlikely to decline substantially in the coming years, even if job creation regains the dynamism of the past.

The employment rate of Luxembourg's residents is comparatively low at both ends of the age spectrum: while global unemployment, despite its recent increase, remains much lower than in most other Member States, youth unemployment is significantly higher than the EU average. Amongst the likely key factors are the relatively poor performances of the country's educational system, the relative generosity of social benefits in Luxembourg, and possibly the strictness of employment protection legislation. At the other end of the age spectrum, the employment rate of older workers is exceptionally low because the pension system provides very high replacement rates and often allows retirement before the statutory age of 65. The implicit tax rate on continued work at older ages is thus high, despite the comparatively low taxation of labour incomes (especially when compared with neighbouring countries). Developing lifelong learning could also be important for increasing employment. To ensure full utilisation of the economy's labour potential, in particular the unemployed, the young and older workers, reducing disincentives to work for the unemployed and lowering the implicit tax on continued work at older ages would thus be opportune.

15.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Although Luxembourg is a small open economy in the middle of a large and integrated market, some sectors remain relatively protected from competition by strict market regulations. Competition in the domestic services sector is particularly weak. Regulations in professional services are among the most restrictive in the whole OECD, with only some lower income countries having more stringent ones. Public control of prices and on industries remain more frequent than in most industrialised countries, barriers to entrepreneurship are high, procedures for setting-up a company and recruiting the first employee prove lengthy and expensive, and sector-specific regulations are frequent and often more stringent than needed, limiting entry and reducing competition.

The increase in public investment has been one of the main elements of Luxembourg's Economic Recovery Plan. The budgetary measures on the expenditure side for 2010 amount to about 1½% of GDP, of which 0.6% of GDP for public infrastructure. The improvement in infrastructures should be continued: the large number of cross-border workers puts a heavy load on road and rail infrastructures, especially taking into account that a large part of the growth in activity and employment has concentrated in the south of the country, in particular in Luxembourg City. This congestion of transport infrastructures has been reinforced by high and rising property prices, which have probably deterred many persons working in Luxembourg to settle in the country. Housing supply, which is chronically insufficient, could be fostered by removing supply constraints, many of which are institutional or policy-induced, like severe zoning regulations and cumbersome procedures.

15.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Total R&D spending is comparatively low in Luxembourg compared to neighbouring countries. This is due for a part to low public R&D spending but also to the fact that, the biggest firms often belonging to foreign groups, most of the research is done abroad, while benefiting the Luxembourg's subsidiaries of those groups. The low level of private R&D spending in the country thus probably constitutes a smaller handicap than could seem at first sight. As far as public R&D spending is concerned, it is projected to increase substantially, especially through the development of the University of Luxembourg. The government intends to raise it from ¼% of GDP in 2005 to 0.6% in 2010 and eventually to 1% of GDP.

Although there was considerable progress in the last years in reducing early school leaving rates, there is still a lot of potential for increasing the upper secondary completion rate, particularly for youth from a migrant background. Moreover, adult participation in lifelong learning could be further increased in order to increase the level of qualifications of the adult workforce. This factor may play a role in the country's structural unemployment problem since it can constitute a handicap for residents, especially younger ones, who are facing an intense competition from a large pool of available and often highly skilled potential workers living in neighbouring regions. Improving the contribution of the education system to the human capital formation including quality of the education system and the efficiency of education expenditure would be of crucial importance for Luxembourg. A major reform of the educational system has recently been launched and could contribute to achieve this objective.

16. HUNGARY

16.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Hungary was in a fragile economic condition when the financial crisis broke out in autumn 2008 even though it had been consolidating its public finances from the end of 2006. In a context of reduced risk appetite linked to the global financial crisis, financial market conditions in Hungary rapidly deteriorated to the extent that the external financing needs of the government could no longer be met through market channels. Moreover, due to a sudden decline in external demand and high uncertainty regarding the severity and duration of the crisis, both exports and industrial production dropped significantly in 2009. Labour productivity and thus potential output had started to decelerate some years earlier, while lax fiscal policy and growing private sector indebtedness had sustained domestic demand at elevated levels.

Following the 6.3% GDP decline in 2009, output growth is expected to stagnate in 2010 and recover only later, mainly owing to the need to adjust the considerable imbalances in the public and in the household sectors. In the longer term, Hungary's economic growth potential is projected to be somewhat weaker than its 2000-2008 average of 3.0%, at around 2½% between during the period 2010-2020, which is slightly above the EU27 average (around 2%). After 2020, long-term potential growth in Hungary is projected to remain around the level of 1% p.a., which is lower than the average of the EU27. ([30])

16.2. MACROECONOMIC FRAMEWORK CONDITIONS

16.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, following a period of consolidation in the late 1990s, the budget strategy shifted towards pro-cyclical loosening of fiscal policy in the early 2000s. The mid-2006 reversal successfully reduced the deficit from above 9% to below 4%. The sharp economic downturn in 2009, which could not be countered by stimulus measures in view of the limited fiscal space, engendered further cuts to stabilise the deficit, implying a continuation of the improvement in the structural balance, that included a number of structural measures.

In the light of the current level of the government deficit and government debt (4% and 78.3% of GDP in 2009 respectively), a key challenge is the need to continue fiscal consolidation and reduce the high level of government debt, while strengthening efforts to reallocate public expenditure towards growth-enhancing items. Since the current consolidation of the budget was not fully based on structural measures, steps to achieve further consolidation based on structural reforms (notably in local government, health care and public transport) and a more efficient public sector remain necessary. A further acceleration of the absorption of the EU funds and widening of the tax base may also facilitate the attainment of these targets.

In the long run, the budgetary impact of an ageing population will be below the EU average. However, a significant part of people have accumulated less wealth than needed to complement the pension benefits that are expected to be relatively low. This may lead to pressures to increase social transfers, which in turn may challenge the long term sustainability public finances.

16.2.2. Macro-financial stability

Regarding macro-financial stability, the economic and financial crisis hit Hungary particularly hard. In October 2008 global money market turbulence brought Hungary to the brink of sovereign default and the currency had depreciated by 30% by March 2009 compared to the pre-crisis level. Shortfalls of foreign capital threatened the stability of the banking sector which is largely foreign owned and has been focused on foreign currency loans. Since the end of Q1-2009, the financial market stress appears to have somewhat subsided and the exchange rate appreciated close to its pre-

([30]) European Commission (2009), op. cit.

crisis level mainly due to the fiscal efforts and the improvement of the global risk appetite. The Hungarian banks have up to now demonstrated their capacity to absorb the shock, also thanks to the willingness of the largest parent banks involved in the European Bank Cooperation Initiative to maintain their exposure in Hungary and a limited degree of government support for banks through recapitalisation and liquidity. ([31])

The share of the foreign currency denominated debt in the household debt increased from 1% in 1999 to more than 60% by 2009. This has put upward pressure on the proportion of income that households have to use for repayment in a context of domestic currency depreciation and foreign currency financing shortage. This entails risks to economic growth and the solvency of the bank sector and limits the potential manoeuvring room of monetary policy. Moreover, the credit quality problems have been forcing the banks to follow a cautious approach towards lending. It is therefore important for Hungary to ensure a viable and stable financial sector by reducing the risk from over-exposure to foreign denominated credit. An ongoing effort in strengthening of the financial supervisory and regulatory framework will help to reduce the share of the foreign currency denominated debt (as well as the overall indebtedness of the economic players concerned) as will a stable macroeconomic framework.

16.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Hungary is the second most open economy in the EU 27. Its catching-up process has been driven mainly by external trade. Indeed, the share of exports in GDP rose from around 40% in 1995 to above 120% in 2008, while Hungary increased its market shares. In terms of export structure, the country has a comparative advantage in research-intensive products, making exports more sensitive to the business cycle. Hungary posted high current account deficits in the last two decades (e.g. 7.2% of GDP in 2008), which appears to be closely linked to the level of public expenditure and the catching-up process of the economy. From 2009 the external position improved significantly, showing a positive balance of close to 2% of GDP. It reflects both the effects of fiscal consolidation that dampened domestic demand and consequently led to a fall in import, and a depreciation led improvement in price competitiveness.

Hungary has been quite successful in attracting foreign investors. Over the period 1995 to 2008, FDI inflow reached an average of 6% of GDP, which contributed to rapid productivity growth and the development of an export-oriented manufacturing sector. However, the knowledge and technology transfer facilitated by FDI for domestic companies has been weak. This has contributed to a strongly dual structure in Hungary's private sector: highly productive multi-national companies on the one side, coexisting with low-productivity small- and medium-sized enterprises, producing primarily for the domestic market, on the other side.

16.3. GROWTH DRIVERS

16.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The level of employment in Hungary is very low with an overall employment rate of 55.4% in the 15-64 age cohorts, the second lowest among the 27 Member States. The trend is also discouraging. Between 2000 and 2009 the employment rate decreased by 0.5 percentage points while the EU27 average increased by 2.5 percentage points. The very low activity rate indicates supply side impediments. Activity rates are particularly low among the young, older people, low-skilled, women in reproductive age, as well as the disadvantaged groups, including the Roma population and people with disabilities. This reflects, despite recent tax reforms reducing the tax on labour, the still high tax wedge (with a narrow tax base), generous social benefits, low skill levels, low labour mobility, limited active labour market policies and insufficient day care and kindergarten services combined with a lack of flexible working time arrangements. In addition, in the long run,

([31]) These efforts were financed from the international financial assistance package of EUR 20 billion provided by the EU and the IMF, which supported the new economic programme of the Government adopted in October 2008, which was crucial in promoting Hungary's return to market-based external financing.

Hungary's labour market and growth potential will be burdened by the very unfavourable demographic prospect. Therefore, Hungary's growth potential would clearly benefit from ensuring full utilisation of the economy's labour potential, in particular through raising the participation and employment rates.

In the long run, Hungary's labour market could also benefit significantly from a decisive improvement in the education and training systems, which appropriately caters for the knowledge and skills necessary for integration into the labour market. Increasing training efforts towards those re-entering the labour market while tailoring the training service to the needs of the labour market would contribute to reducing the unemployment rate of the older people with low educational attainment.

16.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Insufficient competition removes incentives to adapt to structural changes. In this respect, Hungary does not perform well yet in terms of the competition framework. While competition policy has made efforts to open up some markets, further steps are needed. State aid is well above the EU average. Moreover, the share of sectoral aid in total aids, in particular aids to manufacturing, is relatively high, which creates competitive distortions among companies. In addition, the tax system is complex and the administrative burden is still important, in particular on start-ups. This may contribute to maintaining an important shadow-economy activity.

SMEs have been hindered both by an unfavourable policy environment and limited accountability and transparency in public administration and in business. Regarding SMEs, the lack of their integration in the product chain of the multinational companies prevents them from benefitting from positive spillovers, including an efficient knowledge transfer. It is therefore a challenge for Hungary to improve its business environment to facilitate the development of a more viable SME sector, and to promote favourable conditions for R&D and innovation activities. It would also enable Hungary to profit from the potential business opportunities and know-how transfers provided by the large international companies. Policies at the micro-level could target more forcefully the creation of business clusters in order to lock in locally-created know-how.

16.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth is a group of policies in the area of R&D, innovation and education which support the knowledge base. Hungary's research performance is still relatively weak, due to several reorganisations of the governance structure for science, technology and innovation and the lack of sufficient expert knowledge to attract research projects. Total R&D expenditure has increased only slowly since 2000 (from 0.78 to 1% of GDP in 2008) and the bulk of private R&D activities, which represents 53% of the total R&D activities, is still conducted by a handful of large, foreign owned companies in a few sectors, whereas the domestic companies are hardly involved. As a result, Hungary still displays relative weaknesses in innovation (patents, number of SMEs introducing a product or process innovations) even though the number of Community trademarks has improved over recent years.

The general business climate is not very favourable to R&D and innovation. Industrial needs are hardly taken into consideration despite the relatively good performance of public research institutes. Knowledge transfer is impeded by a very low level of researcher mobility between research performing sectors. Some universities have started to establish co-operations with industry but further effort is needed in order to foster transition of knowledge from research institutes to the business sector and assuring that start-up enterprises have access to venture capital.

In view of the noted weaknesses in the labour market and innovation capacity, Hungary needs to improve the contribution of the education and training system to the human capital formation including educational inclusion and the quality of the education system could also be the a means to raise potential output. Improving the quality of the education system through better vocational and language training and the proper implementation of the lifelong learning strategy would support growth through a higher employment rate and inclusion of minorities. The country's lifelong learning strategy, adopted in 2005, lacks concrete measures and targets to assess progress in its implementation.

17. MALTA

17.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

In the period 2005-07, Malta's economy expanded at rates well above those recorded in the euro area as a whole. Household consumption was boosted by an improving labour market while exports increased steadily thanks to the marked expansion of the services sector. Although the global crisis affected Malta primarily through the trade channel, the fall of foreign sales in 2009 was less pronounced than the contraction in world trade would have suggested. A sharp retrenchment in investment acted as a major drag on domestic demand in 2009.

Real GDP growth is anticipated to outperform again that for the euro area as a whole in both 2010 and 2011, albeit less markedly than in recent years. The lagged impact of the downturn on the labour market led to an increase in the unemployment rate in 2009, but this increase was relatively contained, reflecting also recovery measures aimed at avoiding layoffs. A further rise is projected in 2010. Should this be translated into an increase in structural unemployment, Malta's potential growth in the medium term will be affected beyond the already low contribution to growth from labour input before the crisis, due to low labour market participation. Low and weakening total factor productivity is another factor holding back growth, whereas the contribution of capital deepening has been on a declining trend over the past decade, which may reflect the decreasing weight of manufacturing in the economy. Looking forward, the projected acceleration in demographic ageing will pose a further challenge for potential growth in Malta. In this context, support to potential growth in the medium- to long-run will have to come from higher labour market participation as well as increased human capital and innovative capacity of the economy.

17.2. MACROECONOMIC FRAMEWORK CONDITIONS

17.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Malta maintained a relatively sound budgetary position in the years following EU accession in 2004, but the general government deficit widened markedly in 2008-2009, not only as a result of the economic slowdown but also reflecting non-recurrent expenditure items especially in 2008. The government plans to bring the deficit below the 3% of GDP threshold by 2011 relying mainly on expenditure containment. Since the early 2000s, gross government debt has hovered around 60 to 70% of GDP.

In a longer time perspective, a major challenge for fiscal policy in Malta is to ensure the long-term sustainability of its public finances, given the above-EU-average projected impact of demographic ageing on both health care and pension spending. The parametric changes introduced in the 2006-2007 pension reform, in particular the more dynamic indexation of the ceiling on pensionable income and the introduction of a guaranteed national minimum pension for persons retiring from 2026 onwards, contribute to the significant long-term increase in pension spending. At the same time, the stipulated gradual increase in statutory retirement age from its current low level alongside the increase in the number of contribution years will have a positive impact on the sustainability of the pension system.

17.2.2. Macro-financial stability

Regarding macro-financial stability, Malta's financial system has not been significantly affected by the international financial turmoil, mainly as a result of its more traditional structure compared to that in other EU Member States. However, the slowdown in the real estate sector may be a source of vulnerability, even though recent stress tests based on house price crash scenarios carried out by the Central Bank of Malta confirm the banks' ability to withstand this type of shocks. As a result of the downturn, there has been some increase in the rate of non-performing loans, especially in the non-financial corporate sector, but the situation should improve as the economy recovers strength.

Overall, the Maltese economy does not appear affected by large macroeconomic imbalances and there has been no pronounced housing bubble. While the construction of new houses has slowed somewhat since 2008, the downward adjustment of house prices, which rose by 6% on average over the 2000s, has been contained so far.

17.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, as a very small and very open economy, Malta has traditionally posted a current account deficit. The external deficit peaked at 9.2% of GDP in 2006 and subsequently narrowed to 3.9% in 2009. The deficit declined markedly in 2009 on the back of a sharp fall of merchandise imports compared to the drop of exports, in particular in the categories of imports of industrial supplies, fuel and consumer goods. In addition, despite the drop in tourism, the external surplus in services remained healthy as a result of the positive performance of new and relatively a-cyclical service activities, notably ICT, financial services and online gaming.

During the last decade, Malta's real effective exchange rate (ULC-based) registered a substantial appreciation with respect to industrialised countries, owing to unfavourable developments in Malta's unit labour costs as well as a weakening dollar (which is the main transactions currency in the predominant ICT sector). These developments led to a reduction in profit margins in manufacturing, which in turn dampened private investment. In this context, wage moderation could be sustained through a more efficient and flexible wage setting process that allows better alignment of wage and productivity developments, including in the public sector. At the same time, measures aimed at improving labour productivity will be important. This would improve Malta's competitiveness, which is especially relevant in the euro-area context.

In addition, fostering further diversification of the economy and an expansion of high value-added and fast-growing export-oriented sectors would help Malta reduce its reliance on tourism and manufacturing of electronics and enhance the non-price competitiveness of its exports as well as potential growth. Investing further in renewable energy sources as a new area of growth would offer the additional benefit of reducing Malta's high dependency on imported oil for energy. Given the small size of the economy, FDI is likely to continue to represent the main source of productivity-enhancing technology transfer to domestic businesses, pointing to the need to enhance the attractiveness of Malta as a business location.

17.3. GROWTH DRIVERS

17.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The employment rate in Malta is very low by EU standards. In 2009, it was at just around 55%, mainly due to a very low female participation rate and an even lower rate of participation for older workers. There also appears to be shortage of skilled workers with the employment rate amongst the low skilled being some 40 percentage points lower than amongst the high skilled. ([32]) The effect of the crisis on unemployment became visible in 2009 but was relatively muted thanks to government assistance to encourage companies to avoid layoffs, while offering training to employees. The total participation rate seemed to be relatively unaffected by the crisis with the 2009 rate being slightly higher than that in 2007.

In the medium term, a more efficient wage setting process that aligns wage growth to productivity increases would not only improve Malta's competitiveness but could also lead to a decline in unemployment.

In addition, better utilising Malta's labour potential, in particular that of women and older workers, would be important for boosting potential growth. More flexible working time

([32]) European Commission (2009) *Labour Market and Wage Developments in 2008*, European Economy, 8.

arrangements ([33]) and widespread availability of childcare facilities would help boost the female participation rate. Use of early retirement schemes, the currently low statutory retirement age (61 years for men and 60 years for women) and very high inactivity rates for older female cohorts are the main reasons for the low participation rate of older workers. Some positive effects in this respect may be expected in the medium/long term as result of the recent pension reform which increased the retirement age to 65 for men and women. Intensifying the fight against the phenomenon of undeclared work would also be crucial to raise the employment rate and to strengthen the labour market. Also, enhancing the effectiveness of ALMPs, in particular training and lifelong learning policies, would help to bring the low-skilled unemployed back to work. Finally, investing in human capital to ensure that the skills required are available would also help to meet the high demand for medium and high skilled workers.

17.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. SMEs form the backbone of the Maltese economy. Accounting for two-thirds of total employment in Malta, small and micro businesses are an essential source of entrepreneurship. However, the very small size of Malta's economy lends itself to market imperfections, and competition is very limited in some markets, leading to high mark-ups. ([34]) In this context, a strong role of the competition authority is important to enhance competition. The business environment could also be improved by reducing the administrative and regulatory burden for firms. This would help to enhance Malta's attractiveness as a business location for foreign investors. ([35])

The contribution of capital accumulation to Malta's potential growth has been on a declining trend over the past decade and is projected to remain subdued in the coming years. The inadequacy of capital infrastructure (eg. road and electricity) is posing problems to entrepreneurship and SMEs' competitiveness and may be a factor holding back FDI. In addition, Malta's almost exclusive dependence on imported oil for energy supply exposes the economy to external price shocks and may negatively impact on Malta's price competitiveness. Investment in new areas of growth could be explored, such as investment on renewable energy sources, given the abundance of wind, solar and wave energy in Malta.

17.3.3. Knowledge Base (R&D, innovation and education)

Major drivers of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. R&D and, more so, innovation capacity are of paramount importance for a country to develop future economic potential and maintain a high level of competitiveness. The high and increasing share of exports in the high-tech segment, supported by the technology transfer to domestic firms from FDI and an ICT environment that is supportive to businesses, represents Malta's relative strength. The ongoing shift in Malta's economic structure, which began in the run-up to Malta's EU accession from manufacturing to services with high technology content, has had a positive impact on Malta's rate of innovation. At the same time, low education levels, particularly in science and technology, the absence of research and/or innovation-based clusters and well-developed university-industry collaboration in R&D, as well as under-performance in developing product or process innovations are factors constraining innovative capacity.

In order to support the move to higher value-added activities, it will be important to ensure a stronger contribution of the education system at all levels to human capital formation, notably by addressing the high rate of early school leavers (39%), the low percentage of youths having obtained at least an upper secondary level of education in Malta (53%), as well as further raising the number of science and technology graduates. This will allow the economy to provide the level of skills that is

([33]) Almost ¾ of employees in Malta have working hours set by their company with no possibility of changes – See the European Commission (2009), ibid.
([34]) European Commission (2008), op. cit.
([35]) See for instance Ernst & Young (2009), *Malta Attractiveness Survey 2009* and World Economic Forum (2009), *The Global Competitiveness Report 2009-2010*.

required in the labour market, in particular in the emerging services sector, and help foster investment in new areas of growth through R&D and innovation.

18. THE NETHERLANDS

18.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The global economic and financial crisis highlighted the sensitivity of the Netherlands to changes in global demand, with high economic growth recorded in 2006 and 2007 coming to a sudden end in the second quarter of 2008. The subsequent acceleration of the downturn led to a severe contraction of economic activity in 2009. The economy showed its first signs of recovery in the second half of 2009, resulting from a rebound of exports. Looking ahead, the prospects for a sustained economic recovery in the Netherlands are subdued and present a mixed picture. While the external sector is expected to provide support for economic growth in the coming years, on the back of the global economic recovery, domestic demand is foreseen to remain sluggish at first and to only show a rebound in 2011. All in all, GDP is expected to grow by 1¼% in 2010 and 1¾% in 2011 according to the Spring 2010 Commission services' forecast. With potential growth projected at around 1¼% for the coming years, the output gap is foreseen to close gradually.

In view of the rapidly ageing population and its adverse effects on labour supply through the decrease of population at working age, potential growth is foreseen to be negatively influenced by labour input in the coming decades. ([36]) This suggests that policies stimulating labour supply, aimed at decreasing the amount of unused labour will be an important element in raising long-term growth. Also, the projected limited contribution of capital deepening to potential growth suggests that long-term productivity could benefit from capital investment. Looking beyond the year 2020, Dutch potential growth is projected to be at 1½% p.a., around the EU27 average.

18.2. MACROECONOMIC FRAMEWORK CONDITIONS

18.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, before the crisis, the Netherlands appeared to be in a relatively good budgetary position with a budget surplus of 0.7% of GDP in 2008, partly owing to the use of the trend-based budgetary framework, which was introduced in 1994 and has generally been considered to be efficient and effective. ([37]) The free use of automatic stabilisers, together with the implementation of a 1% of GDP fiscal stimulus package, resulted in a general government deficit of 5.3% of GDP in 2009. A further deterioration of the budget balance is foreseen in 2010 (to 6.3% of GDP), mainly stemming from various lagged effects, in particular the projected increase in unemployment. The better-than-expected economic outlook for 2010 is not expected to be used for a better budgetary position. For 2011, a positive contribution from cyclical conditions together with the withdrawal of stimulus measures and the introduction of a consolidation package amounting to ¼% of GDP are expected to reduce the deficit again to 5.1% of GDP.

In the medium term, the Netherlands would benefit from an adequate and well specified budgetary consolidation effort, which would lead to the correction of the excessive deficit by 2013. This would also contribute to halting the rapid rise of the debt ratio, which increased considerably in 2008 as a result of operations to stabilise the financial markets of around 15% of GDP. In 2011, the debt ratio is expected to reach almost 70%, nearly 25 percentage points higher than in 2007. (Early) repayments of government support by financial institutions could substantially lower the debt ratio.

18.2.2. Macro-financial stability

In a longer-term perspective, the budgetary strategy presented in the 2009 update of Dutch

([36]) European Commission, (2009), *The 2009 Ageing Report*, European Economy, 2.

([37]) See for instance IMF (2001), Code of Good Practices on Fiscal Transparency and OECD (2002), Best Practices for Budget Transparency, OECD Journal on Budgeting, 3.

stability programme would not be sufficient to stabilise the debt-to-GDP ratio by 2020. ([38]) The impact of the ageing population is significantly above the EU average, due to relatively high increases in both pension and long-term care expenditure, leading to high risks to the sustainability of public finances. Regarding macro-financial stability, the Dutch financial services industry is relatively large, but at the same time highly concentrated limiting competition on domestic financial retail markets, even though the retail prices in the retail banking sector are relatively low in comparison to other EU countries. The financial crisis had a significant impact on the Dutch financial sector, triggering a wide range of government rescue measures aimed at stabilising the financial system, totalling almost 20% of GDP. These measures included an expansion of the deposit guarantee scheme, the introduction of an inter-bank loan guarantee scheme and the recapitalisation of financial institutions. Furthermore, the government nationalised a major bank and provided assistance for both foreign and domestic mortgage portfolios held by domestic banks. Part of these measures represents a sizeable contingent liability on the public finances. The financial crisis also led to a tightening of lending conditions for both the corporate and the household sector. At the same time, demand for credit decreased. These factors together resulted in a slower growth of credit. Finally, the crisis hit the well-developed Dutch second pillar pension system.

Ensuring a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy is an important challenge. Maintaining confidence in the financial sector and ensuring access to finance for economic agents remain highly relevant. The risks to the stability of the financial sector have not fully disappeared and require close monitoring of cross border activities and the supply of credit. When implementing an appropriate exit strategy for its interventions in the financial system it would be important for the government to avoid putting at risk the financial stability and without creating (further) distortions to the competitive environment.

([38]) European Commission (2010), The Netherlands: Macro Fiscal Assessment. An Analysis of the January 2010 Update of the Stability Programme.

18.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the Netherlands is one of the most open economies in the euro area. The consistent and sizeable current account surplus in the Netherlands, on average over 6% of GDP over the past decade, does not point to the existence of a competitiveness problem. This surplus has predominantly been determined by a surplus of the trade balance, which can in part be explained by the export of natural gas and the high share of re-exports related to the Dutch geographical position. Domestic demand is relatively low in terms of GDP. Structural reforms promoting private investment and consumption would help raising the economy's growth potential over the longer term. Since exports dropped less sharply than world trade in 2009, partly due to the composition of Dutch exports, and given the continuous gain in market share over the past years, the Netherlands is in a good position to profit from the revival of world trade. A projected decrease in unit labour costs in both 2010 and 2011 is foreseen to improve competitiveness, as wage growth is set to decrease in view of the loosening labour market. For the longer-term, the current account is foreseen to be negatively affected by a rebalancing of growth towards domestic demand resulting from an ageing population and partly due to a gradual decrease in natural gas revenues. A long-term strategy shifting Dutch exports towards more high-tech intensive products, where competition is more limited, would involve an increase in R&D spending and innovation (see below) and would at the same time lead to higher productivity growth.

18.3. GROWTH DRIVERS

18.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Despite the severe economic downturn in 2009, the unemployment rate showed a limited increase and remained, with 3½%, at a very low level. This limited adjustment is the result of the tight pre-crisis labour market, extensive labour hoarding, the introduction of a part-time unemployment scheme by the government and a high share of very flexible self-employed. The low unemployment rate hides a challenge, namely that there exists a significant unused labour potential as although the Netherlands has very high participation rates, the total amount of hours worked per year is one of the lowest in the EU, mainly as a result of a very large share of women working part-time (around 75%). The relatively low number of hours worked is in part due to insufficient financial incentives for either entering the labour market or for extending the amount of hours worked, e.g. the high marginal tax rate on second incomes, which can in some cases turn out to be above 80%. In addition, there is an early exit from the labour market once older workers become part of the 60-64 age group, which can be partly linked to the long duration and high level of unemployment benefits. Finally, there is a large and increasing group of partly disabled, long-term unemployed and people with a migrant background facing an increasing risk of flowing into structural unemployment. This underlines the need for more effective implementation of active labour market policies focussing sufficiently on these groups. Besides the unused labour potential, the Dutch labour market is characterised by rigidities, such as strict employment protection legislation (for workers with fixed contracts), which negatively affect labour mobility and therefore labour matching. Labour mobility is further hindered by the relatively inefficient transport infrastructure (see below), leading to road congestions, and the relatively high transaction costs on housing.

18.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The Dutch business environment and overall competition framework seems to be broadly in line with the EU average. Furthermore, to improve the overall business environment, a more efficient use of existing (e.g. through road pricing) and investment in new transport infrastructure may be considered, given that businesses and workers are suffering from a relatively inefficient transport infrastructure, leading to relatively long commutes and unreliable travel times and high congestion costs. ([39]) Furthermore, the latter are expected to further increase until 2020 based on a no-policy-change assumption. Improvements in the efficiency of infrastructure, particularly of roads, would not only improve the overall business environment, but would also contribute to labour mobility and productivity and thus to potential growth.

18.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. The Netherlands appears to be a relative underperformer in the area of R&D spending as evidenced by latest available Eurostat data, which indicates that Dutch R&D intensity has decreased from 1.82% of GDP in 2000 to 1.63% of GDP in 2008, below the EU average of 1.9% of GDP. The gap is largely due to lower business R&D expenditure, which accounts for 54% of total R&D expenditure, whereas the EU average stands at 64%. According to the European Innovation Scoreboard 2008, relative weaknesses are in the area of 'Firm investments' and 'Innovators'. When looking at the Dutch labour force, a mixed picture emerges. On the one hand, it is highly skilled, with a relatively high share of workers who attained tertiary education. On the other hand, the percentage of young people who have completed secondary education is low (76.2%). ([40]) However, there was important progress over the past years in improving the educational level and diminish early school leaving. The educational system does not always meet labour market needs, in particular vocational training, ([41]) as is also evidenced in the past by a relatively high amount of vacancies per

([39]) The average commuting time in the Netherlands is the highest in Europe, see Agnès Parent-Thirion, Enrique Fernández Macías, John Hurley and Greet Vermeylen (2005), Fourth European Working Conditions Survey. For the cost of congestion see INFRAS/IWW (2004), *External Costs of Transport: Update Study, Koopmans and Kroes (2003), Estimation of congestion costs in the Netherlands*, Proceedings of the European Transport Conference, Strasbourg, 8-10 October, 2003. and Kennisinstituut voor Mobiliteitsbeleid (2009), Mobiliteitsbalans 2009.

([40]) Ministry of Economic Affairs (2009), Annual progress report 2009 – The Netherlands in the context of the Lisbon Strategy.

([41]) See for instance the report of the Commission Bakker: Commissie Arbeidsparticipatie (2008), *Naar een toekomst die werkt*.

unemployed. Increasing participation in lifelong learning, including re-training measures, could boost the supply of qualified labour.

The underperformance of the Netherlands in R&D may negatively affect future economic growth and the competitiveness of the Dutch economy. The ability to stimulate R&D and exploit and disseminate the acquired knowledge is essential for growth in innovation-driven economies. It would therefore be important to promote the economy's innovation capacity to support investment and orientation towards high value-added production and services, also to trigger positive spill-overs throughout the economy. Regarding education, a challenge is to improve the educational level of the population, including policies of Life Long Learning and to better align education to the labour market needs.

19. AUSTRIA

19.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Before the recent global economic and financial crisis broke out, Austria enjoyed almost a decade of real GDP growth survey passing that of the euro area average, which was accompanied by one of the lowest rates of unemployment in the EU. In the third quarter of 2008, the country entered a recession, which lasted for a year and was primarily transmitted to Austria by falling exports, reflecting the collapse in world trade.

Looking ahead, a gradual but steady recovery is expected, with real GDP growth reaching around 1½% both in 2010 and 2011. The recovery will be first led by net exports. Subsequently, domestic demand is expected to take over as the main driver of growth on the back of gross fixed capital formation returning to positive growth rates. In the long term, potential growth might be negatively affected by labour supply shortages, in particular of high-skilled workers.

19.2. MACROECONOMIC FRAMEWORK CONDITIONS

19.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the last decade was characterised by stop-and-go consolidation efforts. In 2000, Austria adopted a strategy of a balanced budget in each year, which was achieved in 2001 and was subsequently changed into aiming for a balanced budget over the business cycle. However, surpluses in "good times" were never generated. The close-to-balance position arrived at only in 2007 and maintained in 2008 was then reversed in the wake of the global economic and financial crisis and the subsequent implementation of expansionary measures, resulting in 2009 in a general government deficit and public debt of 3.4% of GDP and 66.5% of GDP respectively. Since most of the measures contained in the stimulus package were of permanent nature, there is an urgent need to specify and implement consolidation measures in order to bring public finances back on a sustainable path, while combining consolidation with a reallocation of public expenditure towards growth-enhancing items.

Recently, Austria has embarked on a far-reaching reform of the budgetary framework law at the federal level. The first part of the reform, which entered into force on 1 January 2009, established a new multi-annual expenditure framework with fixed ceilings (for about 80% of total expenditures) set for four consecutive years on a rolling basis. It is expected to prevent pro-cyclical spending and to enhance the effectiveness of the automatic stabilisers. The second part, legally already enacted to come into force in 2013, involves the introduction of output-based budgeting ("performance budgeting"), the modernisation of the public administration’s accounting system and planning on the basis of long-term projections.

In the medium run reforming the fiscal relations between various layers of government would bring in substantial savings, support fiscal consolidation and free up resources for growth-enhancing investment in areas such as R&D and education. It is widely acknowledged that current relations are rather complex and somewhat opaque. Not only are revenues from most individual taxes shared among the different territorial levels by fixed proportions, but also decision-making in many areas is divided among various levels of authority. For a number of activities revenue-raising and spending responsibilities do not reside within the same level of government.

19.2.2. Macro-financial stability

Austrian banks are well capitalised, as witnessed by the capital adequacy ratio for the banking system which has remained stable. Having plunged in 2008, profitability increased in 2009, albeit only to about half of the pre-crisis level. A striking feature of the Austrian financial sector is its exposure to the Central and Eastern European countries (CEEC). Austrian banks’ assets in the new EU Member States, equivalent to more than 50% of Austrian GDP, constitute the largest share of total foreign claims on these countries. In the context of the global financial market turmoil, the fiscal implications of a potential banking crisis in the CEEC raised concerns, and the risk premium on Austrian government bonds, as measured by the spread vis-à-vis German bonds, soared to over 130 basis points in early 2009. In line with the general market recovery, the risk premium has declined significantly and stabilised at around 30 basis points vis-à-vis German bonds which is amongst the lowest in the euro area. In order to alleviate the consequences of the financial crisis, several measures were adopted. Among others a clearing bank was established to reinvigorate the interbank market, state guarantees for bond issues by commercial banks were issued to the tune of about 7.5% of GDP and the federal government injected nearly 2% of GDP worth of capital into five Austrian banking groups. Accordingly, there is a need for regulation and adequate monitoring of domestic and cross border activities to ensure a viable and stable financial sector capable of meeting the financial intermediation needs of the real economy.

While the financial crisis has revealed weaknesses of the Austrian financial system, its direct effects on domestic economic activity have so far been limited, although bank margins for loans have increased and lending conditions have been tightened to a certain degree, especially for larger enterprises which also faced more difficult terms for issuing corporate bonds and raising equity capital. However, most recent surveys indicate a slight easing in credit standards and conditions and show that the slowdown in credit growth reflects to a greater extent weaker demand due to lower investment activities. It should also be noted that Austrian banks have passed on to their customers the ECB´s key interest rate cuts. By international comparison, indebtedness of both Austrian non-financial corporations and households is not particularly high and does not raise concerns.

19.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Austria has benefited from a depreciating real effective exchange rate and a solid current account surplus for almost ten years. The country's competitive performance over the last decade and a half has paralleled that of Germany. This is unsurprising since close ties to the German economy have led to Austrian wage-setting being closely aligned with developments in its most important trading partner. More recently, the dramatic fall in external demand had a severe impact on export-led growth in Austria. Being highly concentrated on machines, vehicles and processed materials, Austrian exports were particularly hard hit by the global downturn. At the same time, unit labour costs increased on the back of high wage settlements and falls in productivity triggered by labour hoarding. Stronger domestic demand could help to broaden the basis for economic growth. A policy framework removing structural impediments to private investment and consumption would be instrumental to raising the economy's long-term growth potential. The main challenge will be to support more dynamic internal demand while preserving the competitiveness of the economy. Key factors of success will be keeping up with the technological progress and assuring an adequate supply of human capital

19.3. GROWTH DRIVERS

19.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. For many years, Austria has enjoyed one of the lowest unemployment rates in Europe. However, this has been accompanied by one of the lowest employment rates of older workers. While the average exit age from the labour market and the employment rate of older workers increased in recent years, there is still a gap between Austria and the EU, in particular in the employment rate. In fact, Austria has one of the highest shares of working age population receiving old age and early retirement benefits and one of the highest implicit taxes on continued work in the EU. In addition, the seniority pay rules tend to push wage above productivity, thereby weakening the incentives to employ older workers. Recent pension reforms have strengthened incentives to work longer but they have long transition periods and early retirement is still a widely used option. The recent prolongation of provisions for early retirement for the long-term insured, and the suspension of the mechanism for adjustment of the pension system to longer life expectancy are backward steps. The high number of disability pension recipients underlines the potential benefits from modifying the disability pension scheme and adapting working conditions for older workers including enhanced health prevention.

In light of the decreasing contribution of employment to potential growth and the budgetary implications of ageing population, further improving labour market participation and employability of older workers remains an important challenge for Austria, moreover, additional labour supply could come from the activation of workers facing disincentives to take up work. In this respect, it should be noted that Austria displays one of the highest labour tax wedges in the EU. The interplay of taxes and especially employees' social security contributions are particularly discouraging for low-skilled workers. In an attempt to address the issue, exemptions for low-skilled workers from paying unemployment insurance contributions were introduced in 2008. Subsequently, as a part of the stimulus package, personal income tax rates were reduced in 2009. Further revenue neutral tax and benefit reforms are needed to restore incentives to take up work, especially amongst the low-skilled workers.

19.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The transparent and stable business environment in Austria creates favourable conditions for long-term decisions of businesses. The Austrian competition framework has been strengthened by the introduction of a new Federal Competition Authority in 2002 and a substantial reform of the antitrust legislation in 2006. As regards state involvement in the economy, direct participation in business operations is relatively limited and the overall amount of state aid does not exceed the EU average. In spite of the relatively business-friendly environment, the number of people taking advantage of this positive climate remains low, suggesting that it is the attitude towards entrepreneurship that needs to be addressed. There may be some room for improving conditions for creating new businesses in Austria. In particular, the administrative burden on start-ups, including the number of procedures which the to-be-entrepreneurs need to accomplish, appears very high. A related issue is a relatively low availability of early stage venture capital which may hinder the creation of new, mainly innovative, companies. All these factors prevent Austria from benefitting fully from its innovative potential.

19.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Austria's expenditure on R&D has been growing continuously over the last decade and reached 2.73% of GDP in 2009. These increases have primarily been driven by government spending in recent years. However, there are signs that Austria may not have been fully exploiting its innovative potential yet, as indicated by the low shares of high-tech goods exports, knowledge-intensive services and employment in high-tech sectors. One reason for that might be Austria's relative underperformance in terms of the volume of venture capital, which can hinder the generation of innovations, their practical use and dissemination. On top of that, in the future, the relatively low, though slowly increasing, number of science and technology graduates may act as a brake on the development of innovative capacity of the economy, unless the potential shortages of research staff are compensated through more substantial immigration of high-skilled labour.

Austria's education system has been good at equipping the labour force with vocational skills. However, improving the system by strengthening links between tertiary education (or equivalent qualifications), research and innovation would help the country reap fully the benefits of the technological progress. From the growth-enhancing perspective, particularly reforming the tertiary level could be effective as the share of the tertiary educated both in the total employment and in the total working age population is low, although growing gradually over the last several years. In view of the aforementioned reliance on preserving the competitiveness of its economy, ensuring a stronger contribution of the educational system at all levels to human capital formation, and raising the number of science and engineering graduates would support innovation and in particular facilitate the translation of its relatively high spending on R&D into upgrading of the production structure of the economy towards high-tech goods and services.

20. POLAND

20.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The economic boom of the years 2003-2008, characterised by robust real GDP growth, contained inflation and falling unemployment, was followed by a pronounced slowdown in 2009 caused by the global financial crisis. This crisis affected Poland via three main channels: lower demand for exports, lower foreign direct investment and a slowdown in credit growth. Nevertheless, due to a constellation of favourable factors, such as sound fundamentals at the outset of the crisis, a well capitalised and sound financial sector, the relatively low degree of openness of the economy, a sizeable depreciation of the Polish currency at an early stage of the crisis, the cushioning effect of real wage adjustment on employment and timely reactions from monetary and fiscal policies, Poland was able to resist the headwinds and was the only EU country to record positive growth in 2009. The fiscal position has remained weak over the period with the structural general government balance averaging -4.4% between 2003 and 2008 and widening to -7.2% in 2009.

Going forward, the prospects for economic recovery are firming up. Output growth is expected to pick up to 2.7% in 2010 and 3.3% in 2011, while in the longer term the Polish economy's growth potential is projected to decrease from its 2003-2008 average of 4.4% to around 2½% in 2020, owing mainly to a shrinking labour force.

20.2. MACROECONOMIC FRAMEWORK CONDITIONS

20.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the Polish authorities did not use the strong growth period of the years 2003-2008 to improve the underlying fiscal position. The high social spending, being the legacy of the unfinished pension reform and high and untargeted social protection benefits such as almost fully subsidised farmers' social security fund (KRUS), special early retirement regimes for miners and uniformed services and large stock of disability benefits' recipients, weighted on the overall fiscal position. However, the ambitious 1999 pension reform and the 2008 reform of early retirement resulted in a projected decrease in public pension spending and hence improved the long-term sustainability of public finances. Recent reforms on the revenue side, which reduced the tax wedge by cutting social security contributions and lowering PIT rates, though needed, were not entirely compensated by additional revenues or expenditure cuts. These measures together with increases in public sector wages and favourable pensions' indexation contributed to the expansionary fiscal stance in 2008-2009 and helped the economy weather the impact of the global crisis. Overall, the significant deterioration from a deficit of 3.7% of GDP in 2008 to 7.1% of GDP in 2009 reflects to a large extent the impact of the crisis on government finances, but also was brought about by stimulus measures with an impact of about 2% of GDP which the government adopted in line with EERP.

Given the high headline and structural deficits and the relatively high share of social transfers in total public expenditure, reducing the high general government deficit and implementing reforms of public expenditure that ensure a reallocation towards growth-enhancing items, including infrastructure, would be important for Poland. In particular, efforts to increase public sector efficiency and limit the scale of the special expenditure regimes (e.g. KRUS) would support the necessary fiscal consolidation. In view of the underdeveloped infrastructure network, which is key for attracting FDI and increasing productivity, public investment spending should be protected during the medium term consolidation process.

20.2.2. Macro-financial stability

Regarding macro-financial stability, the Polish financial system, mostly foreign owned, has resisted relatively well to the global financial crisis. Financial system supervision and the incentive to build up capital by retaining profits accumulated in the previous year have contributed to reinforce the robustness of the banking system. The impact of financial stress on the economy was reflected in tightened credit conditions and an increase in non-performing loans. Moreover, an adjustment in real estate prices reduced collateral value and hereby worsened the quality of bank loan portfolios. However, the private sector indebtedness, in particular corporations, remains low. The negative impact of the currency depreciation on the balance sheets of households indebted in foreign currencies (ca. 34% of all the loans in 2009) has been partly counterbalanced by an abrupt fall of the corresponding market interest rate.

While the immediate risks for the stability of the Polish financial system are contained, a further careful monitoring of the foreign currency debt issuance would help to diminish any future risks related to foreign exchange rate movements, especially for the household sector. However, Poland lags behind the peers in the level of financial sector development while private sector would benefit from better access to debt markets and their increased liquidity.

20.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the Polish economy does not have significant external imbalances with a current account deficit of 1.6% of GDP in 2009 and external debt at 59% of GDP. The appreciation of Poland's real exchange rate since 2000 was smaller than the average for other recently-acceded EU Member States (except if export prices are used as deflator) reflecting the moderation in real unit labour costs. Since the late 1990s, FDI inflows in Poland have fluctuated around 4% of GDP and have played an important role in total investment, contributing to the development of new areas of specialization in more research-intensive sectors. In the medium term, the competitiveness of the Polish economy will largely depend on its capacity to upgrade the export structure of the country, by focusing it on capital-intensive and high-technology industries. This process depends on Poland's attractiveness for foreign investors, which rests on improving the quality of infrastructure, increasing the efficiency of the public sector, deepening financial markets and developments in human capital. Moreover, transition towards a low-carbon economy will require industrial restructuring and actions to develop green economy sectors both in services and production. Efficient use of local fuel resources (i.e. coal and shale gas) is of utmost importance in this context. Due to high share of coal in electricity production in Poland (which, according to the Polish authorities, will be maintained till 2020) development and implementation of clean coal technologies such as CCS, which will be the key element to secure energy safety, is therefore crucial.

20.3. GROWTH DRIVERS

20.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. After 6 years of continuous fall, the 2009 slowdown resulted in a moderate rise in the unemployment rate, amid increasing labour supply benefiting from recent structural reforms. However, the sharper-than-anticipated adjustment of real wages mitigated the effects of the downturn on employment, which kept growing during the crisis, especially in the services sector. The negative impact of the labour market deterioration on gross disposable income was effectively cushioned through social benefits and high property income payments. In the context of the short-term recovery from the recession, labour market policy ensuring adequate job matching and appropriate training, especially among the young, which are the most affected by the economic downturn, appears to be important.

In the medium term and in view of unfavourable demographic developments after 2020, further improving labour market participation, focusing on the extreme ends of the age distribution, and bridging the regional divide in the labour market performance would be important to support growth potential. The average exit age was low at 59.3 years in 2007. The older cohorts have incentives to retire early, given the numerous special retirement schemes and limited training opportunities, though the recent reform of the early retirement regime limited the number of eligible beneficiaries and contributed to an increase in activity rate among the oldest workers. Meagre participation of younger workers results from the high tax wedge, especially among the least skilled, massive outflow of the Polish labour force abroad and the educational/skills mismatches. The low labour force activity rate is a source of concern especially in view of demographic developments. Moreover, existing regional disparities in the labour market, reflecting low internal labour mobility (resulting from underdeveloped transport infrastructure and housing market rigidities), unfinished restructuring in agriculture and the impact of the farmers' social fund (KRUS), are further aggravated by the inefficient functioning of traditional mechanisms of regional equalisation (uneven concentration of FDI investment, minimum wages fixed at the national level).

20.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Despite a strong deterioration of external economic conditions, the Polish corporate sector has resisted to the economic crisis relatively well. The fall in demand was counterbalanced by appropriate cost adjustment. Limited access to credit had a negative impact on private investment activity, but was offset by the increase in public investment spending on infrastructure, which in medium term can also have positive effects on private sector productivity.

The underdeveloped transport infrastructure (gap between the existing and desirable length of motorways in Poland and lack of a high-speed railway network) is a key obstacle to attract investment and level off regional disparities. Moreover, the energy infrastructure is ageing rapidly and a new energy generation capacity had to be built, as the existing network is reaching its limits. Furthermore the upgrade of transport and energy infrastructure is key to meet the raising environmental standards. Poland also lags behind in terms of the development of the broadband internet network. Upgrading the physical infrastructure, including of transport and energy network, would help reduce regional disparities, improve integration with the Single Market, promote FDI and boost potential growth.

Despite ongoing progress, there remain serious obstacles to do business in Poland, ([42]) including unduly costly procedures for starting business, cumbersome tax and business regulations, inefficient legal framework and high number of business licences and construction procedures. Moreover, the underdeveloped financial system hampers growth prospects, as the banking system is overly fragmented and the corporate debt market relatively underdeveloped. Increasing the efficiency of public administration and accelerating financial deepening plays a key role in improving the business environment.

20.3.3. Knowledge Base (R&D, innovation and education)

Major drivers of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Notwithstanding its relatively high share of university graduates, Poland has tended to display weak performance in R&D and innovation. An extremely weak and decreasing overall level of gross R&D expenditure (GERD), both private and public, stands out in an EU comparison (0.6% of GDP in Poland vs. 1.9 % in the EU on average in 2008). This reflects the structure of the industry (skewed towards low and medium technology), weak institutional framework (low level of direct funding of business R&D and tax incentives) and lack of sufficient links between businesses and public research institutes.

Business surveys point to the existence of significant mismatch between the skills needed by the business and the ones supplied by education institutions which reflects in particular the low, though rapidly increasing, number of graduates in science and technology. Moreover, the structure of funding and spending creates barriers to competition between private and public universities. Overall, the insufficient quality of the tertiary education system translates into a limited capacity to co-operate and innovate, as measured by below-average scientific publications and patenting record. With respect to education and life-long learning, participation of adults in lifelong learning activities is much lower than the EU average. In the view of the above, it is

([42]) World Bank (2008), op. cit. and European Commission (2008), op. cit.

important to promote innovation capacity in order to support investment, diversification of the economy and orientation towards higher value-added production and services by strengthening the links between tertiary education, research and innovation system.

21. PORTUGAL

21.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The global crisis has caught the Portuguese economy in a situation of sluggish economic growth for almost a decade, reflecting structural fragilities, notably low productivity and potential GDP growth. After stagnation in 2008, GDP fell in 2009 by 2% in real terms largely driven by a shrinking domestic demand, notably investment and to a lesser extent household consumption, whereas net trade was slightly positive to growth. Although the downturn was less severe than the EU and Euro Area average, it is having a significant impact on jobs and unemployment has reached historical highs. Imbalances existing before the crisis, notably the external deficit, have remained sizeable, even if slightly reduced, reflecting low domestic savings, low productivity growth and eroded competitiveness. At the same time, the current crisis is severely affecting public finances, with the government deficit and the debt reaching also record highs in recent decades.

Looking ahead, the prospects for economic recovery appear mixed, as considerable imbalances in both the government and private sector need to be redressed, notably in the light of large external borrowing needs, a large external debt and the limited room they leave for domestic demand expansion. In addition, low potential GDP growth reflects weak productivity and a high weight of low-growth sectors. As a result, GDP growth is expected to pick up to rates of ½% in 2010 and ¾% in 2011, according to the European Economic Forecast spring 2010.

A move towards a growth pattern based on exports and investment, with a mirroring decline in the weight of consumption and higher savings would be essential in order to put economic activity on a sustainable path. In view of the relatively low contribution from productivity growth to potential GDP growth in the pre-crisis decade, this suggests that lifting productivity will be essential to raise long-term growth, which makes it an overarching policy challenge for the years ahead.

21.2. MACROECONOMIC FRAMEWORK CONDITIONS

21.2.1. Fiscal policy and long-term sustainability

Albeit declining before the current crisis, high government structural deficits have been persistent leading to the upward trend in government debt ratio since the early 2000s. A visible fiscal consolidation effort took place in 2006 and 2007, but government deficit just below 3% of GDP left no safety margin to accommodate a major shock as the current crisis. From late 2008 onwards, public finances became subject to a combination of adverse forces: the severity of the recession with a much stronger than expected negative impact on fiscal revenues, the operation of the automatic stabilisers, and a discretionary fiscal expansion in the context of the EU European Economic Recovery Plan, coupled with an acceleration in underlying spending, resulted in a major budgetary deterioration, with the fiscal deficit reaching over 9% of GDP in 2009.

The currently high starting point in Portugal's government deficit poses a considerable consolidation challenge if a return towards a budgetary balance is to be achieved over the medium term. Given contained prospects for economic activity over the medium tem, a considerable discretionary fiscal adjustment is required to contain an otherwise increasing public debt that undermines long-term sustainability. Moreover, Portugal should accelerate its fiscal adjustment in order to ensure the sustainability of public finances – the recent stepping up of consolidation is a step in that direction. Whereas the need to swiftly and significantly reduce the government deficit needs to be balanced in the short term against the risk of abruptly choking off a nascent return to growth, a delay in fiscal consolidation may be harmful to economic prospects, if nothing else by the adverse confidence effects it may have on consumers and investors beyond lenders to the government itself. Finally, the efficiency and effectiveness of the public sector, and in particular of public spending, needs particular attention as it may have significant spillovers to the productivity of the overall economy and consequently to the GDP growth path. Therefore, reducing the high government structural deficit while ensuring a reallocation of public expenditure towards growth-enhancing items will be an important challenge both for the immediate and longer term.

In the longer term, the budgetary projections in the March 2010 update of Portugal's stability programme taken at face value would imply a stabilisation of debt levels in the medium term, whereas the long-term budgetary impact of an ageing population is positive but clearly below the EU average. In the opposite direction, the accumulation of large deficits over the medium term will undermine long-term sustainability due to the large and rising government debt ratio and highlights the importance of tackling fiscal consolidation. In this context, the frontloading of fiscal consolidation as recently announced by the Portuguese government is much welcomed. Sustainable government expenditure developments is a crucial dimension in a context of continued low GDP growth over the medium term and of high and rising government debt.

21.2.2. Macro-financial stability

Regarding macro-financial stability, financial turbulence during the crisis so far has been relatively contained and no credit crunch has been observed. That has happened despite the large external borrowing needs of the economy as a whole and seems to reflect the absence of a real estate price bubble and the fact that banks' exposure to 'toxic' assets was limited and consequently with little needs for write-downs on theirs capital basis. Nevertheless, a series of measures were implemented in late 2008 to strengthen financial stability, including increasing bank deposit guarantees, granting of guarantees to borrowing by Portuguese banks until end 2009, and, the possibility of reinforcing banks' capital through government investment. The guarantee scheme had just limited use in comparison with the amounts originally allocated to it and the recapitalisation scheme has not been used. A shift to restrictive lending conditions took place at the onset of the crisis and visible falls in the volume of new credit granted have been recorded, however the stock of credit actually increased in 2009. Credit lines for corporations, notably small and medium enterprises, sponsored by the government may have cushioned the tightening of credit conditions.

The financial crisis has raised a number of challenges for the financial shape of economic agents. A major risk comes from the high levels of debt of households and corporations. This is especially the case since, with most of the debt (especially of the household sector) at floating rates, debtors will become increasingly burdened with high debt levels and the associated debt servicing costs with interest rates that sooner or latter will grow from their current lows. In all, that is likely to strain household finances and increase non-performing loans. This underscores a need to limit the risks from high household indebtedness and household sector deleveraging is needed and will be an important challenge, especially as interest rates begin to rise.

As in many other EU member states, the negative feedback loop from real economy to the financial sector is another main type of risk to financial stability, which is heightened in the case of Portugal by higher-than-average external debt levels and subsequent pressure for deleveraging. Finally, the vulnerable shape of public finances and the higher interest rates on Portuguese sovereign debt may imply higher borrowing costs for the private sector amidst a perception of a higher macroeconomic country-specific risk and the subsequent demand of higher risk premia by foreign lenders. In particular, it seems that the financial sector per se is not a major source of concern in the sense of being the origin or source of major shocks, yet it is exposed to the risks coming from the 'real economy'.

21.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the imbalances in the Portuguese economy are reflected in its persistent reliance on net lending from abroad to help finance the spending of its domestic sectors. Between 2001 and 2009, Portugal recorded an average current account deficit of some 9½% of GDP per annum and the current crisis has only led to a small narrowing of this imbalance. At the same time, reflecting the continuous record of those high external deficits, the stock of net external liabilities has steadily worsened having reached over 110%

of GDP at the end of 2009. In fact, the chronic external deficit reflects also a rising primary income deficit – at 4% of GDP in recent years – on account of the remuneration of that stock of liabilities. External imbalances relate to eroded competitiveness, low productivity growth and insufficient labour costs adjustment in a context of, first, increased competition in global markets, notably in labour-intensive sectors where Portugal used to show a comparative advantage and, second, rather benign financing conditions for a number of years, which have allowed a level of consumption that has gained some weight in terms of GDP. Promoting competitiveness will be important to support the return to and sustainability of export-led growth, also in view of the likely subdued domestic demand developments during the adjustment process. Cost competitiveness, including wage and price adjustment, alongside with continued structural reforms namely in education, public administration and R&D, has an important role to play in this respect, and call for a promotion of wage moderation. Portugal's membership of the euro area reinforces the role of this adjustment channel. Current labour laws, however, forbid so-called unjustified wage decreases, making it difficult to adjust wages downward. In the current context of low or even negative inflation, the resulting nominal downward wage rigidities are of major concern as they sharply restrict the speed at which cost and price competitiveness can be improved with the subsequent costs in activity and employment levels.

It is clear that besides proper price and wage behaviour vis-à-vis competitors, other aspects are crucial to improve the performance of the export sector including continuing to upgrade the range of goods and services exported and strengthening presence in fast growing markets. That is concomitant to a move of the supply side towards offering goods and services of higher added value and higher productivity levels. Therefore, the diversification effort of recent years, both in terms of goods and services exports, and in terms of trade partners should be reinforced. In addition, to the extent that the external deficit is also the result of high imports in a context of inflated consumption, developments that contribute to that domestic demand evolving along sustainable paths are needed.

21.3. GROWTH DRIVERS

21.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Portugal's labour market participation rates have historically been among the highest in the EU, and unemployment among the lowest, including for those particular groups often under-represented in the labour force such as women and old workers. However, those rates have stagnated or even worsened over most of the past ten years as a reflection of the subdued economic activity and its toll on jobs. At the same time, wage developments do not seem to have adjusted fully, and especially quickly, to the deteriorating labour market and slowing productivity. That has happened against a backdrop of a so-called dual labour market with a high level of employment protection for permanent workers and a high share of non-permanent workers with much lower job security.

Improved labour market functioning by tackling in particular labour market segmentation and fostering flexibility deserves attention. In this context, allowing for more flexibility in working arrangements to accommodate heterogeneity of production and work specificities could contribute positively. The implementation of the revised labour law, which introduces, among others, a more simplified dismissal process and more flexibility in hours of work, should have a positive impact. A review of the protection of permanent workers and severance payments which are high from a cross-country perspective appears also necessary. Indeed, a gradual transition to contracts that brings more balance between permanent and temporary employment could prove effective in reducing labour market segmentation and improving the labour market outlook. At the same time, with rising unemployment and the need to regain costs competitiveness, mechanisms have to be in place to favour wage moderation, which may be achieved by further decentralising wage bargaining (even if it is already somewhat decentralised), by considering the signalling role of government salaries and of minimum wages on the private sector pay and seeking social partners' convergence on wages and employment policies that support competitiveness and development for the coming years. In addition, the unemployment insurance mechanisms should be redesigned in a way that ensures that wages react quickly to the labour market situation. In all, addressing these issues appears essential to boost the labour market adjustment, including the adjustment capacity in the EMU context.

Fostering employment growth in a durable way is important to allow for a swift reduction in spare productive capacity in the short and medium term. Furthermore, and more relevant for the long term, relatively little room exists to increase potential GDP by means of high labour input in terms of persons or hours worked. Instead, in the long run, Portugal faces the challenge of increasing comparatively low labour productivity levels, by improving the educational quality and the skills of its labour force.

21.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Despite some positive recent developments, Portugal's business environment presents considerable room for improvement to favour entrepreneurship and investment. However, the weakness of investment over this decade must also be seen against the broader subdued economic backdrop. According to the World Bank's "Doing Business Report", Portugal ranked 18 amongst the 27 EU Member States in 2010. Notably, hiring workers and dealing with construction permits are areas of underperformance. On the positive side, trading and closing a business are areas where Portugal fares relatively well also due to the emphasis placed on simplification measures since 2006That simplification gist is also behind the opening of 'one-stop shops' for a number of procedures. However, for instance, the judicial system shows very long delays in the processes to be judged, which does not help neither contract enforcement nor legal certainty.

Room for improvement seems to exist in product and services market, for instances, at the level of some professional services or competition in network industries. Concerning the competition framework, the role of the Competition Authority may be circumvented by the veto power of the Economics Ministry. Given the EMU context, the adjustment capacity of product markets is also essential.

21.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. To raise productivity growth allowing the catching-up of the Portuguese economy, it is necessary to address weaknesses of a more structural nature, including the relatively low levels of formal education of the labour force and the low educational achievements of current students. This is the case as Portugal shows large educational gaps in relation to the EU average. On top of fewer years of education of older cohorts, youth educational attainment levels and the share of early school-leavers do not compare well with EU averages. Furthermore, the efficacy and effectiveness of the education system seems to show considerable room for improvement. ([43]) In fact, empirical evidence shows that education premia, i.e., the additional labour income yielded by education, are among the highest in the EU, which encourages human capital formation. This means also that policies to facilitate de facto access to education can help in increasing social inclusion and mobility. In addition, it is essential to ensure that vocational training schemes are geared towards labour market needs and that life-long learning becomes more common and supportive of labour market mobility. Enhancing the skills level of the workforce by improving the education and training system in a sustained manner is important to support the restructuring of the economy towards higher value-added production and services. This calls for greater educational inclusion, efficacy and effectiveness, and an upgraded skills strategy.

Portugal's investment in R&D has increased visibly. That is explained by the low starting point and the important role of the government in the R&D effort. At the same time, business R&D expenditure has increased very significantly, from

([43]) OECD (2009), *Education at Glance 2009*: OECD Indicators.

0.3% of GDP in 2000 to 0.9% of GDP in 2008, reflecting also some efforts to promote R&D and innovation at the corporate level. Further efforts in this area seem needed, which would benefit from taking into account a supply side characterised by a relatively fragmented firm structure and by a relatively high share of low and medium value added activities. ([44])

([44]) For instance, the levels of 'Employment in medium-high/ high-tech manufacturing' and 'Employment in high-tech services' are significantly below EU average.

22. ROMANIA

22.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

With an average annual real GDP growth of 6.8% between 2004 and 2008, Romania was one of the fastest growing EU Member States. Growth was driven by a domestic demand boom for both consumption and investment, which was fuelled by capital inflows, including those related to a rapid expansion of credit (mostly financed by foreign parent banks), and steadily increasing income expectations. However, strong growth went hand in hand with growing external and fiscal imbalances. With the deepening of the global economic and financial crisis and the associated increase of risk aversion in international capital markets, Romania experienced a plunge of capital inflows and a depreciation of its currency. Negative balance sheet effects and a sharp drop in export demand led to a 7.1% contraction of real GDP in 2009.

The effects of the contraction of economic activity on the unemployment rate, which rose from 5.8% in 2008 to 6.9% in 2009, have been relatively moderate thus far. Inflation has decreased only slowly and has remained relatively high compared to regional peers, reflecting rigidities in labour and product markets. Nevertheless, the inflation rate excluding tobacco has been declining at a more rapid pace. The decline of domestic demand contributed to the reduction of the current account deficit to a sustainable level of 4.5% of GDP in 2009.

Looking forward, real GDP growth is expected to be flat for 2010 as a whole. Current forecasts foresee an export driven recovery starting in the second quarter of the year. The situation is expected to improve in 2011, when GDP growth is estimated to accelerate to 3.5%, driven by an increase in domestic demand. Although much of the GDP decline associated with the economic and financial crisis was cyclical, it may also have negative consequences for potential growth over the longer term. The sharp fall in foreign investment inflows in combination with domestic constraints on credit availability have led to a sharp fall in capital accumulation both in the public and private sector. Moreover, the impact of the economic crisis coincides with the negative effects of ageing and emigration on potential output.

22.2. MACROECONOMIC FRAMEWORK CONDITIONS

22.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, as a consequence of expansionary fiscal policies initially and of the economic downturn later on, the budget deficit increased rapidly from 2.5% of GDP in 2007 to 8.3% in 2009 while the debt-to-GDP ratio reached 23.7% of GDP in 2009, up from 13.3% the year before. With a view to correcting the excessive deficit by 2012 and maintain market confidence, policies aimed at fiscal consolidation are planned to continue in 2010 and 2011. More in particular, the Romanian Government has agreed – within the context of the BoP assistance programme – to take further consolidation measures aimed at a further sizeable reduction in the structural deficit.

However, efforts towards fiscal consolidation are hampered by a number of structural factors, on both the revenue and expenditure side of the budget. Tax evasion is widespread and increases in tax rates tend to be counterbalanced by reductions in compliance, making it difficult to raise revenues. The use of alternative sources of funding such as the EU structural funds is hindered by a limited absorption capacity associated with weaknesses in the public administration and the regulatory environment. The wage bill of the public sector represents an important share of public spending. During the boom years, public sector employment increased rapidly and wage increases were very generous. In the current period of fiscal consolidation, the imbalance between current and capital spending has worsened further, as rising unemployment rates and increased early retirement have led to an increase in social expenditures and a crowding out of public investment. In spite of increased efforts towards fiscal consolidation, it is likely to be difficult to stabilise the debt ratio without further structural reforms. An ambitious reform of the pension system is currently being discussed in Parliament, which is aimed at curbing the increase in age-related expenditures. A reform to improve cost-effectiveness in the health sector appears to be needed as well. Current expenditures dedicated to health administration are high considering the overall low level of health expenditure in the country (public expenditure on health as a percentage of GDP is 3.8%). In the future, Romania faces the challenge to ensure a more sustainable and diversified financing of its health sector as it follows a convergence path towards mainstream EU countries. Consequently, reducing the high general government structural deficit, while generating a reallocation of public expenditure towards growth-enhancing items, including infrastructure and ensuring long-term sustainability of public finances in view of the population ageing would also be a challenge.

22.2.2. Macro-financial stability

Regarding macro-financial stability, after a solid financial performance during the boom years, mainly due to large profits generated by intense credit activity and leveraging, the banking sector was put under stress at the beginning of 2009. The depreciation of the RON had a negative impact on balance sheets of the private non-financial and financial sectors, given the high share of foreign-denominated loans. This came on top of the impact of the severe economic downturn. Given the large share of foreign ownership in the Romanian banking sector, the dependency of the Romanian banking system on cross-border lending to finance credit activity has been relatively high. Nevertheless, during the peak of the crisis the largest parent banks involved in the European Bank Coordination Initiative have supported capital adequacy and broadly maintained their exposure to Romania. The capital adequacy ratio for the Romanian banking system rose form 13.2 percent in March 2009 to 14.0 percent at the end of the year, with no individual credit institution having a capital adequacy ratio under 10 percent.

Although the banking sector has been resilient to the crisis so far, the deterioration in asset quality is likely to continue to weigh on profitability and erode the capital base of banks in the coming quarters. In terms of capital requirements, the Romanian banking system remains adequately capitalised. However, the economic downturn has increasingly impacted the quality of loan portfolios and credit demand. Non-performing loans (loans and interest classified as doubtful or a loss) significantly increased in 2009 and reached roughly 15%, compared to almost 6½% at the end of 2008. A number of challenges remain, particularly in containing potential spillovers stemming from difficulties in Greece and elsewhere by ensuring that provisioning and capital buffers for credit institutions remain adequate going forward. It therefore remains important to ensure a well functioning and stable financial sector, in particular by continuing to ensure sufficient buffers in the banking system to face direct and indirect credit risks.

22.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the current account deficit showed an almost continuous expansion during the boom years and during the initial stage of the crisis when capital inflows dropped sharply. High wage increases and a 22% nominal appreciation of the RON between 2004 and 2007 hampered the competitiveness of the Romanian economy. While the build-up of these external imbalances was gradual, the adjustment occurred almost instantly towards the end of 2008. It soon became clear that the contraction in domestic demand in Romania would be relatively sharp. Within a couple of months RON/EUR exchange rate depreciated from around 3.6 to 4.2 and goods imports (in euro terms) were cut in half. Exports held up relatively well, supported by the depreciation of the RON, and have exhibited a rising trend in 2010. The improved trade balance together with the decline in capital inflows explains the fall of the current account deficit from 11.6% of GDP in 2008 to 4.5% of GDP in 2009. For the coming years, the current account deficit is expected to fluctuate around 4% or 5% of GDP, which appears to be sustainable for a catching up country.

22.3. GROWTH DRIVERS

22.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to a higher growth potential. Romania's structural employment problems are the low employment rate, the high employment in low-productivity activities (particularly agriculture), the low achievements in education and training, the high numbers of early school leavers and the consequent difficult transition from school to work.

During the economic boom years, job creation and wage increases, particularly in the public sector, went well beyond what was justified on the basis of the productivity performance – in 2007 and 2008 compensation per employee increased by more than 20% while the annual HICP inflation was less than 8% in both years. The massive increase in the public sector wage bill was an important cause of the current fiscal problems of the Romanian government. The inability of the authorities and to a lesser extent the private sector to limit wage increases can be explained in part by a system of collective bargaining at the national level, which is regulated by law and sets national minimum pay and conditions applicable to all employees. As a result, the formal wage setting system is rather rigid. At the macroeconomic level, the set-up of the collective bargaining system has had repercussions for competitiveness and growth, affecting particularly the young and long-term unemployed. Adjustments in the wage bargaining system would help to further improve the functioning of the labour market.

Similarly, employment protection legislation appears relatively strict, especially in the area of collective redundancies. However, the effects of a rather rigid labour code – Romania is ranked 113rd in terms of labour market flexibility by a World Bank study – is somewhat offset by the flexibility offered by the black (undeclared jobs) and grey (undeclared salaries) markets. The improvement of the labour code and the adaptation of the flexicurity principles to the Romanian realities (e.g. by introducing flexible working times and the possibility to combine work with training) remain a challenge.

A further more fundamental issue for Romania is to improve the job skills of the labour force. The poor quality of education in rural areas contributes to high levels of youth unemployment and poverty. Therefore, improving the quality of the education system could contribute to human capital formation, boosting labour utilisation and also boost total factor productivity growth. Romania’s results in international evaluations are poor relative to other EU countries, which is slowing the transition of the economy and, more generally, the real convergence process. Moreover, there is a lack of geographical and functional mobility of workers, who have little incentive to leave their hometown except to go work abroad, where wages are much higher. A major reform of the education system is about to be adopted, including a reorientation of the curriculum towards key competencies.

22.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The still relatively strong position of (formerly) state owned enterprises (SOEs) in some of the sectors of the Romanian economy poses a number of problems for the broader economy. First, culture of non- or late payment of debts between SOEs is having repercussions on suppliers of these SOEs, as they do not get paid either. Second, the accumulated losses of the SOEs are likely at one point to be reflected in the state budget. Third, there is a lack of incentives for SOEs to provide quality goods and services at low costs. More generally, there appears to be a lack of competition in certain sectors, including the liberal professions, road construction, pharmaceuticals and the health sector. Such a lack of competition can explain the low quality of health care and budget overruns for transport infrastructure projects in Romania.

In spite of efforts towards administrative simplification, Romania's relative position in the World Bank's ease of doing business ranking worsened last year. According to the World Bank Doing Business indicators, Romania has important weaknesses in closing a business, even though it has recently changed its bankruptcy law.

Moreover, business is suffering from a lack of access to credit as banks consider it more profitable and less risky to service government debt. Finally, the transport infrastructure is underdeveloped and the energy network is outdated and inefficient. All these issues would need to be addressed in order to make the business environment more conducive to investment and to stimulate potential growth. Nevertheless, a number of large scale investment projects have been undertaken recently, particularly in the automotive sector. Upgrading the physical infrastructure, including of the transport and energy networks, could help reduce regional disparities and boost potential growth.

Significant benefits would come from strengthening the efficiency, effectiveness and independence of the public administration. This would result, inter alia, in an enhanced absorption capacity of EU structural funds and contribute to the aforementioned challenge of shifting expenditure towards growth enhancing items.

22.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Investment in R&D and innovation in Romania is low relative to other EU Member States. Public investment is constrained by increasingly tight budgetary conditions, while the focus of the private sector is on the transmission of innovative production technologies largely developed outside the country. In order to make the most out of limited resources, the government has developed a plan to increase the efficiency and effectiveness of public R&D spending.

As already discussed there is a need to increase the quality of Romania's primary and secondary education system in order to ensure an adequate level of basic skills for all. Similarly, the performance of the university system is relatively weak, both in terms of teaching quality and research output. Improving the quality of the education system would contribute to human capital formation, boosting labour utilisation and also boost total factor productivity growth.

23. SLOVENIA

23.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

In the years preceding the crisis, Slovenia enjoyed solid economic growth driven by buoyant exports and investment with the emergence in 2007 of strong inflationary pressures and a widening external deficit. Strong international liquidity and low real interest rates fuelled credit, domestic demand and imports, while accelerating wage growth started to threaten cost competitiveness. Rapid expansion ended in the final quarter of 2008 when the Slovenian economy was hit hard by the global crisis. Given Slovenia’s high degree of openness, the recession was propagated chiefly through the trade channel. The collapse in exports and investments, including strong destocking, caused an estimated 7.8% contraction of GDP in 2009, one of the largest in the euro area. Mainly under the impact of the economic downturn, the Slovenian budgetary position deteriorated rapidly. Meanwhile, the severe retrenchment of economic activity also brought about some adjustment, as the inflation gap vis-à-vis the euro area average narrowed and the external balance improved.

The recovery is projected to be gradual in 2010, accelerating somewhat in 2011. As the economy is not beset by imbalances or structural adjustment needs quite as large as in other countries, the crisis is, so far, estimated to have relatively little long-lasting impact on Slovenia's potential growth. Nevertheless, as a catching up country and despite gains in recent years, the productivity level in Slovenia still lags behind the other euro area countries in its two main determinants - capital deepening and total factor productivity. Meanwhile, labour input, which provided a relatively small contribution over the past decade, will pose a further challenge for potential growth in Slovenia as the projected demographic ageing begins to materialise.

23.2. MACROECONOMIC FRAMEWORK CONDITIONS

23.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy Slovenia undertook successful fiscal consolidation between 2001 and 2007. The preparation for EUI and euro area membership was accompanied by a deceleration of expenditure growth and the achievement in 2007 of a balanced budget. Following expenditure overruns and the impact of tax reforms in 2008, the budgetary position started to worsen again, deteriorating to 5.5% of GDP in 2009 under the impact of the economic downturn and the strong inherent expenditure dynamics of social transfers and the public sector wage bill. The government gross debt increased from 23½% in 2007 to 36% of GDP in 2009 in part reflecting stock-flow adjustments.

The key budgetary challenges for Slovenia remain reducing the general government structural deficit and ensuring the long-term sustainability of public finances, particularly given population ageing. An expenditure-based consolidation strategy is planned to bring the general government deficit below the 3% threshold by 2013. The old-age dependency ratio and consequently pension expenditure are projected to increase significantly over the coming decades, posing a risk for the long-term sustainability of public finances, especially given the currently low employment rate of older workers. In this context, reducing the general government structural deficit and ensuring the long-term sustainability of public finances, particularly given population ageing, is crucial. The government's proposed two-step pension reform is currently being negotiated with the social partners and the other main stakeholders. This reform would gradually raise the retirement age and introduce incentives for longer working lives. Reforms in the area of health-care and long-term care are also envisaged.

23.2.2. Macro-financial stability

Regarding macro-financial stability, the Slovenian financial sector weathered the crisis relatively well as it was not severely exposed to toxic assets. However, banks' increased reliance on short-term foreign borrowing to finance a credit boom that outstripped the growth of domestic deposits did lead to some refinancing difficulties in foreign markets. This in turn resulted in tightening of credit conditions. Moreover, the quality of bank loan portfolios worsened due to declining real estate prices in 2009 and financial difficulties in particular in the construction sector. ([45]) In addition, by international comparison the Slovenian banking sector is relatively inefficient compared to others in the euro-area, suggesting that domestic governance and structural issues are also an important concern. ([46])

While the household indebtedness remains very low compared to Western standards, non-financial corporations are a further source of vulnerability as their debt-to-equity financing ratio has deteriorated and is higher than in most euro area countries.

23.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the Slovenian current external balance deteriorated from 2002, peaking at 6¼% of GDP in 2008, notwithstanding a steadily increasing market share for goods exports. In 2009, as a massive contraction in imports outweighed the decline in exports and terms of trade markedly improved, the current account deficit substantially narrowed, to around 1% of GDP. As the recovery takes hold and domestic demand regains strength, while terms of trade deteriorate, the current account deficit is projected to start growing again.

Although partly driven by strong domestic demand, the high import-intensity of exports and some deterioration of terms of trade, the widening of the deficit during the years before the crisis also reflects competitiveness losses. Over the period 2000-2008, Slovenia's real effective exchange rate based on unit labour costs appreciated vis-à-vis both the euro area and the industrialised countries. Cost competitiveness appears particularly important given Slovenia’s production structure, which is characterised by a marked comparative disadvantage in the high-technology sector and comparative advantage (albeit declining) in manufactured labour-intensive goods. In this context, facilitating a move towards higher value-added activities appears of crucial importance for sustaining competitiveness, particularly in the euro area, and ensuring the resumption of the catching-up process. At the same time, more dynamic productivity growth would enable Slovenia to sustain higher wage growth and standards of living.

23.3. GROWTH DRIVERS

23.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Solid economic growth before the crisis was accompanied by rising employment, resulting in one of the lowest unemployment rates in euro area in 2008. Although measures to stem the impact of the crisis on the labour market favoured labour hoarding, employment dropped in Slovenia by around 2¼% in 2009, and a similar fall is expected in 2010. Most lay-offs to date have been in low value-added manufacturing activities and further job losses are expected in construction. A successful reallocation of labour to growth sectors would prevent this unemployment from becoming longer term. This is particularly important in light of the existence of mismatch between the demand for and supply of labour in certain occupations. As the temporary labour market measures put in place by the government to respond to the crisis expire, the ability of active labour market and lifelong learning policies to support labour market transitions will be of renewed importance.

Labour market institutions are also important to ensure alignment of wages and productivity, in light of recent losses of competitiveness due to developments in real unit labour costs. The Slovenian labour market presents some structural problems beyond wage setting. It is segmented due to the disparities between strong employment protection for permanent contracts and modest protection for fixed-term contracts, which are the norm for young people. The labour market for

([45]) Bank of Slovenia (2009), *Stability of the Banking System Report*, December 2009.
([46]) See for instance OECD (2009), *Slovenia*, Economic Surveys, 7 and IMF (2009), Republic of Slovenia: Selected issues, IMF Country Report, 160.

young people is further characterised by the prevalence of casual, largely unregulated "student work" which benefits from tax advantages. Therefore, reforms to improve the functioning of the Slovenian labour market by enhancing flexibility while tackling segmentation will strengthen potential output. In this context, moving towards more flexible employment protection rules for permanent jobs, reforming "student work", and revising unemployment benefit eligibility rules would help addressing this challenge. Slovenia also has one of the lowest participation rates for the population aged 55-64, mainly due to insufficient incentives for active ageing on the labour market. These factors limit the contribution of labour input to potential output while exacerbating the burden of ageing on the public finances.

Productivity growth, which is the main driver of growth over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The business environment in Slovenia has improved in recent years with a gradual easing of the administrative burden and the creation of a one-stop shop for establishing new companies. However, a range of difficulties in the business environment remain, discouraging business creation, hampering access to credit and raising business costs, particularly for SMEs. This includes high mark-ups and high concentration in certain services sectors, the burden of employing workers, impediments to getting credit and registering property ([47]) and gaps in transport infrastructure. Increasing competition in the service sector and addressing other weaknesses in the business environment would support SME creation, especially in the knowledge-based services, and create spill-over benefits for other economic sectors. The powers and resources of regulatory bodies are important in this respect. More stable sources of finance for banks and lower concentration in the financial sector would ease access to credit for SMEs, some of which would also benefit from a more fully developed venture capital market. Under the present conditions of increasing credit risks and tight credit, efficient credit allocation is particularly important. Credit transaction costs are relatively high and assessment of risk difficult due to limited transparency of credit information.

23.3.2. Knowledge Base (R&D, innovation and education)

Policies in the area of R&D, innovation and education which support the knowledge base are a major driver of total factor productivity growth. The crisis has further underlined the need to promote innovation capacity and increase overall R&D investments to support diversification of the economy towards high value-added production and services as a way of preserving competitiveness in the euro-area. Slovenia's persistent competitive disadvantage in the high-technology sector relates to weaknesses in R&D, innovation capacity and education. R&D expenditure in Slovenia still lags behind the EU level and is relatively inefficient while employment in high-tech sectors and the share of innovative SMEs remain low. Innovation capacity could be boosted through increased R&D expenditures and more efficient spending via better coordination of actors and programmes.

The capacity to innovate will be boosted by refocusing human capital investment, especially in tertiary education, towards emerging labour market needs and the restructuring of the economy. Furthermore, Slovenian tertiary education operates with relatively low staff/student ratios. Reduced incentives to retain “student status” in the labour market would accelerate educational progression. There are also important opportunities with respect to intermediate skill occupations, where vocational training and lifelong learning could, building on the good quality of initial education, support growth and yield synergies with respect to both low-skill unemployment and active ageing.

([47]) The World Bank (2010), op. cit.

24. SLOVAKIA

24.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Slovakia has experienced several years of fast real convergence and GDP per capita in purchasing power parity has been progressively closing its gap with respect to the more advanced EU economies, standing in 2008 at 65% of the EU15 average. In 2009, the economy contracted as external demand plummeted and investments fell sharply, but quarterly growth returned to positive territory already in the second quarter of 2009, when many EU economies were still experiencing recession. This outcome was primarily driven by the increase in both exports and domestic demand, the latter having been supported by the free operation of automatic fiscal stabilizers and to some extent by the anti-crisis measures.

Looking ahead, the prospects for economic recovery appear positive, as output is expected to pick up by 2.7% in 2010 and further accelerate to 3.6% in 2011. Nevertheless, these rates are well below those achieved during the boom phase. In the medium term, the growth of potential product is projected to gradually decrease due to the decline in working age population. The impact of ageing is expected to prove to be even more substantial in the longer run, with growth of potential product projected to decline from 4.2% in 2015 to 2.0% in 2030. This is to be accompanied with a large increase in the old-age dependency ratio (by 13.1 p.p. in the same time period) and age-related expenditures.

24.2. MACROECONOMIC FRAMEWORK CONDITIONS

24.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the government succeeded in reducing the headline deficit averaging 5% of GDP in 2001-2004 to an average of 2.6% of GDP in the subsequent four years. However, the average growth rates of 8% per year attained during this period were not used to consolidate the budget and the structural deficit deteriorated from 1.7% of GDP to 4.7% of GDP. The procyclical fiscal policies therefore left Slovakia's public finances in a vulnerable position at the onset of the crisis. As the government let the automatic stabilizers operate freely while revenues were falling short of expectations, the headline deficit soared from 2.3% of GDP in 2008 to 6.8% in 2009. The budgetary strategy aiming at reducing the deficit below 3% of GDP by 2012 and reach a balanced budget in the medium term is essential to retain the confidence of investors. Nevertheless, main elements of this consolidation still need to be specified in detail, also with a view to ensuring long-term sustainability. Moreover, strengthening the binding character and enforceability of the existing fiscal framework and an introduction of prudential budgetary rules would enhance further credibility of the envisaged consolidation efforts.

Slovakia belongs to countries with a high risk to long-term sustainability of public finances. The initial budgetary position poses a more significant drag on the long-term sustainability of public finances than the costs of ageing, which reinforces the case for early fiscal consolidation. Despite the introduction of important elements of the pension reform in the past, additional steps could prove needed to contain pension-related expenditures, including increasing retirement age and reassessing indexation rules. Moreover, notwithstanding past efforts to improve the overall efficiency of Slovak health sector, there appear to have been some reform setbacks. Consequently, further reforms seem essential for improving the sustainability of public finances. The state of the healthcare sector represents a significant challenge with respect to ageing as the ratio of health-related expenditure to GDP, which is currently one of the lowest in the EU, is expected to rise quite substantially in the future. ([48]) Overall, reducing the high general government structural deficit and ensuring long-term sustainability of public finances in view of the population ageing is instrumental to securing favourable macroeconomic framework conditions for sustainable growth.

([48]) Increase in health expenditure due to ageing (from 2010 to 2060) is estimated to be the second highest in the EU, as shown in European Commission (2009), op. cit.

24.2.2. Macro-financial stability

Regarding macro-financial stability, despite the large shock to the real economy and extreme stress in global financial markets, the banking sector has remained rather strong. This reflects a good liquidity situation of credit institutions and low dependence on cross-border lending. A tightening of lending conditions was observed for households and businesses. The share of non-performing loans is broadly in line with the EU average.

As a result, no major rescue operations have been necessary in Slovakia. The interventions were limited to bank liabilities guarantees, none of which has been granted so far. Nevertheless, after annual increases of residential property prices in 2006-2008 exceeding 20% (euro area average being 4.2%), Slovakia recorded one of the largest price corrections in the EU in 2009, amounting to 11%. This put strains on banks' balance sheet, but the overall profitability of banking sector in Slovakia remained positive in 2009.

24.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Slovakia has continuously run current account deficits over the past years, averaging 6.5% of GDP between 2000 and 2008, while improving mainly in the last few years of this period. This has been accompanied by significant inflows of foreign capital, in particular FDI, increasing the export capacity of the Slovak economy and reshaping its structure. In 2009, Slovakia's exports plummeted as the external demand fell and currencies of neighbouring countries depreciated. A subsequent even larger slump in imports resulted in an improvement of the current account. Hence, the external position of Slovakia does not seem to have suffered excessively from nominal exchange rate developments vis-à-vis non-euro area neighbours despite a sharp fall in net FDI inflows and a decline of other capital inflows. Moreover, given the continuously increasing share on export markets, Slovakia appears to have retained its external competitiveness.

In the run-up to euro adoption, Slovakia had one of the fastest appreciating currencies in the EU reflecting a sizeable appreciation of the nominal effective exchange rate and a positive inflation differential between Slovakia and neighbouring countries. The appreciation of the real effective exchange rate continued also in the first half of 2009 when the nominal exchange rates of neighbouring countries depreciated. As a result, latest estimates point to a risk of moderate overvaluation of the real effective exchange rate in 2009 relative to the equilibrium, which, if sustained, might lead to deterioration in Slovakia's external position in the medium-term. In recent years, Slovakia has managed to diversify its manufacturing exports away from the automotive sector to other segments, namely telecommunications and electronics. However, given the ongoing catching-up process and the likely further appreciation of the real effective exchange rate due to increases in unit labour costs, Slovakia would benefit from a shift to higher value-added sectors. Focusing on structural problems of labour market in Slovakia as elaborated in more detail below would also help keeping growth of unit labour costs contained and thus avoid excessive wage increases as observed in 2008. Stricter wage policy in the public sector is needed, as wages increasing well above productivity gains in this sector could have an undesired impact on wage setting behaviour in the rest of economy. In the medium-term perspective, it would be important to ensure that domestic cost and price developments help sustain competitiveness. Improvements in the business environment could also contribute to promoting competitiveness of the country.

24.3. GROWTH DRIVERS

24.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. Slovakia's labour market exhibits several persisting weaknesses. Despite a rapid decline in unemployment rate during the boom years the unemployment rate still stood at almost 10%, suggesting sizeable structural unemployment. The long-term unemployment ratio is among the highest in the EU. Weaknesses in labour market performance are particularly pronounced at both ends of the age distribution. For the young population aged 15-24, inactivity rate has been particularly high by EU standards despite comparable levels of enrolment in (post)secondary and tertiary education. High inactivity rate of the elderly population aged 55-64 appears to be primarily due to early retirement. Finally, the employment rate of low-skilled workers is one of the lowest in the EU (more than 30 p.p. lower than the EU average in 2008). Targeted and well-monitored active labour market policies could contribute to activation of long-term unemployed and reduction of skill mismatches, which indicate weak functioning of current requalification schemes. To improve the employability of young workers, a better alignment of education and training system with the needs of the labour market seems to be crucial. Generally high inactivity and unemployment rates in Slovakia also point to the usefulness of reviewing the set-up of the tax-benefit system. While recent measures have addressed the supply side of the labour market, emphasis on stimulating the demand for labour could help increase labour utilisation, in particular for workers with low wages and skills. An important issue is that a part of structural unemployment and high inactivity rate is still to be attributed to the low levels of social inclusion of the Roma minority. Therefore, continued effort to increase labour market participation of this group would be crucial. Moreover, the decrease of working age population in Slovakia is expected to be one of the highest in the EU, mainly because of the low fertility rate. It is hence important to improve labour utilisation before the onset of the demographic change, which is expected to occur rather quickly - the peak of working-age population is envisaged already in 2011 An important challenge is therefore to ensure full utilisation of the economy's labour potential, by tackling in particular the long-term unemployed and marginalised groups.

24.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Over the last years, Slovakia has pursued many reforms to increase the flexibility of its business environment. As a result, in international surveys it scores above the EU average in many areas, such as property registration and relative costs of business' start-up procedures. However, there are numerous outstanding issues such as the cumbersome tax and social security contributions' administration, sluggish legal enforcement, high administrative burdens on companies and existing regulatory barriers to competition (e.g. in telecoms and electricity markets). Weaknesses with respect to public procurement have increasingly become an important concern for businesses.

Persisting inefficiencies of the public sector and also concerning allocation of public expenditure lead to under-spending in areas such as education, public infrastructure and R&D. This poses a challenge for future growth, given the diminishing scope for technological catching-up. In particular, over the long-run, the underdeveloped transport network poses a significant challenge for economic growth. Specifically, the lack of a highway connection between the western and eastern part of the country hampers economic development of the eastern regions because it reduces their attractiveness for foreign investors despite lower labour costs in the east. Improvement of the transport infrastructure might help to lower persisting regional disparities, such as GDP/capita, unemployment, wages, and also mitigate labour mobility constraints. Furthermore, the improved absorption of the EU funds, which has been below its full potential until now, could further boost total factor productivity growth.

There is a significant scope for improvement in the quality of public spending and in particular that the additional expenditure towards growth-enhancing items, including education, R&D and infrastructure is used efficiently.

24.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Inflows of FDI, which peaked in 2002 at 15.5% of GDP, played an important role in the convergence process of Slovakia. They contributed to strong total factor productivity growth through transfer of know-how and innovation and a faster build-up of the capital stock. With the gradual closing of the per capita income gap with the EU, Slovakia's ability to rely on knowledge transfers from abroad is likely to diminish and more knowledge would need to be generated domestically. Slovakia's business R&D expenditure level is low by EU standards, having decreased from 0.43% in 2000 to just 0.2% of GDP in 2008. Reallocation of government expenditures towards growth-enhancing R&D is instrumental in increasing knowledge spillovers and synergies with business R&D. Links between the sectors of business and education and training tend to be weak leading to skill mismatches. Consequently, a tighter cooperation between universities and businesses could be encouraged.

Despite the fact that tertiary education attainment is still well below the EU average, enrolment in this segment has risen over the recent period and is now broadly at the EU-wide average. However, an upgrade of labour skills is necessary to shift the Slovak economy towards higher value added output, which will also contribute to sustaining a high rate of convergence. There is potentially scope to increase share of public and private expenditures in education and training in general which is one of the lowest within the EU. Particularly, investments in higher education should be strengthened alongside with measures to enhance its quality and efficiency. In addition, vocational education and training at the secondary level and professional training at the tertiary level of education should better address labour market needs. Given the potential of the human capital to boost potential growth and contribute to real convergence, there is a challenge to ensure that the education system contributes to human capital formation, through focusing on the quality of education and reflecting the labour market needs. One of the key challenges is therefore to ensure reallocation of public spending towards growth-enhancing items, including education, R&D and infrastructure, to maintain the pace of real convergence, given diminishing scope for technological catch-up.

25. FINLAND

25.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Finland entered the international financial market and economic crisis from a relatively strong position, having built up a substantial surplus in the current account and in the government finances. The collapse of world trade in 2009 hit the highly export-oriented Finnish industry severely and undermined domestic private sector confidence, leading to a slump in real GDP by an unprecedented 7.8%. Having accumulated sizeable surpluses in public finances over the previous economic upswing, Finland allowed the automatic stabilisers to operate fully and in addition provided for a relatively large discretionary fiscal stimulus amounting to about 3% of GDP over 2009-2010. This has somewhat helped to cushion the impact of the crisis on domestic activity and notably on the labour market. Consumer confidence has rebounded quickly in the course of 2009 and presently even exceeds the long-term average, while industrial confidence has also rebounded, albeit more modestly.

While the drop in GDP was exceptionally steep, the acute phase of the crisis also appears to have been relatively short-lived and the economy has retained its solid fundamentals. Even though exports are expected to recover with a lag, the current account is expected to remain in small surplus position. Domestic banks have largely withstood the financial market turmoil, enterprises and households do not face major deleveraging needs and the rise in unemployment has levelled off at a rate below 10% of the labour force. In the early stages, domestic demand is therefore seen to drive economic recovery. Although much of the observed decline in actual GDP in the context of the crisis is cyclical, the level of potential output has also been negatively affected. In addition, the crisis may also affect potential growth in the medium term through lower investment and increases in structural unemployment.

In addition, in the longer term the growth potential is projected to be somewhat weaker than over the previous decade on account of the ageing of the population gradually reducing the size of the labour force. Output growth and job creation will therefore increasingly depend on advances in productivity.

25.2. MACROECONOMIC FRAMEWORK CONDITIONS

25.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, Finland appropriately accumulated sizeable fiscal surpluses over the previous decade when good economic times prevailed and maintained an overall countercyclical fiscal stance. This allowed a substantial degree of fiscal loosening in 2009 in response to the global crisis. The full operation of fiscal stabilisers and a large fiscal stimulus have however resulted in a worsening of budgetary positions and a widening of the long term sustainability gap, pointing to a need to rebuild fiscal balances in the medium and longer term.

The budgetary projections presented in the 2010 update of the Finnish stability programme did not yet include a comprehensive medium term consolidation strategy. Medium-term debt projections of the Commission show that, under a no policy change assumption, the debt-to-GDP ratio would not stabilise by 2020. Securing the long term sustainability of public finances is an especially pressing issue, given that the country will be one of the first Member States to face a continuous decline in its working-age population from 2010 onwards and as the budgetary costs of ageing will also exceed the EU average. Moreover, over the past decade, productivity advances in the provision of public services, which to a large extent fall under the responsibility of local governments, have been lagging. Boosting productivity in the public sector is a major challenge as the imminent population ageing raises demand for related public services. In this regard the effectiveness of ongoing productivity-enhancing measures at the central and local government levels is of high importance in order to offset the adverse effects of population ageing.

25.2.2. Macro-financial stability

Regarding macro-financial stability, in spite of the recent global financial turmoil, Finland has succeeded in maintaining the domestic financial sector at a solid footing. While household indebtedness rose over the past decade to historically high levels by Finnish standards - about 100% of annual disposable income - it is still comparable with other euro area countries. Since about 90% of mortgages have variable interest rates and the loan margins are low by euro area standards, the currently low interest rates are effectively passed on to mortgage holders. The real estate market has therefore remained active and is set to sustain construction activity. The corporate sector does not face any major deleveraging pressures, as also evidenced by only a modest rise in nonperforming loans and bankruptcies.

25.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Finnish industry has traditionally had a highly concentrated sectoral structure, with 70% of exports generated by metal engineering (investment goods), electronics, and forestry. Each of these has suffered severely from the global crisis in 2009. While export volumes dropped by one quarter, the sharpest fall in the euro area, imports declined at a similar rate and the terms of trade turned positive on account of the sharp fall in commodity prices. This cushioned the effect on the current account balance, which eased from a surplus of 3.6% recorded in 2008 to one of about 1½ % of GDP in 2009, mainly driven by a reduction in the goods trade. As the expected recovery of the global economy proceeds, it could also revive demand for the key Finnish manufacturers. The current account surplus is nevertheless expected to edge down to slightly above 1% of GDP in 2010-2011, mainly due to the terms of trade turning negative.

Finland's export base remains relatively narrow and highly specialized. The concentrated industry structure renders the economy vulnerable to sector-specific shocks. While Finland's overall competitiveness position in the euro area appears solid and its current account is in surplus, such sectoral developments, often strongly impacted by global trends in addition to domestic policy, have traditionally played a large role in driving overall economic activity. This suggests a need to remain particularly attentive to further diversify exports structure, enhancing diffusion of technologies and taking advantage of knowledge spillovers. Enhancing incentives for resource reallocation towards activities generating higher value added is also central for long-term competitiveness. In this respect the still highly concentrated wage structure, which does not appropriately reflect productivity differences across firms and industries, seem to deter labour reallocation. Moreover, Finnish industry is relatively energy intensive. Its growth and productivity potential therefore also depends on addressing the challenge of climate change and improving energy efficiency. Diversification to reduce the vulnerability of the economy to sector- specific shocks could be beneficial, and this might be induced by enhancing the diffusion of technologies and incentives for resource reallocation, including a wage formation system that would better reflect productivity differentials between companies and industries.

25.3. GROWTH DRIVERS

25.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The previous decade of strong growth enabled the Finnish labour market to recover from the adverse effects of the crisis in the early 1990s. Given the overall strong economic fundamentals and owing to the fiscal counter-action taken, the effects of the current global crisis on the labour market have remained relatively contained, with the unemployment rate likely to remain below 10% on annual average. However, temporary lay-offs and various schemes to reduce working time have been also widely used, involving about 2% of the labour force, but which to a large extent are not reflected in the unemployment statistics. The current crisis has had a particularly severe effect on youth and male unemployment. It is crucial that hysteresis effects and unemployment persistence be averted at the current juncture.

In the medium and long run, the Finnish labour market will have to cope with the adverse effects of the ageing of the population. Finland is one of the first countries in the EU where the working-age population will move to a declining trend already from 2010 onwards. Ageing has negative effects on potential growth and competitiveness through a lower labour supply and potentially also through weaker productivity. Ageing also weakens the sustainability of public finances due to both slower growth of tax revenues and higher public expenditure. These effects can be alleviated by measures to boost employment targeting in particular some segments of the population that have traditionally shown a weaker labour market attachment, notably youth, migrants and low-skilled workers. Furthermore, there is scope for extending the length of working careers and for decreasing regional, sector and skills mismatches' weight on structural unemployment. Indeed, comparative analysis of the Finnish labour market suggests that it has so far proved difficult to encourage geographical and skill based labour mobility. Moreover, social benefit systems occasionally create non-negligible work disincentives and labour force participation of youth, migrants and low-skilled workers is relatively low. Furthermore, labour supply appears weak at the ends of the age spectrum as young people enter the labour market relatively late on account of long study times while early labour market exit continues to affect elderly workers. Concerning the labour force participation of youth, the most problematic groups are young people outside the education system and the early school leavers. Higher employment rates could counterbalance somewhat the projected decline in the working-age population but would be unlikely to entirely offset the demographic shifts in the longer term. The economy would thus have to adjust in coming decades to a declining labour supply. Given the rapid rate at which the share of the population of age 65+ increases in Finland, substantial measures to increase the effective retirement age would be very important.

25.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the long run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The issue of competition in product and service markets is seen as highly relevant for Finland. The lack of competitive pressure in the domestic market, with highly concentrated business structures, is reflected in a relatively high price level. This has adverse consequences for consumers' purchasing power, and crucially also for productivity in the sheltered sectors. Given the country's remote location with sparse population density, the underlying conditions for effective competition are often weaker in the domestic market than in other European economies. This is sometimes aggravated by the traditionally concentrated nature of Finnish businesses, including the retail market. Although productivity growth in the tradable sector has been remarkably high, it is lagging behind in the non-tradable sheltered sectors (agriculture, utilities, and trade), including public services. Competition and productivity shortcomings in some sectors are also reflected in relatively high price levels when compared with most other Member States. A higher degree of competition in services including retail and wholesale trade, would contribute to downward pressure on prices and also to increasing productivity in the sheltered sectors.

25.3.3. Knowledge Base (R&D, innovation and education)

Major drivers of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. With R&D spending at 3.7 % of GDP in 2008, and an excellent primary educational system (as reflected in the PISA survey), Finland remains one of the top performers in the EU. However, several studies have concluded that there are challenges in the commercialisation of new innovative products and services. This weakness is combined with a relatively low level of inward FDI, which is an important route of importing innovation. An additional aspect of the innovation performance is the broadness of innovative activity within an economy. In Finland, R&D is highly concentrated to the ICT-industry and even to one single company (Nokia). While there are benefits for a relatively small economy in high specialisation, it might also give rise to sectoral risks.

26. SWEDEN

26.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

Sweden's very export dependent economy was severely affected by the financial crisis. While GDP dropped sharply, similar to many other countries, it has been one of the few countries in the EU to maintain sound public finances. Indeed, it may be one of the only countries not to have exceeded the 3% of GDP maximum deficit rule in 2009. The Swedish economy is now on a path to becoming more stable. Its trade-openness, however, implies sluggish demand from its trading partners and this continues to affect the strength of the recovery. While the recession hit the export-oriented manufacturing sector particularly hard, the domestic economy has shown greater resilience. Helped by significant policy stimulus in the form of virtually zero policy-controlled interest rates and a series of fiscal stimulus packages, consumer confidence has recovered strongly. Consumer optimism is also helped by an improving labour market outlook and a strong recovery in stock market indices and a return to rising house prices after a short-lived house price correction in the autumn of 2008. The latter trend is sustained by rapidly rising household borrowing. Industrial production, private investment and exports, on the other hand, have so far remained at depressed levels.

Looking ahead, the recovery of the Swedish economy is likely to gradually gain momentum, as buoyant consumer demand in the course of 2010 is reinforced by strengthening exports on the back of more rapid global growth. As a result, annual GDP growth is forecast to reach about 1¾% and 2½% in 2010 and 2011, respectively. However, over the coming decade, the Swedish economy's growth potential is projected to gradually decline to slightly below 2% per year compared with a pre-crisis level of above 3% per year. This is mainly due to slower employment growth as population ageing is making itself felt. Looking beyond the year 2020, long term potential growth in Sweden is projected to remain in the 1½-2% per year bracket, among the highest in the EU27, owing mainly to continued projected increases in total factor productivity and capital deepening. ([49])

26.2. MACROECONOMIC FRAMEWORK CONDITIONS

26.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, the Swedish budgetary framework, which evolved in the second half of the 1990s in reaction to the significant worsening of public finances during the deep recession of the early 1990s, is considered to be strong (including a general government surplus target, a central expenditure ceiling and a balanced-budget requirement for local governments) and is generally perceived to have contributed to the significant debt reduction and prudent cyclical stance observed since its introduction. The framework benefits from broad political support across the political spectrum, which contributes to its credibility. As a result, Sweden entered the recession with relatively strong public finances. The surplus was 3.8% in 2007 and while this has now turned into a deficit it looks set to peak in 2010 without exceeding the reference value of 3% of GDP.

Medium-term debt projections (which assume GDP growth rates that gradually recover to the values projected before the crisis, tax ratios that return to pre-crisis levels and include the projected increase in age-related expenditures) show that the budgetary strategy envisaged in the government's latest convergence programme would put the debt ratio on a declining path, reducing it to about 15% of GDP by 2020. The long-term budgetary impact of ageing is clearly lower than the EU average and the large assets accumulated by the public pension schemes will help finance part of the increase in pension expenditure. The budgetary position in 2009, as estimated in the programme, contributes to the reduction of gross debt. Primary surpluses over the medium term and appropriate structural reforms would contribute to further limiting the risks to the sustainability of public.

([49]) European Commission (2009), op. cit.

26.2.2. Macro-financial stability

Regarding macro-financial stability, while the banking sector was not particularly exposed to the type of mortgage derivatives that triggered the global financial crisis, it nevertheless felt the effects of the crisis in several ways. First, as liquidity dried up in global financial markets, financing costs increased substantially everywhere, putting pressure also on Swedish banks. Second, at least two of the major banks' involvement in the Baltic States left the system exposed to heavy credit losses stemming from these banks' overseas activities. Thirdly, the global recession brought with it the usual rise in corporate bankruptcies. The government took a number of steps to restore market confidence in the banking system, notably by providing guarantees for banks' medium-term borrowing, raising the limit for depositors' guarantees and providing funds for recapitalisation. At the same time, the central bank lowered its policy rates to virtually zero and accepted a wider range of securities as collateral for borrowing in the central bank. These measures, combined with similar measures in other countries, proved successful in stabilising the financial sector.

A strengthening of the financial and supervisory framework can help establish conditions for a stable and viable Swedish financial services sector. While lending to the corporate sector continues to contract, households are borrowing at a double-digit annual pace, mostly to finance house purchases and home improvements. Their debt burden as expressed by the ratio of total loans to disposable income reached an all-time high of 160% at the end of 2009 and the upward trend has continued since then. While the associated debt servicing costs have been eased by a secular decline in interest rates over the last 15 years, their eventual rise over the medium term is likely to strain household finances. Contrary to elsewhere, Swedish house prices have also resumed their upward trend. This underscores a need to limit the risks stemming from a high and rising household indebtedness, which is contributing to rising house prices. An important aspect in this context is the rapid expansion of mortgage loans. An easing of short and medium-term housing supply pressures through an improved use of existing housing stock and the facilitation of rental housing may also help to dampen the demand for mortgages and thus contain price pressures. High exposure of banks to the Baltic region calls for enhanced cooperation of financial supervisors in Sweden and host countries.

26.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, Sweden ran a series of ever larger current account surpluses peaking at more than 9% of GDP in 2007-08. Negative productivity growth in recent years, coupled with increases in labour costs of around 3% per year in 2008-09, have pushed up unit labour costs in the Swedish economy. In the early phase of the recession, the depreciation of the krona more than compensated for this relative rise in unit labour costs from a competitiveness point of view. Its subsequent appreciation has eroded much of that advantage. With productivity set to rebound and the ongoing wage bargaining round likely to yield modest nominal wage increases, however, relative unit labour costs should not deviate markedly from those in Sweden's trading partners. In a longer perspective, it is arguably relevant to maintain and improve the attractiveness of Sweden as a business location, notably through a well educated and trained labour force, adequate infrastructure and a tax and regulatory environment that is conducive to productive investment.

26.3. GROWTH DRIVERS

26.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. As a result of the recession, unemployment rose from about 6% of the labour force before the crisis to above 9% in early 2010. It is important to promote a quick absorption of unemployed in the wake of the recession, which otherwise could lead to a loss of human capital, hysteresis effects and higher structural unemployment. So far, most of the labour shedding has taken place in the manufacturing industry, with the private services sector proving more resilient than many forecasters believed during the most acute phase of the recession. An unusual amount of labour hoarding during the crisis could imply that the early phase of the recovery may be rather job-anaemic and that such potentially jobless growth in turn induces hysteresis effects with permanent loss of labour supply as a consequence. In this context, active labour-market policies may expand in scope and it would then be important that this should not be at the expense of quality.

In a longer perspective, as globalisation is likely to accentuate the pressures on the public sector's financing capacity, already burdened by an ageing population, could be important to strengthen labour supply to its full potential by raising the inclusiveness and employment rate among groups with a currently weak connection to the labour market, such as young persons and immigrants. In this context, the strengthening, training and qualification of the youth and of the unemployed to ensure adequate labour market skill-matching with the job competencies needed in the future will be a relevant aspect. There may be some features of the Swedish labour market model, notably a high level of employment protection for regular contracts and high starting wages, which contributes negatively to inclusiveness and the integration of such groups. Partial reforms have led to a two-tier labour market with a majority of workers enjoying a relative high level of protection (possibly contributing to limit turnover and restructuring flows) and a 12-14% minority on short-term contracts providing about two-thirds of all labour market mobility.

26.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. Sweden ranks among the most competitive economies in the world. According to the World Economic Forum's 2009-10 edition of its Global Competitiveness report, Sweden maintains its fourth place in the league table from the two preceding years (out of more than 130 countries) and has consistently been among the top-10 over the last decade. However, while Sweden's starting position is good, there are a number of factors that could potentially undermine its business climate. ([50]) With increasing mobility of factors of production, the tax system may need to take this sufficiently into account, to minimise undue obstacles to investment in physical and human capital. While the Swedish tax wedge has fallen slightly in recent decades, it remains relatively high and could impair the accumulation of human capital and hold back entrepreneurial activity. Some areas and markets in Sweden suffer from a lack of competition and where it will be important to increase competition over the medium term, including markets where private and public companies compete and in public procurement. In this context, it could be relevant to consider the findings in the comprehensive report published in 2009 by the Swedish Competition Authority, which identified a number of areas where competition indeed might usefully be strengthened. In this context, also the new powers of the Competition Authority could play a potentially beneficial role.

26.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth is policies in the area of R&D, innovation and education which support the knowledge base. Innovation capacity to support investment and a orientation towards high value-added production and services depends on the overall links between tertiary education, research and the corporate sector. In this context, the apparent difficulty in converting large investments in R&D into growth-enhancing productive innovations indicates that to improve the allocation and use of these investments could be a challenge. The process by which R&D investment is converted into commercially viable innovative products could also be enhanced by promoting entrepreneurial activity. A problem to overcome in this regard is the relatively negative attitude towards entrepreneurship in Sweden. In a recent government study, Sweden ranked very low among a group of comparable countries. ([51]) In addition, while Sweden is generally recognised as having a high level of human capital, notably with

([50]) See for instance OECD (2009), *Sweden*, Economic Surveys, 2. and the final report of the Globalisation Council : Globaliseringsrådet (2009), *Utvecklingskraft och omställningsförmåga. En globaliserad svensk ekonomi*.

([51]) Exportutredningen (2008), Svensk Export och Internationalisering. Utveckling, Utmaningar, Företagsklimat och Främjande, Statens Offentliga Utredningar, 90.

a high share of persons with a PhD in the workforce, there are signs emerging that more efforts are needed to ensure a high level of quality in initial education. The sharp increase in early school leaving rates might be a reason for concern. Given the lags involved, this could be a warning signal if Sweden wishes to maintain its top position. Progress in increasing the number of graduates in mathematics, science and technology could be accelerated.

27. UNITED KINGDOM

27.1. ECONOMIC DEVELOPMENTS AND OUTLOOK

The UK entered a recession lasting six quarters in early 2008, following a decade of strong economic growth and low and stable inflation and unemployment. However, this was accompanied by a sharp rise in property prices and a corresponding rise in household indebtedness. Fiscal policy was excessively loose during the pre-crisis decade – with an average cyclically-adjusted general government balance of -3.6% between financial years 2001/02 and 2008/09 – missing the opportunity provided by strong growth to consolidate and prepare for future shocks.

Looking ahead, the prospects for economic recovery appear mixed, as considerable imbalances in the government and household sector need to be redressed. Output growth is expected to pick up only gradually in 2010 and2011. In the long term, the UK economy's growth potential is also projected to be somewhat weaker than its 2000-2008 average of 2.3%, at around 2% between during the period 2010-2020. In view of the UK's relatively limited contribution to potential growth from capital deepening in the pre-crisis decade, this suggests that capital investment will be essential to raise long-term productivity and growth. Looking beyond the year 2020, long term potential growth in the UK is projected to remain around the level of 2% p.a., the second-highest in the EU27, owing mainly to continued projected increases in the size of the labour force. ([52])

27.2. MACROECONOMIC FRAMEWORK CONDITIONS

27.2.1. Fiscal policy and long-term sustainability

Regarding fiscal policy, following a period of consolidation in the late 1990s, the stance of UK public finances became significantly looser since the early 2000s. From the beginning of the crisis in autumn 2007 onwards, UK public finances became subject to a combination of adverse forces: the combination of the severity of the recession, its impact on previously tax-rich income and expenditure, the operation of the automatic stabilisers and a discretionary fiscal stimulus resulted in a major fiscal deterioration, with an expected government deficit of around 12½% of GDP in financial years 2009/10 and 2010/11.

Following the rapid decline in tax revenues and increase in public spending as a share of GDP brought about by the crisis, reducing the high general government deficit and rebalancing the general government budget is a priority for both for the immediate and longer term. Sizeable contingent liabilities contracted as part of financial sector rescue measures during the crisis reinforce this conclusion. Given strong growth in real government expenditure since 1997, improving public sector efficiency can help create room for expenditure adjustments without compromising the quality of public services. Nonetheless, the need to swiftly reduce the government deficit needs to be balanced in the short term against the risk of choking off a nascent return to growth. In the longer term, the budgetary projections in the 2010 update of the UK convergence programme imply a stabilisation of debt levels in the medium term, and the long-term budgetary impact of an ageing population is close to the EU average.

27.2.2. Macro-financial stability

Regarding macro-financial stability, the UK's financial services industry is comparatively very large and diversified and highly open, and strongly marked by London's role as a principal global financial centre. As regards the banking sector, foreign banks make up around half of the entire UK banking sector's balance sheet while in 2007, the last year before the financial crisis took hold, the four biggest UK banks made roughly 44% of their profits overseas. Within the range of banking activities, global investment banking features prominently. The financial crisis took a heavy toll on the UK's financial system, mainly through over-extended international investment activity and imprudent domestic commercial property lending. The banks' difficulties prompted a wide range of

([52]) European Commission (2009), op. cit.

government rescue measures. These included injections of public capital of around 5% of GDP, and a larger asset insurance scheme that represents a sizeable contingent liability on the public finances. However, the probability of the contingent liability from the Asset Protection Scheme being called on is diminishing as the recovery becomes more assured. Financial stability risks aside, direct output and employment falls in the UK financial sector have been limited, as the recession took its sharpest toll on manufacturing output, partly under the pressure of an abrupt shift to highly restrictive lending conditions at the onset of the crisis. This pro-cyclicality of lending further contributed to the deterioration in domestic demand by reducing investment and exacerbating liquidity problems for individuals and businesses. Outside banking, other major sub-sectors of the financial sector, notably insurance companies, have been comparatively unscathed.

A focus on strengthening the financial and supervisory framework, in the context of European and international reform efforts, can help ensure a well functioning and stable financial sector capable of meeting the financial intermediation needs of the real economy. Both the relatively high share of UK output accounted for by the financial sector and the large capital flows required to fund a rebound in private investment underline the importance of re-establishing a sound and sustainable financial sector framework. Meanwhile, the household sector has become increasingly burdened with high debt levels, and while the associated debt servicing costs have been eased by interest rate falls as the crisis unfolded, their eventual rise over the medium term is likely to strain household finances, increase default rates and dampen household spending and GDP growth. This also underscores a need to reduce the risks from high household indebtedness, principally by facilitating household sector deleveraging, notably through increased saving and paying down existing debt. UK average house prices still appear to be high based on some measures such as average incomes or rent levels. If the UK experiences slower future house price growth than in the first half of the past decade, it may limit the growth in new mortgage debt. Easing long-term housing supply constraints may help contain prices and thus further indebtedness increases.

27.2.3. Current account and competitive position

Turning to issues related to the current account and competitiveness, the imbalances in the UK economy are reflected in its persistent reliance on net lending from abroad to help finance the spending and investment of its domestic sectors. Between 1999 and 2008 the UK recorded an average annual current account deficit of around 2½% of GDP, having declined from a position of near-balance in the late 1990s due mainly to a rising goods trade deficit. Between mid-2007 and early 2009 the pound sterling depreciated by around 25% on a trade-weighted basis, and has remained broadly stable since. However, the UK's terms of trade have yet to register a significant change in the relative prices of exports and imports from the pre-depreciation levels of 2007, as UK exporters appear to have markedly increased their sterling profit margins.

Given the constraints on growth that will arise from both the planned fiscal consolidation and the further rebalancing needs of the household sector's financial position, the UK's short- to medium-term growth potential would benefit significantly from a shift of production towards external demand. In the medium run, the expected recovery of global trade coupled with the impact of the weaker exchange rate should lead to such a rebalancing of the economy and thus of the external account. This necessary process would be aided by UK exporters reversing the increases in export profit margins, as this would improve their cost competitiveness and thus facilitate the capture of greater export market shares. By upgrading the range of goods and services exports, the UK could take in the longer term full advantage of the growth opportunities offered by its favourable starting position. Specifically, expanding services exports appears promising, as these already make a strong positive net trade contribution and show a wide diversification. At the same time, the UK's revealed competitive advantage for goods in the intermediate range of the technology and R&D-intensity spectrum could be built on by extending the strong science and technology base. Finally, as part of a wider comprehensive skills and education strategy, efforts to raise skill levels in the manufacturing sector would help address lacking competitiveness in the goods export spectrum.

27.3. GROWTH DRIVERS

27.3.1. Labour supply, employment and labour markets

At the macro level, increased labour utilisation can contribute to higher growth potential. The UK labour market's high degree of flexibility contributed to strong employment creation in the decade leading up to the crisis. The cumulative fall in UK GDP of around 6% from its end-2007 peak to its trough was accompanied by a marked fall in employment, especially full-time, and a broadly commensurate rise in unemployment. In addition, inactivity rates increased slightly over the course of 2009, as the number of inactive students rose by around 200,000. The negative impact of the labour market deterioration on gross disposable income was effectively cushioned through benefits payments acting as automatic stabiliser, but such transfers are unlikely to grow further in the current situation of a stagnating UK labour market.

This underscores the principal importance of fostering employment growth to reinforce domestic demand and allow for a swift reduction in spare productive capacity. In the context of the short-term recovery from the recession, there is a strong case for labour market policy aimed at ensuring adequate job matching, offering continuous training and education to the unemployed and preventing jobseekers and low skilled subsidised workers withdrawing from the labour force. In the long run, the UK faces the challenge to increase comparatively low labour productivity levels which could be tackled ([53]) by improving the educational quality and the skills of its labour force and address the low rates of capital deepening, both of which have until recently acted as a net drag on productivity growth. ([54])

27.3.2. Business environment, entrepreneurship and investment

Productivity growth, which is the main driver of the growth potential over the medium run, is supported by having a favourable business environment that encourages entrepreneurship and investment. The UK has developed into an increasingly open economy with a relatively strong competition policy framework and a highly favourable business environment, as evidenced by a number of surveys and assessments. Start-up conditions and regulatory barriers are favourable in an EU comparison. While UK product markets per se therefore appear to be in good shape, the private sector's track record in generating adequate levels of productive investment in recent years has been somewhat disappointing. Overall, in the context of the markedly weaker fiscal position, future consolidation could be geared to deliver the benefit of limiting adverse confidence effects and a 'crowding out' effect so as to facilitate an increase in aggregate fixed private investment. In view of the UK's typically low rates of capital deepening, a lasting reinvigoration of private fixed capital accumulation would provide an important boost to trend growth. As regards, public investment, in the domain of infrastructure investment, transport networks continue to represent a considerable bottleneck.

27.3.3. Knowledge Base (R&D, innovation and education)

A major driver of total factor productivity growth are policies in the area of R&D, innovation and education which support the knowledge base. Notwithstanding its relatively high share of highly-skilled persons and a number of successful research clusters, the UK has tended to display a relatively weak performance in generating investment in R&D and fostering innovation. A weak overall level of gross R&D expenditure (GERD) stands out in an EU comparison, as does a sharp relative decline in high-tech employment and a below-average patenting record. However it should be noted that the makeup of the UK economy partially accounts for this, being more service-focused than some other EU countries, meaning less direct R&D investment may be possible or necessary. The UK authorities are investigating methods of measuring wider innovation that encompass considerations such as marketing, design, process innovation and changes to business models. Having said this, the UK’s research productivity is high, with the highest level of citations per head of population in the G7.

([53]) Notwithstanding relatively faster growth since the 1990s, UK productivity levels in 2008 were still below Germany, Italy, France and the US, see Office for National Statistics (2010), *International comparisons of productivity. Revised statistics for 2008*, Statistical Bulletin, 18 February, 2010.

([54]) European Commission (2008), op. cit.

The financial crisis has negatively impacted on the level of R&D investments, although less so than tangible investment. In the medium run policies should aim at a recovery to the pre-crisis R&D intensity, which could additionally be supported by measures to improve framework conditions so as to increase business R&D expenditures, especially in small and mid-sized enterprises (SMEs). Educational performance overall remains slightly positive, with a high share of university graduates in the working age population standing out favourably. However, the UK's lower and intermediate skill levels are below the EU average and youth educational attainment levels and the share of early school-leavers are no better than average, with recent trends suggesting a relative decline. Improving human capital formation through a broader skills base would play a key role in lifting the long term growth potential of the British economy.