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Macroeconomic Imbalances
Main Findings of the In-Depth Reviews 2015

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EXECUTIVE SUMMARY

This paper presents and summarises the main findings from the Commission In-Depth Reviews (IDRs) which were released on 26 February 2015 in the framework of the Macroeconomic Imbalances Procedure (MIP). For the Member States selected in the Alert Mechanism Report (AMR) published on 28 November 2014, the IDRs provide an assessment of imbalances and of the degree of severity of the associated macroeconomic risks. On the basis of the IDRs, a conclusion on the existence of imbalances is drawn and whether they are excessive or not. The IDRs discuss issues such as the rebalancing of external accounts, savings and investment balances, cost and non-cost competitiveness, productivity, private and public debt, house prices, credit flows, financial systems and the quality of the adjustment to imbalances, i.e. the implications of imbalances on growth and jobs. The IDRs also take account of the euro area dimension of macroeconomic imbalances and possible policy challenges for the euro area as a whole.

The analysis contained in the IDRs show that, while the rebalancing is making progress, new challenges and opportunities are emerging. In particular, the IDRs illustrate that large stocks of external liabilities remain an important vulnerability in some countries. Moreover, it is shown that, quite often, the adjustment of large current account deficits to positions close to balance or in surplus was mostly linked to the reduction of imports associated to the output contraction rather than competitiveness improvements and an expansion of the export potential, highlighting the need to step up structural reforms aimed at preserving cost competitiveness and enhancing the production of quality goods. The IDRs also provide thorough analysis of the persistence of large current account surpluses in some EU countries, concluding that, in some cases, these surpluses reflect insufficient investment dynamics that should be boosted in order to strengthen the nascent recovery.

For some countries, the IDRs provide evidence that competitiveness improvements are a key condition to set the basis for a strengthened growth potential compatible with macroeconomic stability and a smooth reduction of the public debt-to-GDP ratios. It also appears that concerns about the high level of private and public debt are persisting in a number of Member States despite the deleveraging process, which constrains their ability to grow. In general, housing markets are not driving imbalances but in a few cases they are still a cause of concern in the context of high household debt. In addition, despite a reduction in the dispersion across the EU, unemployment, and especially long-term unemployment, remains a major challenge for many countries.

All in all, the picture that emerges from the IDRs is that, in a macroeconomic context marked by low inflation, moderate demand and uncertainty, the correction of imbalances calls for a more symmetric rebalancing and a coordinated approach to fiscal and structural policies. At the euro area aggregate level, the risks of falling back into anaemic growth must be mitigated by countries that are better placed to contribute to growth, notably by boosting investment consistently with available fiscal space and positive savings investment balance. In parallel, countries whose capacity to sustain demand is constrained by high deleveraging needs and low inflation which makes it harder to repay debt, but also countries whose growth potential is limited by structural growth bottlenecks, must step up structural reforms. Benefitting from positive spillovers within the euro area, in particular from spillovers arising from the policy stance in systemic countries, this combination of policies would contribute to put the rebalancing process in the euro area on a more stable footing, by making it more symmetric and less exposed to the volatility of the external environment, as well as by boosting confidence. Moreover, it would support the action of monetary policy to restore price stability.

*On the basis of the analysis contained in the IDRs, the Commission has considered that five Member States are currently in a situation of excessive imbalances requiring decisive policy action and specific monitoring (*Croatia, Bulgaria, France, Italy *and* Portugal*), three Member States are in a situation of imbalances requiring decisive policy action and specific monitoring (*Ireland, Spain *and* Slovenia*), two Member States are in a situation of imbalances requiring decisive policy action and monitoring (*Germany *and* Hungary*) and six Member States are in a situation of imbalances requiring policy action and monitoring (*Belgium, the Netherlands, Romania, Finland, Sweden *and* the United Kingdom*).*

1. INTRODUCTION

The aim of this paper is to present the main findings from the Commission In-Depth-Reviews (IDRs) which were released in February 2015 in the framework of the Macroeconomic Imbalances Procedure (MIP). The MIP is designed to detect, prevent and correct macroeconomic imbalances and risks that would jeopardise the functioning of the EU and euro area economies. In the Alert Mechanism Report-2015 (AMR-2015) published in November 2014, the Commission provided a first screening of Member States on the basis of the economic reading of a scoreboard of macro-financial indicators. The Commission identified 16 countries for which an In-Depth-Review (IDR) into the existence of imbalances was warranted. ([1]) On the basis of these IDRs, the Commission has drawn conclusions on the existence of imbalances that are reported in a Commission Communication released with the IDRs. ([2])

The decisions related to the MIP take into account the different evolution of challenges and policy responses in Member States using the different available steps in the procedure. Five Member States (*Croatia*, *Bulgaria*, *France*, *Italy* and *Portugal*) are identified to have excessive imbalances which require decisive policy action and specific monitoring; *Ireland*, *Spain* and *Slovenia* are considered to be in a situation of imbalances requiring decisive policy action with specific monitoring; *Germany* and *Hungary* are considered to be in a situation of imbalances requiring decisive policy action and monitoring; *Belgium*, *the Netherlands*, *Romania*, *Finland*, *Sweden* and *the United Kingdom* are considered to be in a situation of imbalances requiring policy action and monitoring. For one country (*Slovenia*), the evidence in the IDR shows a further reduction in macroeconomic imbalances and risks, and on this basis, the procedure has been stepped down. For three other countries (*Germany*, *France*, *Bulgaria*), the MIP is instead stepped up in light of vulnerabilities, inadequate policy reaction given the challenges and systemic relevance of the persisting risks.

This year's IDRs are presented in Country Reports (CRs) which also integrate the additional Commission analysis necessary for the preparation of the EU Semester Country Specific Recommendations (CSRs). The framework for EU economic policy coordination has been strengthened over time, and this year it has been further streamlined. The time of publication of the documents presenting the Commission analysis of the challenges underpinning CSRs has been advanced, ahead of the adoption of the CSRs. Moreover, for the Member States for which IDRs have been prepared in the framework of the MIP, a single country report integrates the IDR analysis and the additional analysis necessary for the preparation of the CSRs. ([3])

The horizontal review of the IDRs findings presented in this paper highlights developments that are common across countries and linked to the evolving economic landscape. The analysis contained in the IDRs suggests that the macroeconomic imbalances that emerged after the crisis are receding, but vulnerabilities persist, adjustment is incomplete, and new sources of risk are looming in the new environment. Despite the reduction in current account deficits in most countries, the stock of foreign liabilities is still high, and the rebalancing in the euro area remains asymmetric, with large surpluses persisting in some creditor countries. The necessary adjustment in competitiveness and in the structure of the economy to ensure a sustainable and growth-friendly adjustment is not complete. Government and private debt is still high in a number of Members States, deleveraging is ongoing but incomplete and made more difficult by the current low inflation environment. In general, housing markets are not driving imbalances but in a few cases they are still a cause of concern in the

([1]) The countries selected for an IDR were Belgium, Bulgaria, Germany, Ireland, Spain, France, Croatia, Italy, Hungary, the Netherlands, Portugal, Romania, Slovenia, Finland, Sweden and the United Kingdom.

([2]) For a presentation of the decisions taken by the Commission, see: Commission Communication to the European Parliament, the Council, the European Central Bank and the Eurogroup '2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under regulation (EU) No. 1176/2011', COM(2015) 85 final, 26.2.2015.

([3]) See: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_reports/index_en.htm

context of high household debt. Labour markets have recently been improving especially in distressed economies but unemployment levels remain in some cases very high and long-term unemployment remains an issue.

The remainder of the paper is structured as follows. Section 2 presents the structure and the content of the IDRs. Section 3 presents how the evolution of the macroeconomic environment is affecting imbalances and the required policy response. Section 4 reports the main cross-country findings. Section 5 presents the individual IDR findings.

2. IN-DEPTH REVIEWS: STRUCTURE AND CONTENT OF THE 2015 VINTAGE

The focus of IDRs reflects the specific risks and challenges countries are facing. ([4]) The IDR structure generally consists of three or four sections dealing with the main external or internal imbalances and, where deemed appropriate, the adjustment process. As macroeconomic imbalances take time to resolve, the focus of the IDR analysis tends to remain stable over the years. For a number of countries, however, recent developments have led to the emergence of new risks, which are for the first time assessed in the context of the MIP. All in all, as shown in Table 2.1, the IDRs cover a wide range of topics, including external rebalancing, cost and non-cost competitiveness, indebtedness, financial sector developments and labour market adjustment. For large countries, a section is devoted to the analysis of potential spillovers.

Table 2.1: Main topics analysed in the In-Depth Reviews 2015

Topics	Countries
External rebalancing	BG, HR, FI, DE, HU, IE, NL, PT, RO, ES
Cost/non-cost competitiveness	BE, HR, FI, FR, IE, IT, PT, RO, SI, ES
Housing and mortgage markets	BE, HR, FR, FI, HU, IE, NL, PT, RO, ES, SE, UK
Corporate indebtedness	BG, HR, FI, FR, HU, IE, PT, RO, SI, ES, SE
Public debt risks	BE, HR, FR, HU, IE, IT, PT, ES
Financial sector, banks	BG, HR, FI, FR, HU, IE, IT, PT, RO, SI, ES, SE
Adjustment (labour)	BG, HR, HU, IE, PT, ES
Spillovers	FR, DE, IT, ES
Other issues addressed in the IDRS	
Investment, potential growth, subdued demand/low investment, state-owned enterprises, energy dependence, innovation and R&D, networks, FDI	

Source: European Commission

A number of horizontal analytical tools have been used in order to assess the severity of risks and the quality of the adjustment in a consistent manner across Member States. To assess progress in the external rebalancing, current accounts have been analysed using cyclically-adjusted figures taking into account the output gap projections used in the Winter Forecasts. Current account benchmarks have also been derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants (demography, resources etc.), policy factors and global financial conditions. ([5]) External sustainability risks have been assessed notably by computing current account balances required to stabilise or reduce the net international investment position (NIIP) to target levels. ([6]) Trade performance and competitiveness have been evaluated through the analysis of allocative efficiency, access to finance, productivity and export performance. Wages benchmarks have also been considered. ([7]) Deleveraging needs and the nature of deleveraging (*active*, *passive*, *unsuccessful*) have been assessed in a framework in which the evolution of the debt-to-GDP ratio is broken down between the impact of growth, inflation, credit flows and other determinants. ([8]) The assessment of the house prices cycle has been carried out with calculations of equilibrium and over- or undervaluation using filtering techniques. The sustainability of public debts has been analysed with short to long term debt projections accompanied by sensitivity analysis and stochastic simulations. ([9]) For large countries, spillovers have also been analysed by distinguishing between trade and financial channels, in particular with the use of a database of bilateral financial linkages, but also by taking into account confidence effects and the impact of structural reforms. ([10]) Finally,

([4]) The section of the Country Reports presenting the IDR is the second section titled 'Imbalances, risks and adjustment'.

([5]) The methodology is akin to the External Balance Assessment (EBA) approach developed by the IMF. See Phillips, S. et al. (2013), 'The External Balance Assessment (EBA) Methodology', *IMF Working Paper*, 13/272

([6]) See Loublier, A. and Zeugner, S. (2015), 'External sustainability risks in the euro area: the role of inflation and interest rates', European Economy-Economic Papers: forthcoming.

([7]) See 'Benchmarks for the assessment of wage developments', *European Commission Occasional Papers*, 146, May 2013.

([8]) See Pontuch, P. (2014), 'Private sector deleveraging: where do we stand?', *Quarterly Report on the Euro Area*, Vol 13 No 3 (2014).

([9]) See 'Assessing Public Debt Sustainability in EU Member States: a Guide', *European Commission Occasional Papers*, 200, September 2014

([10]) See Hobza, A. and Zeugner, S. (2014), 'Current Accounts and Financial Flows in the Euro Area', *Journal of International Money and Finance* and D'Auria, F., Linden, S., Monteiro, D., in 't Veld, J. and Zeugner S., 'Cross-border Spillovers in the Euro Area', *Quarterly Report on the Euro Area*, Vol 13 No 4 (2014).

throughout the reports, QUEST simulations allow for an estimation of the impact of structural reforms. ([11])

The IDR conclusions take into account both economic and policy developments. The bulk of the analysis contained in the In-Depth-Reviews is devoted to the assessment of macroeconomic risks and imbalances against appropriate benchmarks, with a view to ensuring cross-country consistency and taking into account dynamic considerations, including from a forward-looking perspective. The Country Reports also provide an assessment of policy developments. In particular, a detailed assessment of the Country-Specific Recommendations (CSRs) issued in 2014 is systematically provided in the annex of the Country Reports. Based on the full set of information available, for each Member States, the Commission services have identified, economic areas where imbalances are present (see Table 2.2) and have reached conclusions on the degree of severity of the associated risks and the remaining policy challenges.

Table 2.2: Areas in which imbalances have been found

Topics	Countries
External rebalancing	HR, DE, HU, IE, PT, RO, ES
Cost/non-cost competitiveness	BE, FI, FR, IE, IT, PT, SI, RO
Household debt/housing markets	IE, NL, ES, SE, UK
Corporate indebtedness	BG, HR, IE, PT
Public debt risks	BE, HR, FR, HU, IE, IT, PT, ES
Financial sector, banks	BG, HU, IE, IT, RO, SI, SE
Adjustment (labour)	BG, HR, HU, IE, PT, ES
Other	RO, HR

Source: European Commission

The IDR analysis is the basis for the official Commission position on the Macroeconomic Imbalance Procedure. The conclusions from the analysis by the Commission services reported in the IDRs form the basis for the official Commission position on the implementation of the MIP procedure, which is presented in the Commission Communication presenting IDR findings. ([12]) The text of the Commission conclusions for each Member State is reported in Section 5 of this paper.

([11]) See Ratto, M., Roeger, W. and in't Veld, J. (2009), 'QUEST III: An estimated open-economy DSGE model of the euro area with fiscal and monetary policy', *Economic Modelling*, Volume 26, Issue 1, January 2009, Pages 222-233.

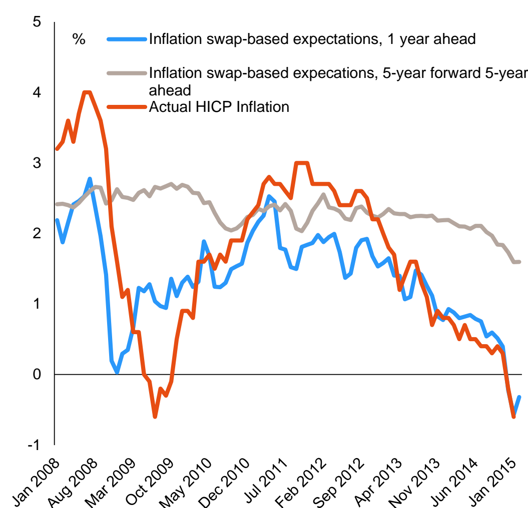
([12]) Commission Communication to the European Parliament, the Council, the European Central Bank and the Eurogroup '2015 European Semester: Assessment of growth challenges, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under regulation (EU) No. 1176/2011', COM(2015) 85 final, 26.2.2015.

3. AN EVOLVING ENVIRONMENT POSING NEW POLICY CHALLENGES

EU Member States have made some progress towards correcting their imbalances in recent years, although risks and adjustment challenges remain. The very large deficits recorded in a number of countries before the crisis have moved to balanced or surplus positions, while net creditor countries still exhibit sizeable surpluses. Despite the adjustment in flows, the stock of external liabilities, in particular debt liabilities, has not been brought down to less risky levels and few countries have been able to record a recent improvement in their Net International Investment Position (NIIP). Private sector deleveraging has progressed, but the reduction in outstanding stocks of debt is still at an early stage with negative credit flows being the main driver of the reduction in debt-to-GDP ratios. Deleveraging pressures and their negative impact on consumption and investment have remained high. Unemployment has reached worryingly high levels in the countries most concerned by current account reversals and debt crises, although latest developments indicate a stabilisation of the labour market.

In 2014, the economic recovery in the EU slowed down, while low inflation became entrenched. The pick-up in growth that started in 2013 lost ground in 2014, and the recovery that was forecast a year ago hit a soft patch in light of weaker than expected demand reflecting uncertainty relating to global growth, the inflation outlook and geopolitical tensions. While some improvements in growth and employment developments could be observed in some non euro-area countries and some euro-area countries concerned by the debt crisis, the growth performance of the euro area proved weaker than anticipated on aggregate despite a broadly neutral stance for fiscal policy, with moderate consumption dynamics and stagnating investment linked not only to constrained credit supply but also to lower-than-expected credit demand, amid pending uncertainties on the strength of the recovery. At the same time, low inflation became increasingly reflected in market expectations, providing the basis for additional intervention by the ECB to support inflation developments in line with its target.

Graph 3.1: Inflation expectations and actual inflation in the euro area

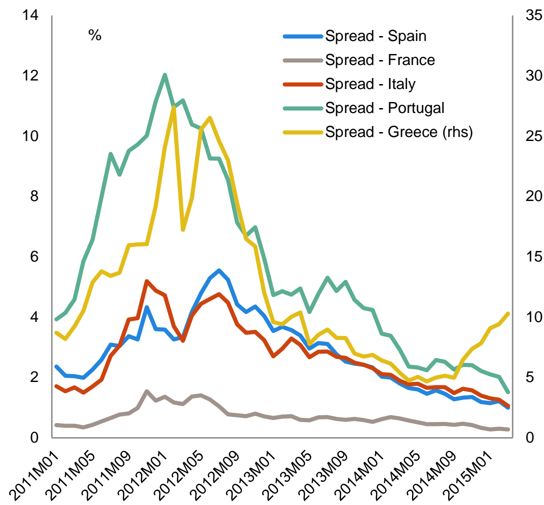


Source: Actual inflation: Eurostat; inflation expectations: Bloomberg.

Since the end of 2014, growth prospects have clearly brightened, against the background of oil price and exchange rate developments, increased room for investment financing and the ECB quantitative easing programme. In the Commission Forecasts that were available when the Country Reports were released, the European economy was expected to grow by 1.7 per cent in 2015 and 2.1 per cent in 2016. ([13]) Compared with what was expected last Spring, the revisions mainly stem from lower oil and commodity prices, a further expected depreciation of the euro exchange rate in light of the divergent stance between monetary policy in the US and the euro area, the impact of the ECB's expanded asset purchase programme, as well as the effects of the Investment Plan launched by the Commission in November 2014.

([13]) See the Commission services' Winter Forecasts of 5 February 2015, European Economy, 1 (2015). Since then, growth forecasts have been slightly revised upwards: according to the Commission Spring Forecasts, the European economy is now expected to grow by 1.8 per cent in 2015 and 2.1 per cent in 2016 (see Spring Forecasts of 5 May 2015, European Economy, 2 (2015).

Graph 3.2: Sovereign bond spreads vis-à-vis the German Bund



Source: Eurostat

However, risks surrounding the growth outlook remain elevated. The persistence of geopolitical tensions, sharply worsening economic prospects in Russia and Ukraine, as well as the reduced pace of economic growth in China contribute to tilt downward the risks linked to external demand. The increased volatility in commodity prices and exchange rates further contribute to increase uncertainty on the outlook for emerging economies. Uncertainty remains also on the US growth and inflation outlook, which has implications for the timing and modality of the normalisation of the US monetary policy. Finally, uncertainty is building up on the extent of reform implementation in major EU economies.

Financial market conditions in the EU have been stabilising, but new sources of risks are emerging. Since the second half of 2012, sovereign bond yields have in general fallen, and spreads have narrowed (Graph 3.2). However, since the second half of 2014 there have been some signs that investors could be re-appraising credit risk and re-orienting their portfolios towards safer assets. Banks in the euro area are well capitalised and resilient to external shocks, arguably comforted by the result of the ECB's comprehensive assessment (Asset Quality Review) and the reduction in regulatory uncertainty. However, the outlook for credit is improving only gradually, not only in light of remaining deleveraging needs, but also because of moderate credit demand, reflecting the uncertain outlook for income and growth. Although capital buffers for banks have improved and sources of risk in bond markets have been reduced, the incidence of non-performing loans remains relevant in some countries and new sources of risks are emerging, notably linked to dismal prospects in Russia and the countries mostly hit by oil and commodity price developments.

In reaction, the Commission identified EU-wide policy priorities in the Annual Growth Survey published on 28 November 2014: (i) a coordinated boost to investment, mobilising EUR 315 billion of additional public and private investment over the 2015-2017 period and improving significantly the regulatory environment for investment; (ii) a renewed commitment to structural reforms by Member States, underpinned by Community initiatives in the framework of the Better Regulation Agenda; (iii) the pursuit of fiscal responsibility, with fiscal policy taking into account available fiscal space and growth objectives. ([14])

In addition, the Commission provided guidance on the best possible use of the flexibility within the existing rules of the Stability and Growth Pact. In its 13 January 2015 Communication, the Commission clarifies how structural reforms will be taken into account in decisions concerning Member States under Excessive Deficit Procedure and the conditions under and the extent to which they could be invoked to allow for a temporary deviation from the MTO or the adjustment path towards it for Member States in the preventive arm. ([15])

Looking forward and within this context, a number of opportunities and challenges for a successful rebalancing emerge:

([14]) See Communication from the commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank 'Annual Growth Survey 2015', Brussels, 28.11.2014, COM(2014) 902 final.

([15]) See Communication from the commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank, Brussels 'Making the Best Use of the Flexibility within the Existing Rules of the Stability and Growth Pact', Strasbourg, 13.01.2015, COM(2015) 12 final

- The low inflation environment makes it harder to repay debt. The room for deleveraging via nominal growth will be reduced, which will require subdued demand dynamics in countries where deleveraging needs remain high. In countries with high government or private debt, growth prospects will thus increasingly depend on successful strategies to boost the growth potential via structural reforms and enhanced framework conditions for productive investment.

- Low inflation coupled with the recent exchange rate and oil price developments will contribute to improving the external balance of most EU countries, notably net energy importers and countries with a high sensitivity of the trade balance to relative prices. On the one hand, these developments will help to consolidate the external rebalancing process of countries with highly negative Net International Investment Positions (NIIP). On the other hand, countries with a surplus will see their external position further improving too. Overall, the euro-area surplus will further grow, and foreign demand will play a stronger role in the recovery. In this respect, at the euro area aggregate level, the risk of a downward spiral of prices and demand which would jeopardise the rebalancing and the nascent recovery, could be mitigated by countries that are better placed to contribute to growth. A more symmetric rebalancing coming from more dynamic investment demand in creditor countries, by spilling over to the rest of the euro area, would make the recovery less exposed to the volatility of the external environment.

The new economic context and outlook, as well as systemic aspects and spillovers, have been taken into account in the IDR conclusions. In particular, the Commission conclusions reflect the risks posed to high stocks of debt by the still uncertain recovery and very low inflation, and the need for a coordinated approach to fiscal and structural policy to support the recovery and create the conditions for ensuring price stability and a successful rebalancing looking forward, as outlined in the 2015 Annual Growth Survey.

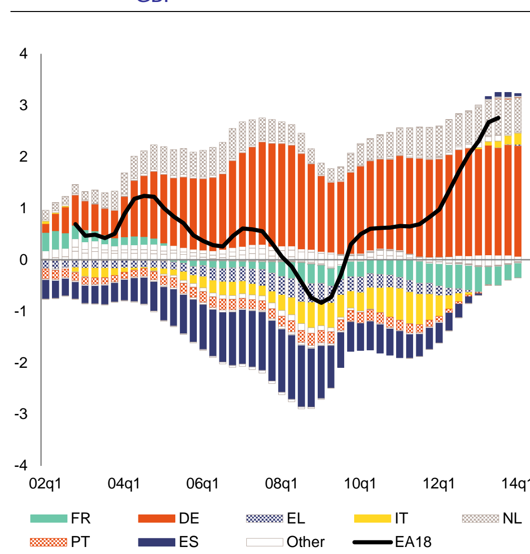
4. IMBALANCES, RISKS AND ADJUSTMENT: MAIN CROSS-COUNTRY FINDINGS

The IDRs provide an assessment of imbalances and macroeconomic risks for the Member States selected in the Alert Mechanism Report. This section summarises the findings concerning the origin, persistence, aggravation or unwinding of imbalances and risks, as well as the adjustment process that is necessary for their correction. The analysis also takes into account the quality of this adjustment, i.e. the implications of the rebalancing on growth and jobs and more generally, its consequences on social developments.

External rebalancing is ongoing, but progress has not yet translated into significant reduction in the stocks of external debt, while large current account surpluses have not adjusted. Most of the debtor countries, which used to run sizeable current account deficits before the crisis, are now recording positions close to balance or in surplus. However, the stocks of external liabilities of these countries are in general at still too risky levels and sizeable current account surpluses are needed for a protracted period of time in order to ensure sustainability. Conversely, current account surpluses in net creditor countries remain persistently large, implying a progressive growth of the stock of their external assets.

Private deleveraging is underway but the outstanding amounts of debt are in general still too elevated and not compatible with a firm recovery. After growing at high rates in the pre-crisis period, private debt started stabilising and embarked on a downward path in a number of countries amid financial sector deleveraging. The fall in household debt was accompanied by a revision in lending standards and a moderation in the growth rate of house price, which turned negative in some countries. Corporate debt also fell in light of reduced credit flows, linked to both supply and demand factors. The dynamics in private debt-to-GDP ratios was determined not only by reduced credit flows to the household and corporate sector, but also by nominal growth, which differed widely across countries in light of the downward pressure on aggregate demand stemming from current account reversals and the consolidations measures put in place to face the debt crisis. Despite some overall progress in terms of debt deleveraging, debt overhang and bad debt risk compromising the prospects for a recovery of credit in some countries.

Graph 4.1: Current account balances in % of euro area GDP



Source: Eurostat (BPM5)

More specifically, the IDRs illustrate the following developments.

Large net external liabilities remain a major vulnerability in some countries and the ongoing process of rebalancing is only partly structural.

- The stock of net foreign liabilities in countries such as *Spain*, *Portugal*, *Croatia,* is still large if judged against prudential benchmarks, not on only in light of the sheer size as a share of GDP, but because the composition of gross and net foreign liabilities is such that volatile forms of investment such as portfolio debt cover a large share (Graph 4.3). The stock of foreign liabilities is also high in *Bulgaria*, *Ireland* and *Hungary*, but risks are to some extent more limited since equity inflows and inward foreign direct investment (FDI) are more prominent. These stocks of external liabilities constitute a vulnerability and need to be brought back to more prudent levels to prevent risks of capital outflows amid re-appraisal of risks by investors.

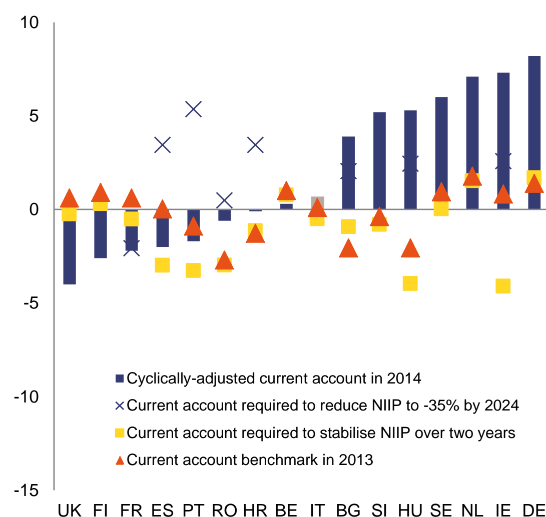
- Current account deficits shrank after the financial and debt crisis as a result of capital

outflows (Graphs 4.1, 4.2 and 4.3). Large deficits turned into positions close to balance or in surplus, with relatively large surpluses observed in *Ireland*, *Hungary*, and large surpluses observed in *Slovenia*. Current account surpluses peaked for most of these countries between 2013 and 2014, and since then have started to decline again, in light of the rebound in economic activity. The current account improvements recorded in previous years were to a large extent non-cyclical, since imports were reduced on a permanent basis as a result of reduced potential output in the non-tradable sector: as the recovery brings back output close to potential, current account balances move to a deficit position, which will however not be as large as before the crisis. Nevertheless, higher growth rates will be compatible with successful rebalancing only if structural reforms and supportive policies are effective in boosting export potential and in accelerating the transition from tradables to non-tradables.

Persistently high current account surpluses reflect weak investment dynamics in some cases.

- Some creditor countries, like *Germany*, *the Netherlands*, have been registering high current account surpluses for a protracted period of time, and the stock of their net foreign assets is positive, with no tendency to fall. The drivers of surpluses differ from one country to another. Moreover, a net financial position in surplus recorded for the whole economy may reflect a different distribution of the surplus across the various sectors of the economy depending on the country considered. In *the Netherlands,* large multinationals engage in substantial foreign direct investment (FDI). As a result, firms often need to hedge against the risk that they take abroad and therefore save. The extent of this investment explains in part the high propensity to save by corporates. Moreover, in light of a highly indebted household sector, deleveraging has also played a role.

Graph 4.2: **Current account: cyclically-adjusted balances, benchmarks and balances required to stabilise or reduce external liabilities (NIIP)**



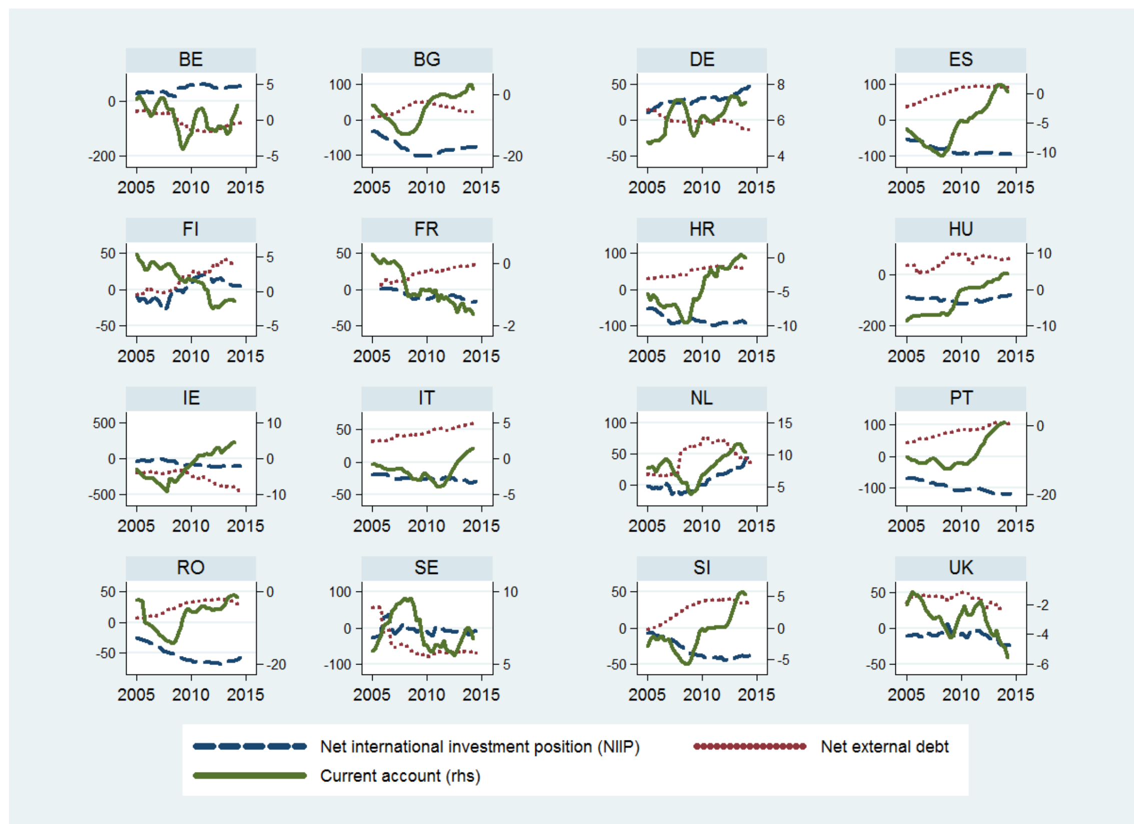
(1) Cyclically-adjusted balances are calculated using the output gap estimates underlying the Commission Winter Forecasts. The estimates based on the methodology described in Salto, M. and A. Turrini (2010), 'Comparing Alternative Methodologies for Real Exchange Rate Assessment,' European Economy-Economic Papers, 427.
(2) Current account balances required to stabilise or reduce net external liabilities rest on the following assumptions: GDP projections stem from the Commission Winter Forecasts (up to two years ahead), the medium-term forecasting framework (between two and five years) and from the latest fiscal sustainability long-run projections (beyond five years); valuation effects are conventionally assumed to be zero in the projection period, which corresponds to an unbiased projection for asset prices; net capital transfers are conventionally projected to be zero.
(3) Current account benchmarks are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants (e.g demography, resources) and policy factors, using a methodology akin to the External Balance Assessment (EBA) approach developed by the IMF. See Phillips, S. et al. (2013), 'The External Balance Assessment (EBA) Methodology', IMF Working Paper, 13/272.
Source: DG ECFIN calculations

- In *Germany,* the surplus position is currently the largest at world level in value terms, it is not falling and it is contributing to the growth of an already large stock of net foreign assets. According to Eurostat data, the bilateral trade surplus of *Germany* with the rest of the euro area has narrowed in recent years, but mostly as a result of falling imports in the other euro-area countries. Drivers of the German surplus are the high household saving rate linked to ageing, increasing corporate savings, and more generally, the high savings rates of all sectors of the economy. The German surplus is also driven by weak investment dynamics, notably in the public sector, as evidenced by a persisting public sector investment differential in respect of the euro area. Stronger investment demand in *Germany* would contribute to a more symmetric euro-area rebalancing and would make the recovery less subject the uncertainties of global growth outlook.
- A more moderate surplus in *Germany* would also help to reduce the growth rate of net foreign assets. Although risks linked to positive stocks of net foreign assets cannot be compared with those arising from negative stocks, the continuous accumulation of net foreign assets may imply growing exposure to exchange rate risk and reduced room for national authorities to reduce risk (e.g., via prudential or regulatory measures) as the share of assets in domestic portfolios originating in foreign countries grow larger.

Competitiveness remains an issue in a number of Member States.

- Cost competitiveness gains were recorded in past years especially in the countries concerned by sudden stops of capital inflows and current account reversals (Graph 4.4). The gains were recorded especially in terms of relative reductions in unit labour costs, partly as a result

Graph 4.3: Net international investment position (NIIP), external debt and current account balance (% of GDP)



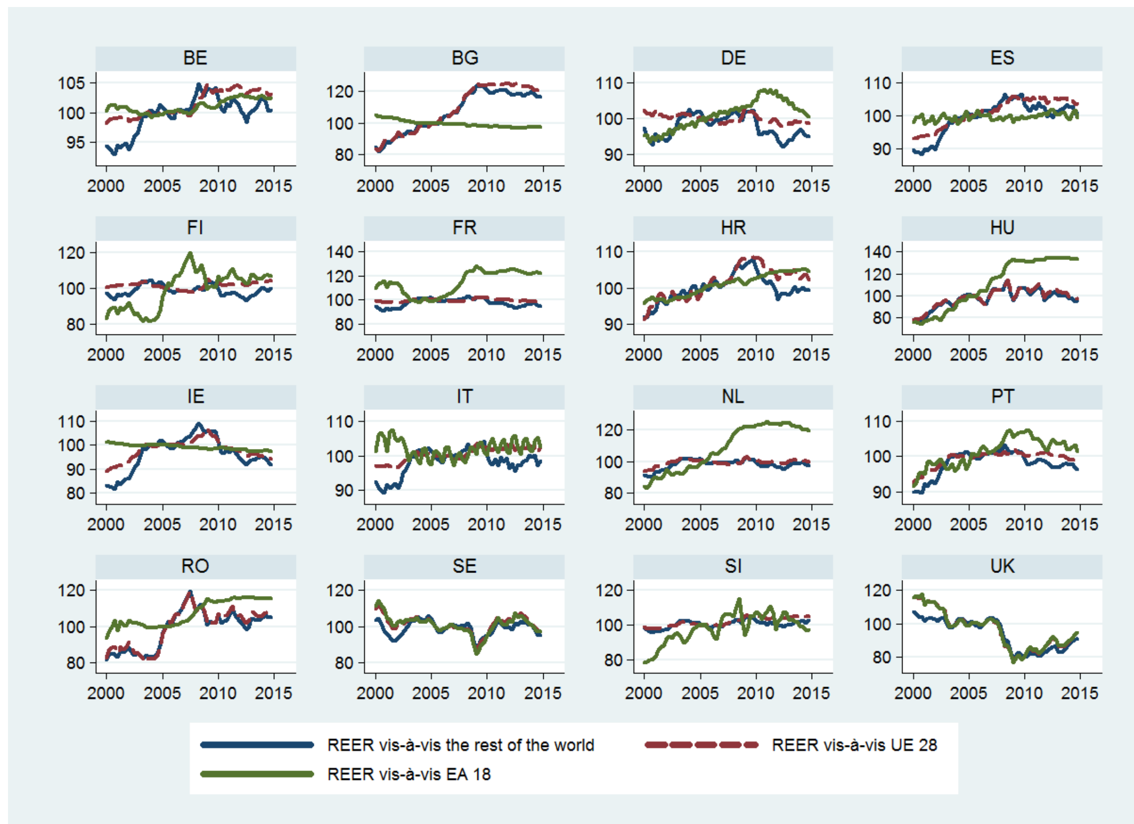
When available, figures are expressed in BPM6/ESA10. In case of missing values, figures are expressed in BPM5/ESA95, resulting in breaking points.
Source: Eurostat

of job shedding, partly in light of wage moderation. For Member States, like *Spain*, whose cost competitiveness has already significantly improved, progress is still necessary to consolidate export growth, including concerning the quality and technological content of export. The need for progress in terms of various dimensions of non-cost competitiveness is also more pressing for *Croatia*.

- In large countries such as *France* and *Italy*, competitiveness improvements are a key condition for setting the basis for a strengthened growth potential compatible with macroeconomic stability, which in turn is key to stabilising government/GDP ratios and prevent the risk of renewed bond market tensions. Despite growth-friendly measures recently taken in these countries including for what concerns fiscal, labour market, and regulatory reforms, the need to maintain the momentum towards measures aimed at enhancing competitiveness while removing growth bottlenecks remains high. For *France*, competitiveness improvements appear desirable also from the perspective of external balances: although the net international investment position is not highly negative and the current account deficit not yet elevated and fairly stable, the current account has moved from stable surpluses to deficits of about 2 % of GDP that, if persisting or growing, imply a progressive dependency on foreign financing.

- Competitiveness improvements, both in costs and in several dimensions of non-cost competitiveness, are needed also in small countries characterised by broadly balanced or surplus external positions, but being subject to relatively weak dynamics in export market shares, including *Belgium* and *Finland*.

Graph 4.4: Quarterly real effective exchange rates vis-à-vis the rest of the world (group of 42 competitors), EU 28 and euro area partners, HICP deflators (2005 = 100)



Source: AMECO

Concerns about the high level of private and public debt persist in a number of Member States.

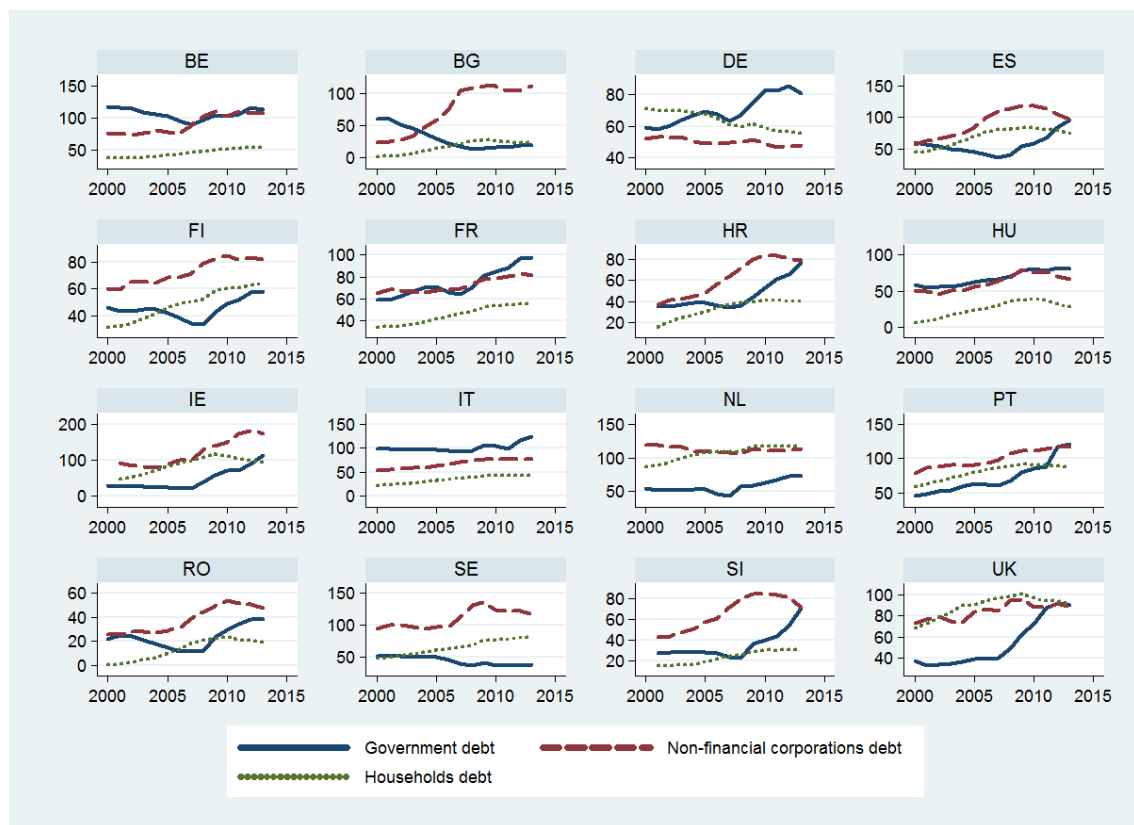
- Although the adjustment of private sector balance-sheets is advancing, the high level of private debt in *Spain*, *Ireland*, *Portugal*, *Croatia*, *Slovenia*, *Bulgaria*, *the United Kingdom*, *the Netherlands*, *Finland* and *Sweden,* represents a source of risk whose severity varies across countries and sectors (Graph 4.5 and Table 4.1).

- Household debt is still high in *Spain*, *Portugal*, *Ireland*, *the Netherlands*, *the United Kingdom*, *Finland* and *Sweden*. In most countries, deleveraging is still ongoing and bringing back the stock of household debt to more prudent levels, in particular in *Spain* and *Portugal*, but also in *the Netherlands*. The cooling off of the housing market has contributed to this subdued dynamics in household debt (Graph 4.9). House prices have corrected at least partially in most countries, in particular in those most hit by the burst of the housing market, like *Spain* and *Ireland*, with the exceptions of *France* and *Belgium*, where a moderate adjustment has taken place recently. Conversely, in *the United Kingdom* and *Sweden*, house prices are still growing, potentially leading to further increases in mortgage debt. In *Croatia*, despite a relatively low debt, households are particularly vulnerable to exchange rate movements.

- A highly leveraged non-financial corporate sector is an issue in *Ireland*, *Portugal*, *Spain*, *Italy*, *Bulgaria*, *Croatia* and *Slovenia*. High corporate indebtedness is not only a source of risks for the financial sector which, in some cases, is still struggling with high ratios of Non-Performing Loans, like in *Portugal* and *Italy* (Graph 4.6), but it is also a drag on the flow of new credit, investment and employment growth.

- The net financial position of the banking sector has been improving in a majority of countries

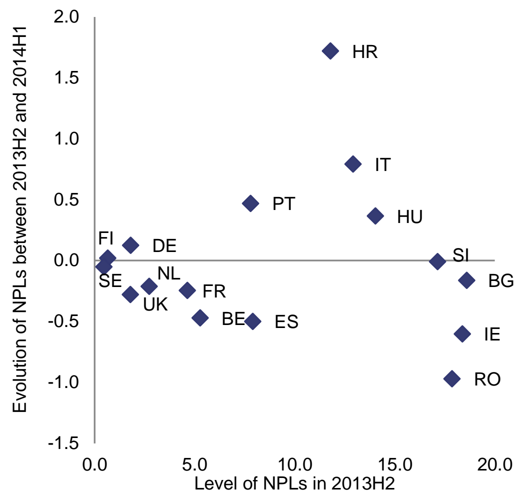
Graph 4.5: Gross debt by sectors (% of GDP)



Source: Eurostat (BPM6 except for the UK)

notably as a result of strengthened capital adequacy requirements and the implementation of the Asset Quality Review, although isolated cases of under-capitalised systemic banks remain, as well as risks to banks' balance sheets linked to Non-Performing Loans, sovereign-bank loops and governance issues in few cases, such as *Bulgaria*.

Graph 4.6: Evolution of Non-Performing Loans (NPLs)



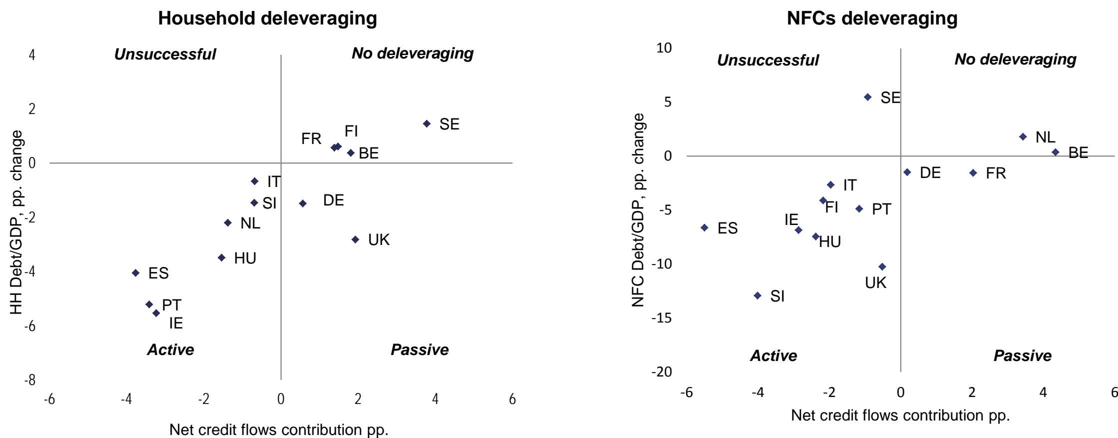
Gross total doubtful and non-performing loans (households and corporates) expressed as % of total debt instruments and total loans and advances. Consolidated banking data.
Source: ECB

- Public debt remains at very high levels, above 90 % of GDP, in *Belgium*, *Ireland*, *Spain*, *France*, *Italy*, and *Portugal*, or at levels that are well above their pre-crisis levels, such as in *Croatia* and *Slovenia*. Although substantial consolidation efforts have been carried out over the past few years in the majority of countries, the pace of adjustment has slowed down, reflecting both cyclical conditions and reduced fiscal effort.

The quality of the adjustment to imbalances linked to external deficits and over-indebtedness has implications for growth and employment.

- Debt deleveraging necessarily implies reduced credit supply and demand, and subdued consumption and investment demand for some time. Most Member States have made progress towards the re-establishment of capital buffers for their banking sector, resolving distressed banks where necessary (e.g., *Ireland*, *Slovenia*, *Spain*, *the United Kingdom*), having this way created the conditions for more dynamic supply of credit looking forward. Credit flows to finance productive investment are, however, limited by the still high leverage characterising the corporate sector in some countries. In the corporate sector, *active* deleveraging has been taking place notably in *Spain*, *Ireland*, *Italy* and *Slovenia*. A part of the adjustment of outstanding debt stocks is also taking place through write-offs of non-performing loans and insolvency proceedings. Supportive frameworks in this respect would help such a

Graph 4.7: Change in households and NFCs debt-to-GDP ratio over 1 year, 2014Q1



Non-consolidated data, cumulative change in debt-to-GDP ratios. The x-axis represents the contribution of net credit flows to the decrease in debt-to-GDP ratio over 1 year.
Source: Eurostat BPM5, DG ECFIN calculations

process looking forward. The contribution of nominal GDP growth to the reduction of the debt burden is low and is expected to start kicking in only gradually. Households' deleveraging needs have recently led to an *active* repayment of outstanding debt notably in *Ireland*, *Spain*, *Portugal* and *Croatia*.

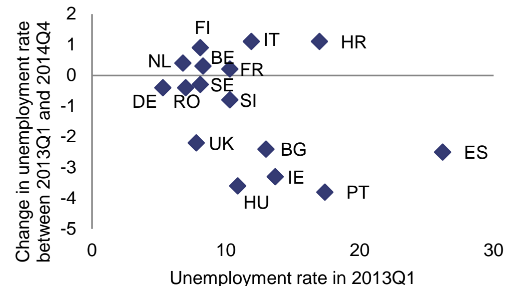
Table 4.1: Private deleveraging needs estimates

Private deleveraging needs (in % of GDP)	Country	Split households/NFCs (%)	Credit market deleveraging pressures
At least 30%	ES	50 / 50	M
	IE	40 / 60	M
	PT	30 / 70	M
	BG	20 / 80	M
20% to 30%	HR	30 / 70	M
	NL	100 / 0	M
10% to 20%	IT	40 / 60	M
	HU	60 / 40	M
	SI	30 / 70	M/H

Deleveraging needs are estimated using two methodologies. The first method determines a sustainable level of debt by estimating debt that is consistent with households' and firms' assets corrected for valuation effects. The second method is based on the typical extent of deleveraging in past episodes, and is a function of the preceding debt increase. For a detailed presentation, see Pontuch, P. (2014), 'Private sector deleveraging: where do we stand?', Quarterly Report on the Euro Area — Vol 13, Issue 3 (2014)
Source: Eurostat; DG ECFIN calculations

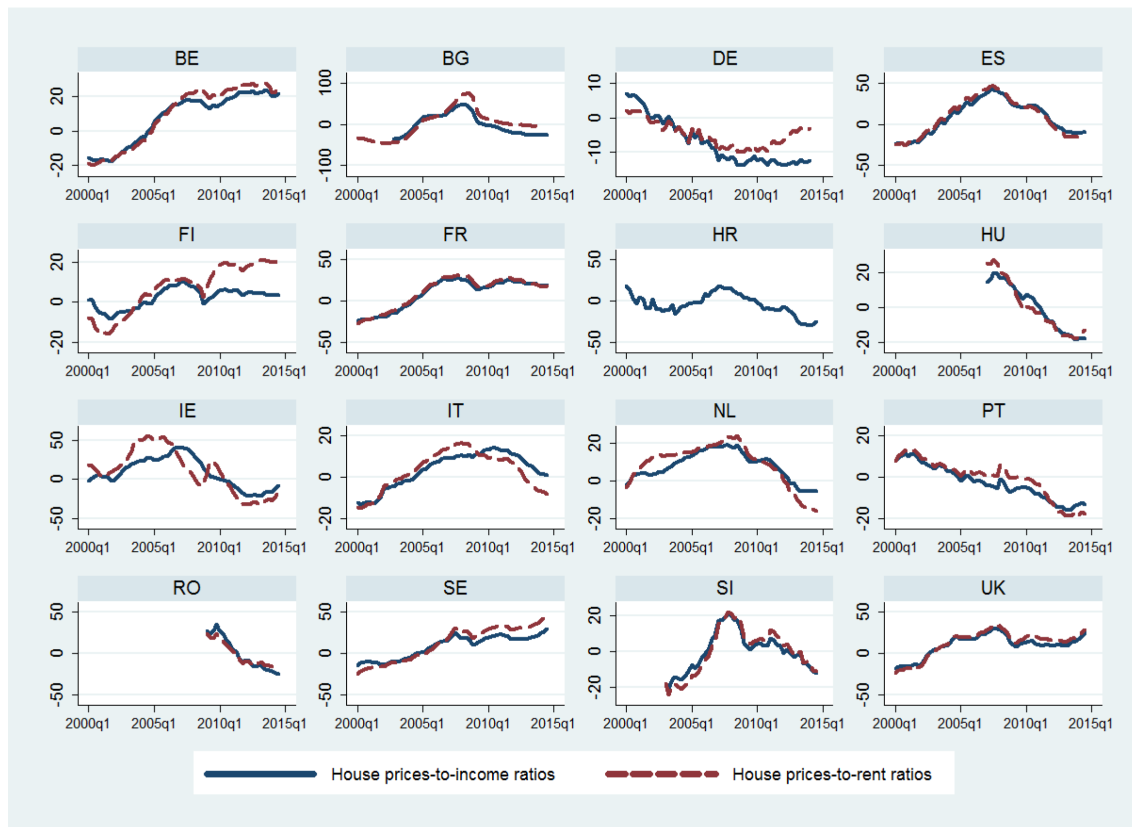
- In countries with robust macro-financial conditions, labour markets recovered soon after the 2009 recession. Other economies, instead, were concerned by current account and debt crises which resulted in a sudden drop in domestic demand, deep recessions, and surging unemployment. The incipient timid recovery of mid 2013 was followed by a stabilisation of unemployment, confirmed by signs of employment recovery during 2014. Even though, unemployment remains very high in some countries, labour market developments in 2014 contributed to the reduction in unemployment dispersion across the EU and the euro area, unemployment having fallen considerably in high-unemployment countries like *Ireland*, *Spain*, or *Portugal* (Graph 4.8). Long-term unemployment remains however an issue in many countries concerned by adjustment and rebalancing.

Graph 4.8: Evolution of the unemployment rate since 2013



Source: Eurostat

Graph 4.9: House prices-to-income and house prices-to-rent ratios



Standardised ratios
Source: Eurostat

5. FINDINGS FROM THE IN-DEPTH REVIEWS BY MEMBER STATES

This section summarises the decisions taken by the Commission with regard to the Macroeconomic Imbalances Procedure that can be found in its Communication. ([16])

- **Belgium** is experiencing *macroeconomic imbalances, which require policy action and monitoring*. Developments with regard to the external competitiveness of goods continue to present risks and deserve attention as a renewed deterioration would threaten macroeconomic stability. Further action to ensure convergence of cost parameters would slow down the decline of employment in the tradable sectors while tangible progress to narrow the historic cost gap could be reinforced by a tax shift towards non-labour tax bases. Public debt remains high but several factors temper associated macroeconomic risks.

- **Bulgaria** is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring*. In particular, the financial sector turbulence in 2014 has raised concerns about the existence of banking practices in the domestically-owned part, with potentially significant implications for financial sector and overall macroeconomic stability. In addition, the still negative, albeit improving, external position, corporate overleveraging and weak labour market adjustment continue to pose macroeconomic risks and deserve close attention.

- **Germany** is experiencing *macroeconomic imbalances, which require decisive policy action and monitoring*. Risks have increased in light of the persistence of insufficient private and public investment, which represents a drag on growth, and contributes to the very high current account surplus which continues to deserve close attention. The need for action so as to reduce the risk of adverse effects on the German economy and, given its size, of negative spillovers to the economic and monetary union, is particularly important.

- **Ireland** is experiencing *macroeconomic imbalances, which require decisive policy action and specific monitoring*. Ireland completed the EU-IMF financial assistance programme in 2013 and is currently subject to post-programme surveillance and European Semester surveillance. Despite a marked improvement in the economic outlook, risks related to the high levels of private and public sector indebtedness; remaining financial sector challenges, in particular with regard to the banks' profitability, and labour market adjustment marked by high structural unemployment, continue to deserve close attention.

- **Spain** is experiencing *macroeconomic imbalances, which require decisive policy action and specific monitoring*. Spain exited the financial assistance programme for the recapitalisation of financial institutions in 2014 and is currently subject to postprogramme surveillance and European Semester surveillance. Despite some improvement in the current account rebalancing, risks related to the high levels of private and public sector indebtedness and the highly negative net international investment position continue to deserve close attention in a context of very high unemployment. The need for action so as to reduce the risk of adverse effects on the Spanish economy and, given its size, of negative spillovers to the economic and monetary union, is particularly important.

- **France** is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring*. The Commission will take in May, on the basis of the National Reform Programmes (NRPs) and other commitments to structural reforms announced by that date, the decision to activate the Excessive Imbalance Procedure (EIP). In a context of low growth and low inflation, coupled with a poor profitability of companies, and given the insufficient policy response so far, risks stemming from the deterioration in both cost and non-cost competitiveness and from the high and rising French indebtedness, in particular public debt have significantly increased. The need for action so as to reduce the risk of adverse effects on the French

([16]) See COM(2015) 85, 26.02.2015.

economy and, given its size, of negative spillovers to the economic and monetary union, is particularly important.

- **Croatia** is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring.* The Commission will take in May, on the basis of the National Reform Programmes (NRPs) and other commitments to structural reforms announced by that date, the decision to activate the Excessive Imbalance Procedure (EIP). In a context of subdued growth, delayed restructuring of firms and dismal performance of employment, risks related to weak competitiveness, large external liabilities and rising public debt coupled with weak public sector governance, have significantly increased.

- **Italy** is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring*. In a context of protracted weak growth and persistently low productivity, risks stemming from the very high level of public debt and the weakness of both cost and non-cost competitiveness have significantly increased. The need for action so as to reduce the risk of adverse effects on the Italian economy and, given its size, of negative spillovers to the economic and monetary union, is particularly important.

- **Hungary** is experiencing *macroeconomic imbalances, which require decisive policy action and monitoring*. In particular, risks stemming from the still highly negative net international position, despite some progress in the rebalancing of external accounts, the high level of public debt as well as the high regulatory burden on financial sector and a high level of non-performing loans which make the deleveraging difficult, continue to deserve attention.

- **The Netherlands** is experiencing *macroeconomic imbalances, which require policy action and monitoring*. Risks stemming from the high level of private debt remain and deserve attention although recent measures support a recovery in the housing market and the curbing of mortgage growth. While the high current account surplus is partially traceable to structural features of the economy the structure of the pension and tax systems may potentially be a source of inefficient allocation of capital.

- **Portugal** is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring*. Portugal exited the economic adjustment programme in 2014 and is currently subject to post-programme surveillance and European Semester surveillance. Despite considerable progress achieved during the programme, both as regards economic adjustment and policies, important risks remain linked to the high levels of indebtedness, both internally and externally, and across various sectors and deserve close attention. There are also strong deleveraging pressures in the context of low growth, low inflation and high unemployment.

- **Slovenia** is experiencing *macroeconomic imbalances, which require decisive policy action and specific monitoring*. The rebalancing is ongoing and overall decisive policy actions, improved export performance and growth conditions have reduced risks compared to last year, in particular those linked to external sustainability. However, weak corporate governance, a high level of state ownership, a still high corporate leverage, and an increasing public debt pose risks for financial stability and growth and warrant close attention. The imbalances are therefore no longer considered as excessive but continue to deserve close attention.

- **Finland** is experiencing *macroeconomic imbalances, which require policy action and monitoring.* In particular, risks related to the weak export performance in a context of industrial restructuring deserve attention. While the decline in export market shares and manufacturing industries has largely come to an end investment remains low and potential growth has declined. Private-sector debt has stabilised and does not appear to be a source of immediate concern, but its relatively high level calls for close monitoring.

- **Sweden** is experiencing *macroeconomic imbalances, which require policy action and monitoring*. In particular, household debt remains at very high levels and keeps expanding as a result of increasing house prices, persistent low interest rates, still high tax incentives and housing supply constraints. Macroeconomic developments linked to private debt continue to deserve attention.

- **Romania** is experiencing *macroeconomic imbalances, which require policy action and monitoring*. In the three consecutive EU-IMF programmes, external and internal imbalances have been significantly reduced. However, risks from the relatively large negative net international investment position and a weak medium-term export capacity deserve attention. Moreover financial sector stability has been preserved so far, but external and internal vulnerabilities of the banking sector remain.

- **The United Kingdom** is experiencing *macroeconomic imbalances, which require policy action and monitoring*. In particular, risks related to the high level of household indebtedness, also linked to structural characteristics of the housing market, continue to deserve attention. The resilience of the economy and financial sector has increased. However, a shortage of housing will persist and is likely to underpin high house prices in the medium term and continue to leave the sector less resilient in the face of risks.

Table 5.1: Summary of the decisions taken by the Commission in 2014 and 2015 under the Macroeconomic Imbalance Procedure

	MIP Findings in 2014	MIP Findings in 2015
BE	Imbalances, which require monitoring and policy action	Unchanged: Imbalances, which require monitoring and policy action
BG	Imbalances, which require monitoring and policy action	Change: Excessive imbalances, which require specific monitoring and decisive policy action
DE	Imbalances, which require monitoring and policy action	Change: Imbalances, which require monitoring and decisive policy action
IE	Imbalances, which require specific monitoring and decisive policy action	Unchanged: Imbalances, which require specific monitoring (post programme surveillance) and decisive policy action
ES	Imbalances, which require specific monitoring and decisive policy action	Unchanged: Imbalances, which require specific monitoring (post programme surveillance) and decisive policy action
FR	Imbalances, which require specific monitoring and decisive policy action	Change to Excessive imbalances, which require specific monitoring and decisive policy action
HR	Excessive imbalances, which require specific monitoring and strong policy action	Unchanged: Excessive imbalances, which require specific monitoring and decisive policy action
IT	Excessive imbalances, which require specific monitoring and strong policy action	Unchanged: Excessive imbalances, which require specific monitoring and decisive policy action
HU	Imbalances, which require monitoring and decisive policy action	Unchanged: Imbalances, which deserve monitoring and decisive policy action
NL	Imbalances, which require monitoring and policy action	Unchanged: Imbalances, which require monitoring and policy action
PT	Programme	Change to Excessive imbalances, which require specific monitoring and decisive policy action
SI	Excessive imbalances, which require specific monitoring and continuing strong policy action	Change: Imbalances, which require specific monitoring and decisive policy action
SE	Imbalances, which require monitoring and policy action	Unchanged: Imbalances, which require monitoring and policy action
RO	BoP programme	Change: Imbalances, which require monitoring and policy action
FI	Imbalances, which require monitoring and policy action	Unchanged: Imbalances, which require monitoring and policy action
UK	Imbalances, which require monitoring and policy action	Unchanged: Imbalances, which require monitoring and policy action

Source: European Commission

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