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Analysis of the euro area economy

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on the economic policy of the euro area

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Executive summary

Following the COVID-19 shock, the euro area economy entered a sudden and deep recession in the first half of this year and remains vulnerable to the persisting health crisis. Unprecedented policy measures are expected to mitigate significantly the immediate impact of the shock, but the uncertainty surrounding the outlook will remain particularly high as long as the pandemic hangs over the economy. Risks remain exceptionally large. Thanks to short-time work schemes, combined with a drop in total hours worked and in activity rates, the unemployment rate is estimated to increase only moderately in 2020. The crisis has had a bearing on private consumption as social distancing measures translated into forced savings, with household savings reaching unprecedented levels. Private sector investment is expected to take a severe hit from the crisis. Despite the symmetric nature of the shock, its impact on GDP appears to vary significantly across countries with a much stronger negative impact on regions more dependent from contact-intensive sectors (e.g., tourism, hospitality and transport).

The risk of widening economic divergences across euro area countries is increasing and can affect negatively the effectiveness of monetary policy. Several factors could drive divergences within the euro area, which warrant a close monitoring, namely: i) the intensity and timing of the COVID-19 shock; ii) the relative size and economic importance of contact intensive sectors (e.g., tourism, hospitality and transport); iii) the differences in the resilience of the economies, including their adjustment capacity and fiscal space available, which may impact confidence, investments and growth prospects; iv) the investment gap also in the green and digital sectors; v) pre-existing regional divergences that may be exacerbated; and vi) institutional differences. In addition, the functioning of product, services, labour and capital markets are important for the adjustment process, including addressing barriers to labour mobility, both geographical and across sectors and firms. Over the longer-term, the current crisis risks having permanent effects on production factors and may translate into lower growth in labour productivity and incomes, in particular on the back of lower human and physical capital.

Measures taken by Member States and the European Union, together with European Central Bank (ECB) policy intervention, have taken aim at preventing bankruptcies and layoffs. In order to safeguard medium-term price stability, the ECB has reacted forcefully and quickly by taking additional monetary policy easing measures ensuring an accommodative monetary stance. On 19 March 2020, the European Commission adopted a temporary framework to use the flexibility under EU state aid rules to support the economy in the context of the coronavirus crisis and on 20 March 2020 the Commission concluded that the EU economy was experiencing a severe economic downturn and the conditions to activate the general escape clause of the Stability and Growth Pact were thus met, a conclusion endorsed by the ECOFIN Council. In response to the COVID-19 pandemic, and as part of a coordinated Union approach, euro area Member States introduced sizeable budgetary measures to contain the pandemic and provide support to individuals and businesses particularly affected. The fiscal stance is forecast to be highly expansionary in 2020 and to remain supportive in 2021 at both euro area and national level. Overall, the debt

sustainability assessment of the euro area leads to the conclusion that the debt position remains sustainable over the medium-term, notwithstanding risks and significant uncertainty.

Implementation of well-designed structural policies will support the recovery, while bringing the euro area closer to the requirements of an optimum currency area by facilitating the transmission of monetary policy and strengthening the resilience and convergence of Member States. Structural policies can also contribute to make euro area economies future-proof, through embracing the green and digital transition. New model simulations provide further evidence that labour and product market reforms could have material growth benefits over the medium term. In general, a number of reform areas appear of particular importance. Insolvency frameworks differ substantially across the EU and this divergence is an obstacle for cross-border capital flows and differences in proceedings contributes to a home bias, as investors shy away from legal risks and costs linked to possible restructuring abroad. Further single market integration, especially in services, is another priority area for reforms. Actions aimed at improving the composition of national budgets, especially through spending reviews and effective public procurement frameworks, can create much-needed fiscal space now, while also help safeguarding fiscal sustainability in the long term. Labour markets and social challenges have been aggravated by the COVID-19 crisis, with the younger and some vulnerable groups most affected, making access to inclusive education and training systems, effective active labour market policies, including hiring incentives, up-skilling and reskilling, and enhanced social protection even more relevant. Gaps in the digitalisation of public administration, including justice systems and public employment services are even more important now.

Euro area banks entered the current stress episode following a continuous risk reduction process that resulted in overall higher liquidity and stronger loss-absorption capacities than before the onset of the Global Financial Crisis, which in combination with various monetary and fiscal policy measures ensured continued credit provision. Nonetheless, the crisis could put further pressure on banks' already low profitability levels. An increase in banks' NPL ratios is likely once government guarantee schemes, debt moratoria, as well as temporary supervisory measures expire. The non-bank financial sector experienced large outflows and valuation losses that have been only partly recovered.

The support provided by swift and sizeable policy interventions has strengthened confidence and helped to preserve macro-financial stability, but entails a number of trade-offs. To mitigate risks it is crucial to avoid a strong feedback-loop between corporate sector vulnerabilities and financial sector risks. For example, prolonged government loan guarantee schemes help protect the banking sector, the non-bank financial sector and ensure credit provision to corporates in a context of a protracted health crisis, which dampens prospects of a quick recovery. At the same time, they could also constitute contingent liabilities for Member States' budgets. Furthermore, in the absence of an effective system that distinguishes viable from non-viable businesses, prolongation of insolvency moratoria and forbearance of non-performing loans entails difficult decisions as it might make the eventual losses under bankruptcy worse, lead to misallocation of funds to non-viable borrowers and in turn undermine business confidence ex-ante.

Further work is needed to improve upon the architecture of the Economic and Monetary Union (EMU). The EU recovery package, with its objective also to strengthen the overall resilience, has the potential to impact the EMU beyond its short-term stabilisation function and its role in supporting the recovery post-crisis. The EMU architecture remains incomplete. Filling the remaining gaps could further increase the euro area's stability and resilience. Important elements are still missing, such as a complete Banking Union and Capital Markets Union. While interrupted by the COVID-19 crisis, it will be important to continue the process of assessing the effectiveness of the current economic governance framework. A strong and resilient EMU will also strengthen the international role of the euro and can ensure Europe's financial and economic autonomy. By increasing the euro area's economic performance and resilience to future shocks, and by increasing issuance of high-quality, euro-denominated debt, the recovery package can strengthen the euro's role as an international reserve currency. The issuance of euro-denominated debt could represent an important step towards further financial markets development and integration in Europe. The issuance of green bonds can quicken the pace of the green transition, in areas such as clean energy.

Introduction

Following the COVID-19 pandemic, the euro area entered a sudden and deep recession in the first half of 2020. The ECB monetary policy interventions, the fiscal policy and other measures Member States and the European Commission have taken aim at protecting jobs, preventing bankruptcies and layoffs and supporting the recovery, while at the same time strengthening the national health sectors to increase their capacity to deal with the pandemic. The European Commission and the Union took unprecedented actions by putting in place short-term emergency measures including the Coronavirus Response Investment Initiative (CRII) and CRII+ packages and proposing Next Generation EU, a major recovery plan which has at its core a new Recovery and Resilience Facility (RRF) as well as adopting a temporary framework to use the flexibility under EU state aid rules and activating the general escape clause of the Stability and Growth Pact, a conclusion endorsed by the ECOFIN Council. In addition, the Union agreed on a number of new instruments to mitigate the impact of the crisis by providing a safety net for workers (by funding national schemes through the Support to mitigate Unemployment Risks in an Emergency - SURE), for businesses (through a scheme by the European Investment Bank) and for Member States including through the European Stability Mechanism's Pandemic Crisis Support Instrument.

The Staff Working Document (SWD) underpins the 2021-22 euro area recommendation, which provides further policy guidance on the reforms and investments that euro area Member States should include in their Recovery and Resilience Plans (RRP) and highlights areas where Member States could work collectively to improve the economic and social resilience of EMU. The SWD offers an analytical assessment of the impact of the COVID-19 crisis on the euro area and investigates five areas of particular relevance where spill-overs and common goods are particularly important: i) risks of further divergence, including in the labour markets; ii) the overall policy stance underpinning the recovery; iii) the role of institutional frameworks and structural reforms; iv) risks to macro-financial stability and v) completing the EMU and strengthening the international role of the euro.

Against the background of a well-coordinated and credible response to the crisis, both nationally and EU wide, the SWD highlights several risks emanating from the COVID-19 crisis that, if materialised, could hamper the functioning of the EMU. First, the continuously weak recovery and high level of uncertainty of the evolution of the pandemic suggest an increased risk of divergence that can undermine the process of economic and monetary integration. Second, the COVID-19 crisis risks further exacerbating the macroeconomic imbalances within the euro area and poses new challenges as public and public debt-to-GDP ratios are on the rise. Third, despite some progress, structural factors hampering growth remain in place in many euro area Member States.

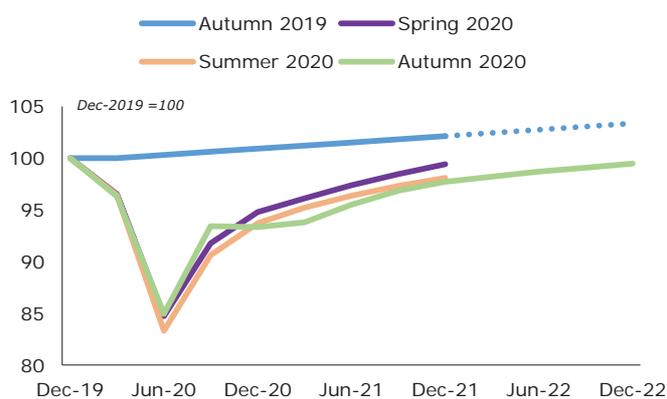
On the positive side, the recent policy response in the context of the Next Generation EU could bring the euro area closer to the requirements of an optimum currency area and improve the transmission of monetary policy, thereby strengthening the economic resilience and convergence of Member States. Further gains could also arise from completing the Banking Union and Capital Market Union and from strengthening the international role of the euro, which will be important to ensure Europe's financial and economic autonomy.

1. Macro-economic outlook and the risk of divergences

1.1. *Macroeconomic context and developments*¹

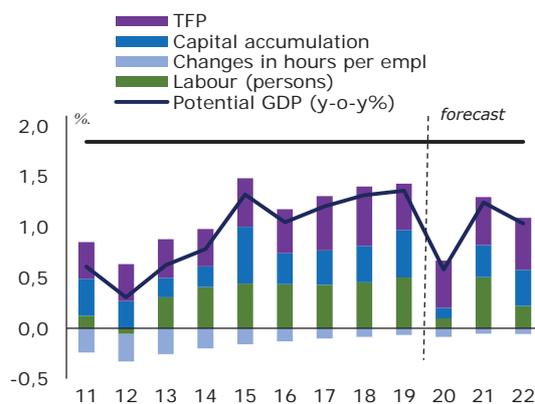
As a result of the COVID-19 pandemic, the euro area economy entered a sudden and deep recession in the first half of this year and it remains vulnerable to the persisting health crisis. GDP growth in the euro area is forecast to decline by 7.8% in 2020 and to rebound by 4.2% in 2021 and by 3.0% in 2022, albeit the recovery is projected to be slower than previously thought (Graph 1). This sudden and deep output contraction halted the expansion observed in recent years and it is expected to weigh on growth over the forecast horizon. Notwithstanding the recovery foreseen in 2021, the level of GDP is expected to be about 2.3% lower than before the COVID-19 crisis by 2021Q4 and to barely reach its pre-crisis levels by 2022Q4 (Graph 1). The coronavirus crisis translated into a series of large demand and supply-side shocks that are expected to ultimately generate a large output gap, of some -7.0% and -3.8% of potential GDP in 2020 and 2021 respectively. Potential output growth is also expected to be significantly lower in 2020 than in the previous five years (and well below its pre-crisis average) resulting from a reduced contribution of labour and capital accumulation (Graph 2).

Graph 1: Euro area GDP forecast in Autumn 2019, Spring, Summer and Autumn 2020



Source: Eurostat and European Commission forecast (Autumn 2019, Spring 2020, Summer 2020 and Autumn 2020).

Graph 2: Contributions to potential growth, in the euro area



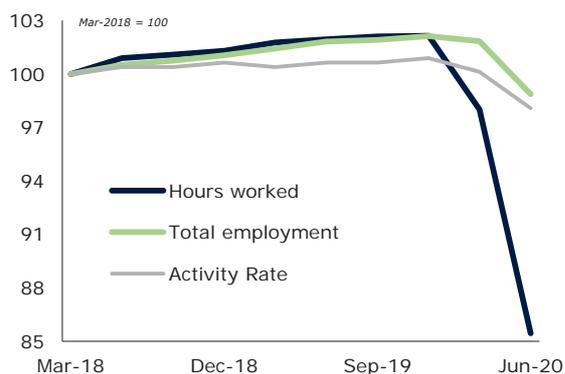
Note: The straight black line corresponds to the pre-crisis (2002-2007) yearly growth.

Source: European Commission 2020 Autumn Forecast, Ameco.

Although policy measures are expected to mitigate significantly the immediate impact of the shock, downside risks are large. Considerable uncertainty over the length of the health crisis still prevails and the initial shock will likely have a longer effect than what had been anticipated earlier. On the positive side, the national support schemes that have been put in place (see section 3) and the prompt coordinated answer from the EU are expected to support the recovery in 2021 and 2022. Other risks predating the crisis, including protectionism risks, are still weighing on the outlook.

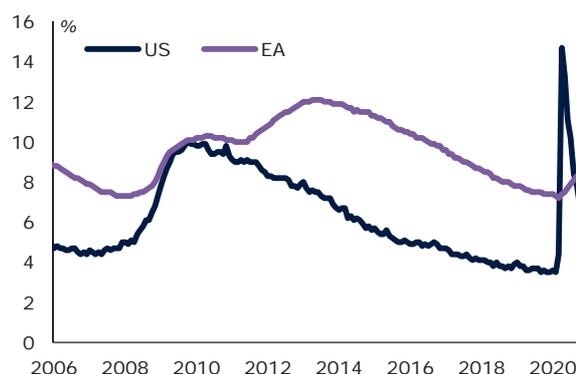
¹ Based on European Commission. Directorate General for Economic and Financial Affairs. “European Economic Forecast: Autumn 2020” (Publications Office 2020).

Graph 3: Hours worked, total employment and activity rates(20-64) in the euro area



Source: Eurostat.

Graph 4: Unemployment rate in the euro area and the US (2006-2021)



Source: Eurostat and FRED.

The COVID-19 crisis is reversing the positive labour market trends of the last seven years further exacerbating unemployment² and inequality trends, although policies have mitigated part of the negative effects.³ As a consequence of the COVID-19 outbreak, the labour market outlook took a turn for the worse. While many jobs were protected through the widespread use of short-time work schemes (supported by the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency - SURE⁴), total hours worked have seen a sharp reduction of some 12.8% in Q2 2020 (Graph 3). The activity rate (age group 20-64) dropped to 76.4% in the euro area in Q2 2020, down by 1.6 percentage points from the previous quarter driven, mostly by a fall in the female activity rate (-1.9 percentage points against -1.5 percentage point of its male counterpart). The widespread use of short-time work schemes and the fall in activity rates contributed to a relatively moderate increase in unemployment rate, from 7.2% in March 2020 to 8.3% in September 2020, and it is expected to remain on the same level in 2020 (on average) and to increase up to 9.4% in 2021 as the short-time work schemes are expected to be gradually phased out. This is very different from the recent experience in the US where the unemployment rate fluctuated much more than in the euro area (Graph 4) reaching 14.7% in April (from 3.5% in February).

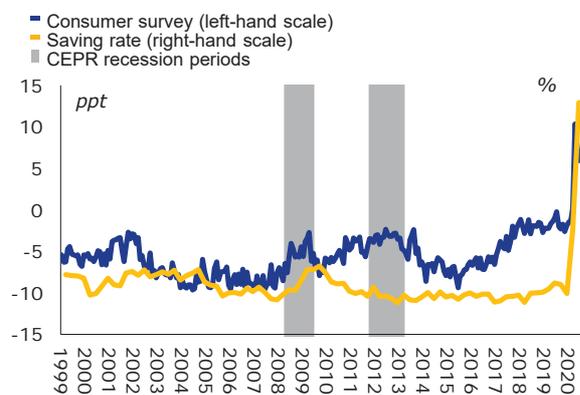
² The unemployment divergence in the euro area is largely due to differences in labour market institutions across countries and one of the main drivers of cross-country differences is youth unemployment. Dispersion in youth unemployment rates – although decreasing over time – remained high already before the COVID-19 crisis and youth unemployment was still above 30% in 2019 in some Member States (Greece: 35.2%; Spain: 32.5%). The COVID-19 crisis is likely to exacerbate those differences. See the Joint Employment Report (2020).

³ Despite the deceleration of economic growth relative to 2018, throughout 2019, the euro area had the highest employment in history and the lowest unemployment level on record. Employment rate increased up to 68%, from 63.5% in 2013, while unemployment rate fell by 4.5 percentage points (between 2013 and 2019), down to 7.5% in 2019. Activity rates for people aged 20-64 continued to rise in 2019, reaching a record high rate of 78.6% in the last quarter.

⁴ Support to mitigate Unemployment Risks in an Emergency (SURE) is a new instrument providing funding solidarity to Member States. SURE can provide financial assistance up to EUR 100 billion in the form of loans from the EU to affected Member States to address sudden increases in public expenditure for the preservation of employment. The Council has already approved a total of €87.9 billion in financial support to 17 EU Member States, based on proposals from the Commission. The first instalments, worth €17 billion overall, have been disbursed to Italy, Spain and Poland. On SURE see https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en.

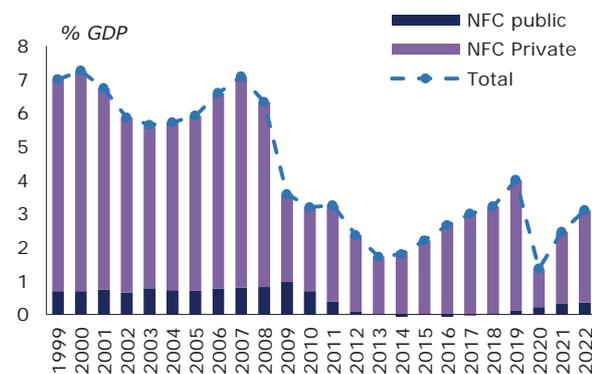
The coronavirus shock is expected to exert downward pressure on inflation and wages in 2020-21. Headline inflation (as measured by the Harmonised Consumer Price Index) in the euro area is forecast to fall sharply to 0.3% in 2020, but to recover to 1.1% in 2021. Compared to the winter forecast, this represents a downward revision of 1.1 percentage points in 2020 and 0.3 percentage points in 2021. The combination of weakening economic activity and a deteriorating labour market outlook translates in the near term into lower domestic price pressures that also weigh on core inflation (excluding energy and unprocessed food prices), which is forecast at 0.9% in 2020 and 1.0% in 2021. The worsening of the labour market situation is also projected to limit increases in wages and salaries in 2020-21. By the second quarter of 2020, a large majority of euro area countries recorded negative changes in nominal wages (on a year on year basis). Depending on the design of national short-time work schemes, the share of employees involved and the intensity of the drop in hours worked, wage decreases varied considerably.⁵

Graph 5: Households' propensity to save in the euro area



Note: Grey bars represent the recession periods as defined by the Centre for Economic Policy Research.
Source: ECB.

Graph 6: Net private and public investment in the euro area



Note: Net investment is the difference between gross investment and net of consumption of fixed capital (or depreciation).
Source: Ameco.

The crisis had a bearing on private consumption as social distancing and other restrictive measures translated into loss of income and forced savings (Graph 5). Private consumption in the euro area fell sharply in March and April as consumers lacked the opportunity or confidence to spend. This is in stark contrast with the pre-COVID-19 era, whereby private consumption was a strong driver of euro area GDP growth. Notwithstanding differences across income levels, the overall unprecedented savings by households were a key feature of the consumption weakness in the first half of the year. Already in the first quarter of 2020, the household saving rate had increased to 16.7% of gross disposable income, reaching an all-time high of 24.9% in the second quarter, up from 12.6% in the fourth quarter of last year.⁶

⁵ Particularly high decreases, above 8%, were recorded in Italy, Belgium and France, in terms of growth of compensation per employee on annual basis.

⁶ Recent ECB research found that more than two-thirds of the additional savings during the first six months of 2020 constituted “forced savings” — money set aside because people could not spend it. Only a much smaller

Private sector investment is expected to take a severe hit from the crisis. Gross fixed investment is forecast to decline by around EUR 1 trillion in 2020 and 2021 cumulatively (compared to the pre-crisis baseline given by the Autumn 2019 Forecast) on the back of falling aggregate demand, extreme uncertainty and a severe squeeze on corporate liquidity.⁷ In contrast to the aftermath of the Global Financial Crisis, the current crisis appear to have mainly affected private sector investment levels, with little or no impact on the expected public sector investment. As savings persist and low net private investments are expected (Graph 6), there is scope for public investments to play a larger role; indeed public sector investment has remained broadly unchanged in net terms since 2011.

Exports of goods and services are likely to remain dampened for some time as demand from outside the EU remains subdued and existing global supply chains continue to adjust. World trade is forecast to decline by some 10.8% in 2020 and euro area exports by 11.5%. As the euro area is very open⁸ in comparison with other major trade partners,⁹ the COVID-19 crisis is expected to have a major impact on output with the net trade contribution to GDP growth expected to fall by 1.1% in 2020, further worsening a -0.5% drag on growth in 2019 (in comparison with +0.4 and +0.1 percentage point of contribution to GDP growth in 2017 and 2018 respectively). Besides the drop in trade volumes, the pandemic has also altered the geography of trade (particularly of services), whereby a regional re-centring towards European value chains has occurred. If this trend persists, while it could reduce supply risks and uncertainty, lower trade diversification could also affect negatively economic resilience and productivity. This in turn can have a bearing on convergence given the differences in euro area countries' integration in European and global value chains.¹⁰

The current account of the euro area as a share of GDP has been ebbing since 2017 and is projected to further decline in 2020. In 2019, the euro area current account balance is estimated at 2.3% of GDP, remaining the largest worldwide in nominal terms.¹¹ At unchanged policies, the euro area current account surplus is expected to further decrease to

proportion was saved for precautionary reasons which are typically an important factor in explaining the increase in household savings during downturns. For more details, see Dossche, M. and Zlatanov, S., "COVID-19 and the increase in household savings: precautionary or forced?", Economic Bulletin, Issue 6, ECB, September 2020.

⁷ For more details, see "Commission Staff Working Document: Identifying Europe's recovery needs", accompanying the document "Communication from the Commission to the European Parliament, The European Council, the Council, the European Economic and Social Committee and the Committee of Regions: Europe's moment: Repair and Prepare for the Next Generation", SWD(2020) 98 final, 27 May 2020.

⁸ Trade openness can make it more difficult to stimulate domestic demand expansion as it spills out through the import channel. For more details, see for instance, Spilimbergo, A., et al., "Fiscal Policy for the Crisis", IMF Staff Position Note, SPN/08/01, December 2008 and Sutherland, D., et al., "Counter-cyclical Economic Policy", OECD Economics Department WP No. 760, May 2010.

⁹ Exports of goods and services represented in 2019 28.5% of euro area GDP while imports of goods and services represent 25.2% of euro area GDP. Exports and imports in terms of GDP amount to 11.8% and 14.5% in the US, 17.8% and 17.7% in Japan; 18.5 % and 17.4% in China.

¹⁰ For more details, see Miroudot, S., "Resilience versus robustness in global value chains: Some policy implications", VoxEU.org, 18 June 2020. doi: <https://voxeu.org/article/resilience-versus-robustness-global-value-chains>.

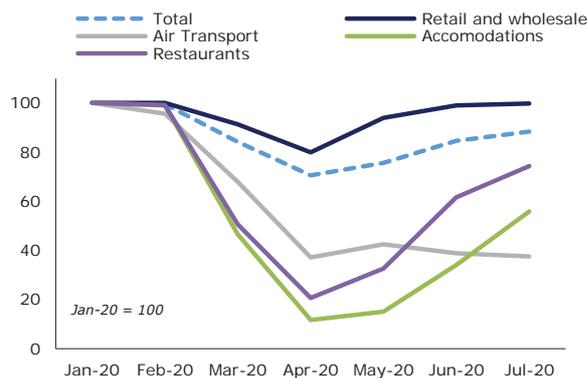
¹¹ This surplus continues to mainly reflect the large, but steadily falling, surpluses recorded in Germany and the Netherlands, whose combined external balances accounted for 2.7% of euro area GDP in 2019.

1.8% of GDP in 2020 and to edge up to 1.9% of GDP in 2021. While the geographical breakdown of the current account surpluses are expected to remain fairly stable across countries in 2020 and 2021, considerable changes are taking place in the net lending position across sectors of the economy, as the large increase in the net lending position for the private sector is almost fully offset by a deterioration in that of the government sector.¹²

1.2. COVID-19 and the risk of divergence

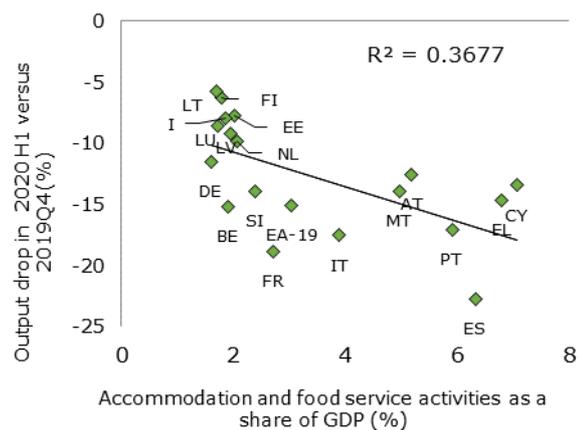
The impact of the COVID-19 crisis on GDP has depended on different factors, including the intensity and duration of the pandemic and has increased with the stringency of the containment measures implemented to impede the transmission of the COVID-19 virus. Governments have taken drastic measures to contain the spread of the virus (e.g., lockdown and school closures), while voluntary social distancing was also an important element across euro area countries. These measures have led to many businesses being shut down temporarily, widespread restrictions on travel and mobility, financial market stress at the onset of the crisis, an erosion of confidence and heightened uncertainty.

Graph 7: Services production in the euro area



Source: Eurostat.

Graph 8: Share of accommodation and food in GDP relative to the fall in 2020 H1



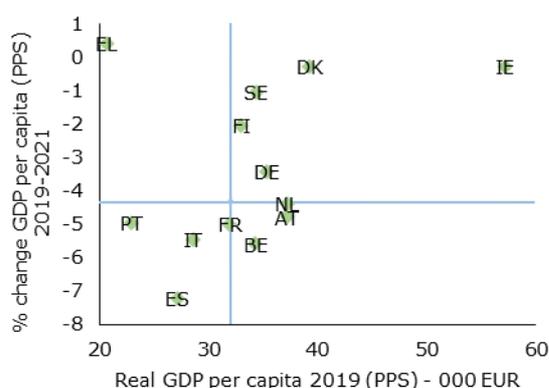
Source: Eurostat.

By its nature, the COVID-19 shock has had a much stronger impact on services activities that require physical interaction and has thus been more detrimental to euro area countries where those activities predominate. Most notably, monthly data through to July show production in the restaurant, hotel, and air transport sectors was hit much harder than in other sectors and they were lagging the overall recovery by large margins (Graph 7). Euro area countries with the largest shares of food services and accommodation in their economies have thus witnessed the steepest fall in GDP (Graph 8), and may experience slower economic recovery and may experience a slower economic recovery. The negative impact on employment has been cushioned by short-time work schemes and, in some countries, restrictions to lay-offs in the first half of 2020. However, these sectors tend to be labour-intensive and more prone to job losses, which is a threat for more than one in three

¹² For more details, see 2021 Alert Mechanism Report (2020).

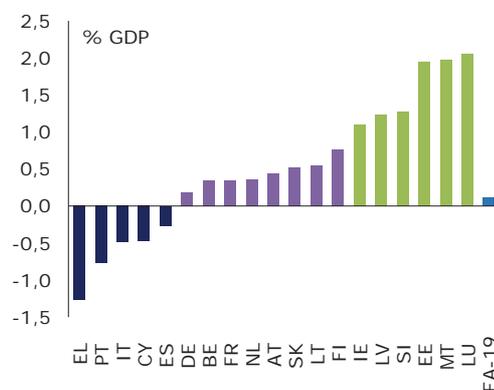
jobs¹³ in Cyprus, Greece, Spain, Italy and Malta, largely linked to tourism.¹⁴ Moreover, some durable goods sectors have also been significantly hit by the crisis, most notably the automotive sector¹⁵ that was already going through considerable structural changes.

Graph 9: GDP per capita (PPS) in EU 14 (expected 2019-21 change versus actual 2019)



Note: the straight lines correspond to the EU14 average. (Luxembourg is also included in the average, although it is not shown).
Source: European Commission 2020 Autumn Forecast.

Graph 10: Net public investment in the euro area (2019)



Note: Net investment is the difference between gross investment and net of consumption of fixed capital (or depreciation). Net public investment above 1% of GDP is in green as this level is consistent with a public capital stock remaining at 50% of GDP in the euro area in the short term and gradually increasing in the longer term, to take into account the additional investment needs related to the Green Deal and the digital transformation.
Source: European Commission 2020 Autumn Forecast.

Persistent macro-economic divergences across euro area countries can also affect the effectiveness of euro area monetary policy.¹⁶ National institutions and the functioning of labour, product and capital markets are still very idiosyncratic, despite the progress in building the internal market. Moreover, increased specialisations and agglomeration effects have been reinforced through economic integration. Business cycles have synchronised further while their amplitudes have again become more divergent within the euro area.¹⁷

The COVID-19 crisis is increasing the risk of economic divergences across the euro area. Most notably, GDP per capita level (PPS) in all Member States (excluding Greece) are

¹³ The jobs considered fall under the broad sectors “wholesale and retail trade, transport, accommodation and food service activities” and “arts and entertainment” sectors (Source: Eurostat, National Account, Annual Employment Data).

¹⁴ Mobility patterns have suffered a strong drawback in the recent crisis. The jobs considered fall under the broad sectors of “wholesale and retail trade, transport, accommodation and food service activities” and “arts and entertainment”. See Eurostat, National Account, Annual Employment Data, Nace Rev. 2 Classification.

¹⁵ The personal transport equipment sector accounts for about 42% of durable goods in the euro area.

¹⁶ Real convergence is the cornerstone of EMU resilience. It relates to the idea of narrowing the gaps between euro area economies on a macroeconomic level through the long-term process of catching up. From the perspective of an efficient monetary policy, convergence of business cycles is a critical factor for a successful monetary union. Moreover, another important dimension of convergence is the concept of convergence towards resilient economic structures. It implies that euro area economies reduce their vulnerability to shocks, together with an increase in their capacity to absorb shocks and in their ability to re-allocate resources. For more details, see “Sustainable convergence in the euro area: A multidimensional process”, Quarterly Report on the Euro Area (QREA), Vol. 16, No. 3 (2017)/16.

¹⁷ Franks J., B. Barkbu, R. Blavy, W. Oman and H. Schoelermann (2018), “Economic Convergence in the Euro Area: Coming Together or Drifting Apart?”, IMF Working Paper No. 18/10.

expected to remain well below the 2019 GDP per capita level (PPS) over the next two years (Graph 9) and Italy, Spain and Portugal are forecast to fall by more than the euro area average. There are several factors that could undermine the process of convergence linked to the COVID-19 shock, while jeopardizing the proper functioning and stability of EMU¹⁸ and ultimately reduce long-term growth prospects. They warrant a close monitoring:

- **The intensity and timing of the initial shock and its impact on movements of workers.** To respond to the health crisis, euro area countries have had to implement mobility restrictions. As a result, mobility dropped by 45%¹⁹ between March and mid-May compared to pre-pandemic levels, contributing to the large fall in GDP in 2020H1 (see section 1.1). In addition, barriers to labour mobility, both geographical and across sectors and firms, limit the potential of labour reallocation. Indeed, many mobile workers (especially cross-border and seasonal workers) were cut off from their place of work or their place of residence in spring. Currently, the situation has stabilised for cross-border and seasonal workers, but overall a strong decrease in a new flow for longer-term mobility can be expected in 2020-21. The closure of borders within the EU has highlighted the importance of intra-EU labour mobility in constantly supporting the balance of labour demand and supply and the smooth functioning of the Single Market.
- **The relative size and economic importance of contact intensive sectors (e.g. tourism and hospitality).** Some more contact intensive sectors or ecosystems will take longer to recover even after lockdown measures are relaxed, exposing some euro area economies more than others. Physical distancing requirements and associated changes in consumer preferences, a lasting shift to remote working and the increasing digital delivery of services would impact sectors' sizes, change the mix of jobs available and the location of some workplaces. The different sectoral composition of Member States' economies and particularly the proportion of vulnerable occupations requiring close contact with other people, or servicing high contact-intensive sectors and ecosystems, will determine differences in the employment and social impact of the crisis. Most notably, the labour-intensive activities linked to the contact intensive sectors are inherently more prone to job losses. Unless the shock proves temporary in nature, adjusting to these changes is likely to require substantial labour and capital reallocation, and effective active labour market policies, including incentives, to take up jobs notably in green and digital sectors, re-skilling and up-skilling policies to allow workers to move where there are opportunities.
- **Differences in fiscal space available, which may impact confidence, investments and growth prospects.** The depth of the COVID-19 shock required an unprecedented fiscal response (see Section 2) and a consequent large deterioration in fiscal positions. Countries with less fiscal space were more constrained to provide stronger support

¹⁸ On the risk of dampening support for the common currency, see also S.Bergbauer, N. Hernborg, J-F Jamet, E. Persson and H. Schölermann "Citizens' attitudes towards the ECB, the euro and Economic and Monetary Union", ECB Economic Bulletin, Issue 4/2020.

¹⁹ As measured by the Google Mobility Index. For more details, see Summer (interim) Forecasts 2020.

during the recovery phase because of the risks of adverse market reactions. The EU policy response to the crisis will likely alleviate this by offering large-scale financial support for investment and reforms and by better preparing Member States for a sustainable recovery, and providing much-needed technical assistance. **Investment gap also in the green and digital sectors.** The shortfall of investment induced by the crisis is set to differ substantially across euro area countries, especially with regards to public investment (Graph 10).²⁰ Moreover, Member States enter the recovery from different starting points with respect to investment levels aimed at green and digital growth.

- **Pre-existent sub-national level differences.** Existent differences at sub-national levels can further compound the divergence risks.²¹ The regional impact of the COVID-19 shock is multidimensional. A region more open to trade may be more exposed both to the global shock of COVID-19 and to the disruptions to supply chains. Such regions comprise those with major ports and other trade infrastructure and those with relatively larger shares of employment in manufacturing and other tradable sectors.²²
- **Institutional differences, including the role of social partners.** Differences in the institutional set-up affect the capacity to respond to shocks. Member States where a strong social dialogue culture prevails have shown to overcome economic shocks more easily. During the COVID-19 pandemic, the involvement of the social partners has been most meaningful in Member States with well-established social dialogue structures, as this enabled social partners to make a meaningful difference.²³

1.3. Long-term impact of the COVID-19 on productivity growth

The current crisis is having a negative impact on productivity growth, which was already low before the crisis. If not addressed, it could leave scars on potential output in the medium to longer term and further hold back the process of real convergence. In the long run, economic growth is largely driven by productivity improvements, or the ability of societies to innovate and adopt new technologies (so-called Total Factor Productivity). Labour and total factor productivity growth in euro area, which was already low before the Global Financial Crisis,²⁴ have worsened since then (Graph 11).²⁵ From the mid-1990s, both labour and total

²⁰ Research and development (R&D) and innovation (R&I) are important drivers of growth but research intensity in the euro area is still lagging behind other advanced economies. For example, in 2018, R&D spending in the euro area was around 2.2% of GDP. This is well below R&D spending in the US (2.8 % of GDP), Japan (3.3% of GDP) and Korea (4.5% of GDP). See Eurostat, Intramural R&D expenditure (GERD) by sectors of performance.

²¹ For more details, see Annoni, P. and Dijkstra, L., “The EU Regional Competitiveness Index”, Publication Office of the European Union, 2019.

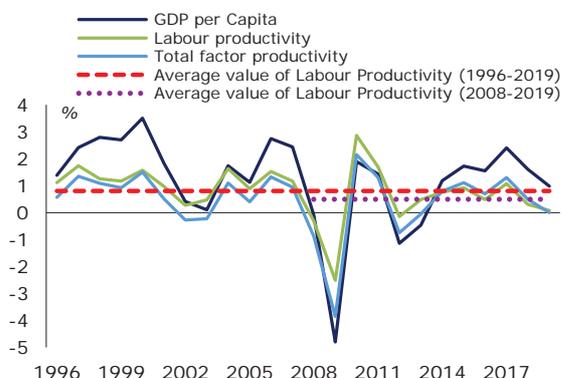
²² See OECD, “From pandemic to recovery: Local employment and economic development”, OECD Policy Responses to Coronavirus (COVID-19), 27 April 2020 <http://www.oecd.org/coronavirus/policy-responses/from-pandemic-to-recovery-local-employment-and-economic-development-879d2913/>.

²³ European Commission (2020), ‘Employment and Social Developments in Europe 2020’.

²⁴ Fernald, J. and R. Inklaar (2020), “Does Disappointing European Productivity Growth Reflect a Slowing Trend? Weighing the Evidence and Assessing the Future,” FRB of San Francisco WP 2020-22.

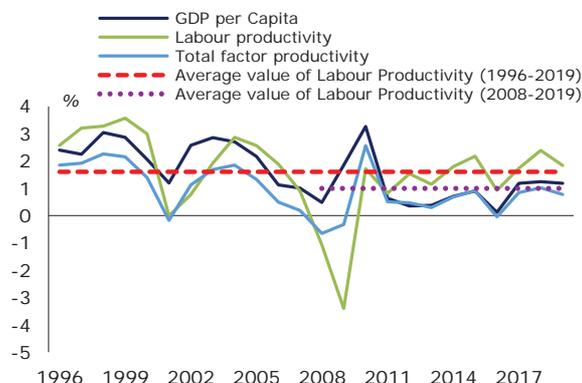
factor productivity growth in euro area have, on average, remained lower than in the US²⁶ (Graph 12), especially so since the Global Financial Crisis.²⁷ Differences across countries, and regions, are also stark in some cases and have implications for the functioning of EMU.²⁸

Graph 11: Labour productivity and TFP growth in the EA-19 in 1996-2019



Source: Ameco.

Graph 12: Labour productivity and TFP growth in the US in 1996-2019



Source: Ameco.

There is significant uncertainty on the likely impact of the COVID-19 pandemic but it risks having a permanent effect on production factors and translating into lower growth in labour productivity (and lower potential output) and incomes. There are several channels through which the COVID-19 shock could impact labour productivity in the euro area in the medium term:

- **First, the pandemic is expected to lead to a large contraction in business investment, which in turn will translate into a lower level of capital stock and reducing labour productivity.** In the recent past, so-called “biological shocks” have had a permanent impact on productivity, through heightened uncertainty and a negative impact on investment. For example, a recent World Bank study on four epidemics since 2000 - SARS (2002-03), MERS (2012), Ebola (2014-15), and Zika (2015-16) - found that the average lasting impact on labour productivity and output amounted to 4% cumulatively after three years.²⁹ In the face of high uncertainty about future sales prospects, cost of funding and potentially more difficult access to credit,

²⁵ In the aftermath of the previous crisis real convergence stalled due to a stronger decline in productivity (especially TFP) in the catching-up euro area countries compared to the rest of the euro area. See also Chiacchio, Gradeva, and López-García (2018), “The post-crisis TFP growth slowdown in CEE countries: Exploring the role of Global Value Chains”, ECB Working Paper, No. 2143.

²⁶ In the period 1996-2019, the average growth rate of labour productivity in the euro area was 0.8% (versus 1.6% in the US), while TFP growth rate was 0.5% (versus 1.0% in the US).

²⁷ Cette, G., J. Fernald, and B. Mojon. (2016.), “The Pre-Great Recession Slowdown in Productivity.” *European Economic Review* 88(C): 3-20.

²⁸ For more details, see Diaz del Hoyo, J. L. et al, “Real convergence in the euro area: a long term perspective”, ECB occasional paper series, N. 203, December 2017.

²⁹ For more details, see A. Dieppe (2020), “Global Productivity: Trends, Drivers, and Policies,” Advance Edition. World Bank.

firms are likely to postpone or cancel investment plans.³⁰ Moreover, revenue losses during the lockdown and the costs incurred to adapt to the pandemic may constrain firms' ability to finance investment projects in the near term, and longer if the increase in debt leads to deleveraging needs.

- **Second, weaker business investment means lower accumulation of physical and human capital that could also translate into lower TFP growth.** The slower accumulation of capital and slower adoption of capital-embodied new technologies could feed back into lower labour productivity.³¹ Weak aggregate demand in the aftermath of the Global Financial Crisis drove the sharp fall in private fixed investment. This drop is likely to have contributed to subdued labour productivity growth not only by weakening the contribution of capital deepening, but also by affecting TFP growth itself through a slower adoption of new technologies.³² In addition, TFP growth could be lower as the lack of face-to-face contact could hinder knowledge acquisition and transfer.
- **Third, weaker trade and foreign direct investment flows, accompanying a potential re-centring of global value chains, could further dampen productivity growth in the euro area.** There is evidence of a positive relationship between trade and labour productivity.³³ Plummeting global trade in 2020, – global imports (excluding the euro area) are expected to plunge by 10.3% in 2020, almost twice the level of the drop in world output – has been a distinguished feature of the COVID-19 crisis. Weaker trade growth could impact upon the pace of technology diffusion across countries and restrict competitiveness between firms, limiting the pressure on European firms to increase productivity. The supply chain risks³⁴ and the potential³⁵ re-centring of global value chains' activities could have an ambiguous impact on productivity. On the one hand, re-shoring towards Europe could reduce efficiency and productivity gains, which have been important drivers behind the rise of global value chains. On the other hand, the re-shoring phenomenon may force higher capital intensity, which could positively impact capital deepening.

³⁰ See also “Business and consumer survey results for April 2020”, which expected a decrease in industrial investment although a considerable part of replies was collected before strict COVID-19 containment measures.

³¹ See G. Adler, R. Duval, D. Furceri, S. Kılıç Çelik, K. Koloskova, M. Poplawski Ribeiro (2017). "Gone with the Headwinds; Global Productivity," IMF Staff Discussion Notes 2017/004, IMF.

³² Based on data for 112 countries over 1970–2014, IMF empirical estimates of this effect suggests that falling investment may be responsible for lowering TFP growth by nearly 0.2 percentage points per year in advanced economies over the post-crisis period. See G. Adler, R. Duval, D. Furceri, S. Kılıç Çelik, K. Koloskova, M. Poplawski Ribeiro (2017). "Gone with the Headwinds; Global Productivity," IMF Staff Discussion Notes 2017/004, International Monetary Fund.

³³ For more details, see “Does trade play a role in helping to explain productivity growth?”, ECB Economic Bulletin, Issue 7, November 2017. https://www.ecb.europa.eu/pub/pdf/other/ebbox201707_01.en.pdf.

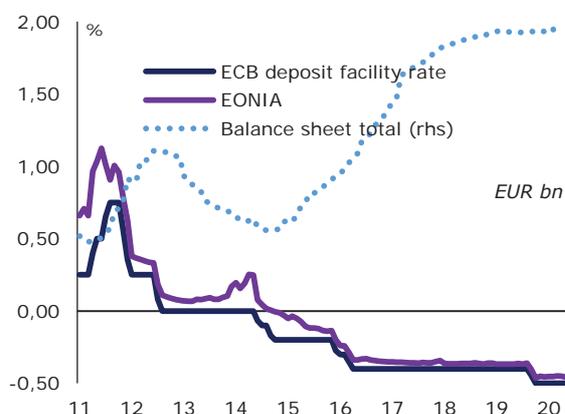
³⁴ See OECD, “COVID-19 and global value chains: Policy options to build more resilient production networks”, OECD Policy Responses to Coronavirus (COVID-19), 3 June 2020. <http://www.oecd.org/coronavirus/policy-responses/COVID-19-and-global-value-chains-policy-options-to-build-more-resilient-production-networks-04934ef4/>.

³⁵ Tough Global Value Chains have been impacted, the existence of complex value chains is expected to persist as globalisation is already too advanced for a sharp reversal. See, for instance, Miroudot, S., “Resilience versus robustness in global value chains: Some policy implications”, VoxEU.org, 18 June 2020. <https://voxeu.org/article/resilience-versus-robustness-global-value-chains>.

2. The macroeconomic policy stance

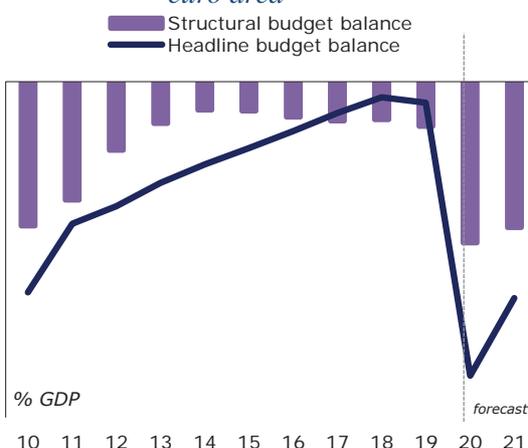
In light of the ongoing COVID-19 crisis, a broader policy mix in which monetary, fiscal and structural policies interact can better support a sustainable recovery over the medium term. In a context of monetary policy at the zero lower bound and limited fiscal space, the current economic situation requires a supportive, coordinated comprehensive and consistent broad policy mix, in particular to limit any long-term negative impact on the functioning of markets, reduce significant economic divergence and imbalances within the euro area and, more broadly, avoid negative consequences on potential economic growth. Stepping up structural reforms, while taking into account country-specific circumstances, complements and reinforces the other two pillars. New simulations presented in Box 2 (see section 3) using DG ECFIN’s QUEST model provide further evidence that labour and product market reforms can have material growth benefits over the medium term.

Graph 13: ECB deposit rates and balance sheet



Source: ECB.

Graph 14: Government budget balance, euro area



Source: European Commission.

In light of the unprecedented economic contraction in the euro area and to safeguard the medium-term price stability objective³⁶, the ECB has reacted forcefully and quickly by taking additional monetary policy easing measures, thus ensuring an accommodative stance (Graph 13). The ECB’s measures can be grouped into three broad areas: i) provision of additional liquidity to banks³⁷; ii) easing of collateral requirements; and iii) substantial additional purchases of public and private sector assets. The ECB announced substantial additional purchases of public and private sector assets, which will amount to EUR 1470

³⁶ The ECB has defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. In the pursuit of price stability, the ECB aims at maintaining inflation rates below, but close to, 2% over the medium term.

³⁷ The additional liquidity provided to banks includes additional Long-Term Refinancing Operations (LTROs) and a new series of seven pandemic emergency longer-term refinancing operations (PELTROs), priced 25bp below the average MRO rate prevailing over the life of the operation. Moreover, the ECB decided on more favorable terms for existing and outstanding targeted operations with long maturities (TLTRO III). Lastly, the ECB also offered daily USD-denominated refinancing operations within an enhanced USD swap line agreement with the Federal Reserve.

billion under the Asset Purchase Programme (APP, EUR 120 billion until the end of 2020) and the Pandemic Emergency Purchase Programme (PEPP, EUR 1,350 billion until at least mid-2021). The intended aim of these measures was to maintain favourable financial conditions and contribute to the easing of the policy stance. Along with the ECB's monetary policy measures, macro-prudential authorities and supervisors implemented a wide range of targeted measures with the aim to limit financial stability risks and spillovers between market segments.³⁸

2.1 The fiscal policy stance

On the fiscal side, the EU and its Member States took unprecedented actions to counter the negative impact of the COVID-19 shock. On 20 March 2020, the Commission concluded that the EU economy was experiencing a severe economic downturn and the conditions to activate the general escape clause of the Stability and Growth Pact were thus met.³⁹ This conclusion was endorsed by the ECOFIN Council. Consistent with the activation of the general escape clause, euro area Member States introduced sizeable emergency budgetary measures aimed at supporting businesses and households (see Box 1). In addition, the European Commission and the Union adopted a temporary framework to use the flexibility under EU state aid rules to support the economy in the context of the coronavirus crisis⁴⁰ and put forward measures to provide emergency liquidity, such as the CRII⁴¹ and CRII+ packages, as well as a European Strategy for the Recovery, which includes the Next Generation EU⁴², with the Resilience Recovery Facility (RRF) as its central pillar. The Facility will provide large-scale financial support for investments and reforms in the Member States, with the aim of fostering economic and social convergence and resilience. In addition, national and EU authorities have put in place exceptional liquidity support, mainly via guarantees to ensure the flow of credit, including through the new SURE instrument and the Pandemic Crisis Support by the European Stability Mechanism (ESM).

³⁸ Measures included lower regulatory capital requirements for banks, the temporary permission to operate below certain capital buffer requirements and acceptance of lower liquidity coverage ratios, as well as taking a flexible approach in the supervisory treatment of NPLs covered by state guarantees. At the same time, several national authorities decided to release countercyclical capital buffers (CCyB) or to revoke previously announced CCyB increases and reduced other buffer requirements such as for structural risks.

³⁹ The Council endorsed this assessment on 23 March.

⁴⁰ For more details, see https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1872

⁴¹ The CRII (Coronavirus Response Investment Initiative), in force as of 1 April 2020, gives Member States an upfront cash injection of EUR 8 billion from the EU cohesion funds which could accelerate up to EUR 37 billion of European public investment to fight the coronavirus. The CRII+ (Coronavirus Response Investment Initiative Plus) extended the scope of support of the funds, provided immediate liquidity and gave flexibility in programme amendments. See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020_PC_0113&from=EN

⁴² The EU Commission estimates that effective implementation of Next Generation EU can deliver around 1¼ % of additional EU GDP in 2021 and 2022, rising to 2¼% by 2024, and create 2 million jobs. See SWD(2020) 98 final - Identifying Europe's recovery needs.

BOX 1: Overview of national fiscal measures put in place to respond to the crisis

Member States have announced and taken sizeable emergency measures in response to the COVID-19 pandemic.⁴³ Discretionary budgetary measures with a direct budgetary impact that were announced by euro area Member States by 22 October 2020 are estimated at 4.0% of GDP in 2020 (Table 1). These discretionary measures come on top of automatic stabilisers – the non-discretionary part of fiscal policy. The discretionary components consist primarily of additional spending amounting to 3.6% of GDP including health care and other epidemic-related spending (0.6% of GDP) and other items including subsidies to specific sectors and top-ups to the regular unemployment benefit schemes (3.0% of GDP). Tax relief measures amount, on average, to some 0.4% of GDP.

Table 1: National fiscal measures in the euro area in response to the COVID-19 crisis, 2020 - 2022

EA-19	2020		2021		2022	
	bln EUR	% of GDP	bln EUR	% of GDP	bln EUR	% of GDP
Initiatives by the Member States¹						
A. Measures with a direct budgetary impact²	448.3	4.0	-237.6	-2.0	-130.6	-0.9
1. Expenditure	400.9	3.6	-223.1	-1.9	-114.4	-0.8
1. a) Health care	69.3	0.6	-38.1	-0.3	-19.4	-0.1
1. b) Other	333.0	3.0	-184.9	-1.6	-94.9	-0.7
<i>of which impact from guarantees*</i>	10.5	0.1	-7.2	-0.1	-0.7	0.0
<i>public investment*</i>	10.9	0.1	5.9	0.0	-10.3	-0.1
<i>short-time work schemes*</i>	111.8	1.0	-84.5	-0.7	-27.3	-0.2
2. Revenue	47.4	0.4	-14.5	-0.1	-17.3	-0.1
B. Liquidity measures without a direct budgetary impact						
1. Tax delays	121.3	1.1				
2. Public guarantees (available framework)³	1894.0	16.9				
<i>of which current take-up (actual contingent liability)</i>	426.7	3.8				
3. Others	261.4	2.3				

¹ The amounts included cover the impact of nationally-financed measures, net of funding provided e.g., by EU initiatives.

² In line with the established principles for recording fiscal policy measures under the no-policy-change assumption, the impact of the measures is given in increments compared to year t-1 in accrual terms (ESA2010). GDP projections are based on the Commission 2020 autumn forecast.

³ Figures refer to the maximal public funds involved if all of the available guarantees were taken-up. Guarantees to EU and international level instruments are excluded. For Germany, the size of available (not only new guarantee schemes) is included, while the overall guarantee framework is actually unlimited.

* Reporting is optional, only included for MS where reliable estimates are available; thus figures are likely to represent a lower bound.

Source: ECFIN staff calculations.

Most of the measures have been announced as temporary, whilst some have been extended and new ones supporting the recovery will have effects beyond 2020. Currently, more than half of the measures is expected to have an impact only in 2020. Going forward, the impact of the measures are expected to further decrease in 2022. "Emergency" measures in direct response to the outbreak of the pandemic were clearly announced as temporary. At the same time, the resurgence of the spread of the COVID-19 may lead to a prolongation of existing and/or adoption of new measures leading to budgetary effects also in 2021, beyond

⁴³ The results of the identification and quantification of measures presented in this section should be considered work-in-progress. The estimation of the budgetary impact is subject to revision as new information becomes available or Member States announce new measures. The estimated budgetary impact also depends on statistical classification decisions and guidance by national statistical authorities and Eurostat.

what was projected until now.

In addition to the direct budgetary support for businesses and households, euro area Member States have provided ample liquidity support with no direct budgetary impact to date, estimated at 20.3% of GDP, to counter the economic fallout of COVID-19. This primarily includes public guarantees (16.9% of GDP⁴⁴) and tax deferrals within the year (1.1% of GDP) as well as other measures (2.3% of GDP) to provide liquidity support. Some of these measures could have a delayed impact, as some of the postponed tax obligations may never be settled, for example due to corporate bankruptcies and in particular in light of the second wave. The comparability of these figures across Member States is particularly challenging given the diversity and complexity of the guarantee frameworks.

The euro area fiscal stance is expected to be strongly expansionary in 2020 due to the sizeable emergency fiscal measures taken by Member States.⁴⁵ After reaching historically low levels in 2018-19 (0.5% GDP), the euro area general government deficit is projected to increase to 8.8% of GDP in 2020 (Graph 14 and Table 2). The expenditure-to-GDP ratio is expected to increase by around 8% of GDP in 2020 (Table 2), reflecting the working of automatic stabilisers and unprecedented discretionary policy measures (including the increase in health expenditures) adopted to cushion the economic and social impact of the pandemic.⁴⁶ At the same time, revenue is expected to fall in line with nominal GDP in 2020, reflecting the decrease in tax receipts, capturing both lower income tax revenues, as well as weaker consumption tax collection and declining import duties.

Table 2: General Government budgetary position (per cent of GDP) in the euro area, 2016 – 2022

	2016	2017	2018	2019	2020	2021	2022
Total receipts (1)	46.3	46.2	46.5	46.4	46.5	46.0	45.8
Total expenditure (2)	47.7	47.2	46.9	47.1	55.2	52.4	50.5
Actual balance (3) = (1)-(2)	-1.5	-0.9	-0.5	-0.6	-8.8	-6.4	-4.7
Interest expenditure (4)	2.1	1.9	1.8	1.6	1.6	1.4	1.3
Primary balance (5) = (3)+(4)	0.6	1.0	1.4	1.0	-7.2	-5.0	-3.4
One-offs (6)	0.1	-0.1	-0.1	-0.2	0.0	0.0	0.0
Cyclically-adjusted budget balance (7)	-1.0	-1.3	-1.2	-1.5	-4.8	-4.3	-3.6
Cyclically-adjusted primary balance (8) = (7)+(4)	1.1	0.7	0.6	0.1	-3.2	-2.9	-2.3
Structural budget balance (9) = (7)-(6)	-1.1	-1.2	-1.1	-1.3	-4.8	-4.3	-3.7
Structural primary balance (10) = (7)-(6)+(4)	1.1	0.8	0.7	0.3	-3.2	-2.9	-2.3
Change in actual balance:							
of which change in:							
- Cycle	0.5	0.8	0.4	0.1	-4.8	1.8	1.0
- Interest (inverse)	0.2	0.2	0.1	0.2	0.0	0.2	0.1
- One-Offs	0.2	-0.2	0.0	-0.1	0.1	0.0	0.0
- Structural primary balance	-0.4	-0.3	-0.1	-0.4	-3.5	0.3	0.6
Change in structural budget balance	-0.2	-0.1	0.1	-0.2	-3.5	0.5	0.7
Public debt (% GDP)	92.2	89.7	87.7	85.9	101.7	102.3	102.6

Note: contributions to change in actual balance may not add up to total due to rounding.

Source: European Commission 2020 Autumn Forecast, Ameco.

⁴⁴ The figure refers to the available public guarantee framework, i.e. the maximum public funds that would be committed if all of the available guarantees were taken-up.

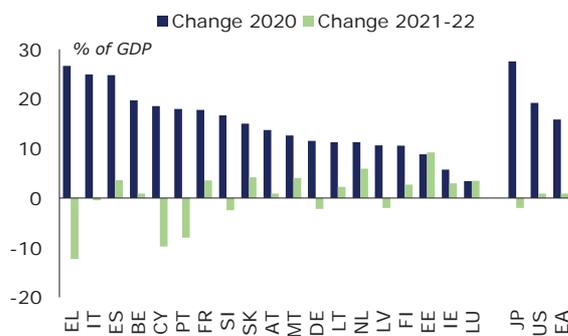
⁴⁵ See 2020 Autumn Economic Forecast.

⁴⁶ These measures are assumed to be phased out gradually in the course of 2021 under a no-policy-change assumption.

The fiscal stance in 2021 is expected to remain supportive at both euro area and national level. Given the current high level of uncertainty, withdrawing fiscal support too early is a primary source of concern, as it could put the still-fragile recovery in jeopardy. The estimated decline in the structural primary deficit of around ½% of GDP in 2021 reflects the phasing out of temporary support measures introduced in 2020 (Table 2).⁴⁷ After excluding the emergency measures, the underlying fiscal stance would appear to remain supportive in 2021, also thanks to measures announced in the 2021 draft budgetary plans. In addition, the implementation of Recovery and Resilience Plans, which is only partially reflected in the Autumn 2020 Forecast, should contribute to a more supportive fiscal stance in the euro area in 2021.

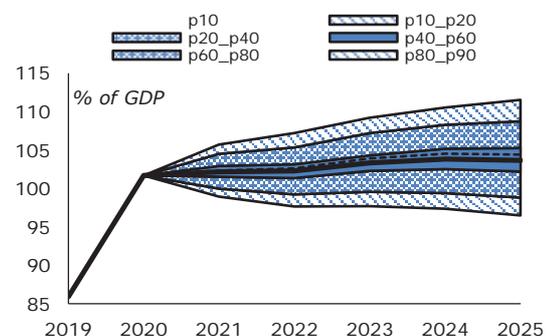
A significant deterioration of the debt-to-GDP positions is also projected in line with what is foreseen in other major advanced economies (Graph 15). The euro area debt-to-GDP ratio is forecast to increase by 16 % of GDP, compared to 2019, to just above 100% of GDP in 2020 (Graph 16) and to remain around this level by 2022. Overall, the primary deficit will continue to weigh on debt dynamics in 2021 and 2022, but a favourable interest rate-growth differential should help contain the projected increase. In line with the increase in the debt-to-GDP ratio, government gross financing needs (GFN) in the euro area are estimated to reach to around 25% of GDP in 2020 (against less than 15% of GDP in 2019). This rise stems mainly from large new financing requirements (i.e. widened budgetary deficits), which compound with the need to rollover accumulated debt. They are expected to decrease below 20% of GDP by 2022.

Graph 15: Changes in the debt-to-GDP ratio, in the euro area and other advanced economies



Source: European Commission.

Graph 16: Debt-to-GDP projections in the euro area



Source: European Commission.

Overall, the debt sustainability assessment suggests that the debt position remains sustainable over the medium-term, notwithstanding risks and significant uncertainty. The debt-to-GDP ratio in the euro area is expected to stabilise (Graph 16) over the medium term as the impact of the COVID-19 crisis on public finances gradually unwinds.⁴⁸ However,

⁴⁷ The gradual withdrawal of the temporary emergency measures is expected, assuming that the pandemic wanes and the negative economic impact of containment measures tapers off. At the same time, these temporary emergency measures distort the traditional fiscal indicators of the fiscal stance.

⁴⁸ The 2020-22 Commission baseline incorporates fiscal policy measures (adopted or at least credibility announced) and information as of 22 October 2020. Starting in 2023, countries are generally assumed to

there is significant uncertainty over this projection given the unprecedented nature of the crisis and uncertainty about its future evolution, notably the duration of social distancing measures and the strength of the recovery. According to stochastic simulations (Graph 16), the debt-to-GDP ratio is expected to stand between more than 95% and 110% of GDP by 2025 with an 80% probability. Relatedly, contingent liability risks may arise from the private sector, via the possible materialisation of government guarantees put in place to support firms and self-employed, representing about 20% of GDP in 2020 (according to Autumn 2020 estimates). On the other hand, several mitigating factors exist including the lengthening of debt maturities in recent years, relatively stable financing sources, historically low borrowing costs, and EU initiatives such as the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) and, importantly, the Recovery and Resilience Facility (RRF).

The European Recovery and Resilience Facility (RRF) is expected to support debt dynamics.⁴⁹ The provision of EU grants under the RRF should allow fiscal stimulus without raising national debt in the medium-term, with this effect being more pronounced for the highly-indebted countries and/or countries receiving a relatively larger amount of funds. The overall impact will depend on several factors such as the composition of public spending financed by these funds, the (strength/persistence of) fiscal multiplier effects on growth, and the degree of additionality of the funds received (versus other sources of financing). In addition, RRF loans are expected to present attractive funding conditions for most Member States and in particular those more affected by the crisis.

2.2 Expenditure Policy

The crisis has significantly impacted public expenditures across the euro area, placing considerable strains on Member States' public finances. The large part of the increase in expenditures has been directed to support economies and citizens, as public support has been extended to keep businesses and households afloat (see Box 2). Going forward, Member States plan to phase out temporary support measures to firms and households, when the epidemiological and economic conditions allow and to plan this in a way that mitigates the social and labour-market impact of the crisis, while, at the same time, aiming at achieving prudent medium-term fiscal positions.

In a moment of unprecedented fiscal expansion, improving the composition of national budgets appears particularly relevant. Moreover, the quality and efficiency of public finances also play an important role. In order to create fiscal space, expenditure reviews are utilised across Member States to rationalise public spending and direct it to areas, and

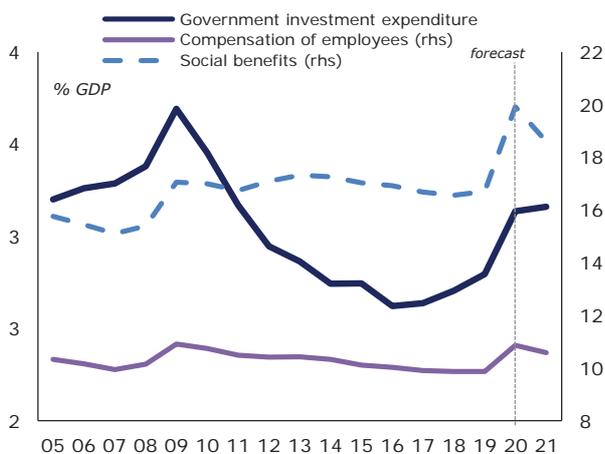
gradually adjust their structural primary balance to return to the level that was forecasted for year 2021 in the (pre-pandemic) Commission 2019 Autumn Forecast. In order to avoid an unrealistic fiscal path, the yearly adjustment of the structural primary balance is capped at 0.6 % of GDP.

⁴⁹ Given the limited information on the use of RRF, the approach to its incorporation in the 2020 Autumn Forecast, and thus in the figures reported in the document, is based on technical assumptions. In particular, the forecast only incorporates those measures that are credibly announced and sufficiently detailed in the draft national budgets. Similarly, no financing from the RRF has been included on the revenue side of the budgetary projections (only the pre-financing).

individuals, in greater need. Engaging in spending reviews in large areas of expenditure such as pensions or health can help improve the efficiency of spending while also ensuring the long-term sustainability of public finances. Public procurement of goods and services amounted to some 14% of GDP in 2019.⁵⁰ However, according to the Single Market Scoreboard, there are still large differences between Member States in terms of public authorities' performance in getting the best value for money in their purchases.⁵¹ The efficiency of public procurement systems is especially important in this recovery process and successful twin green and digital transitions. In addition, efficient investments can also strengthen health systems. The COVID-19 crisis provided evidence that health systems in Member States were not adequately prepared to face this challenge due to a number of structural weaknesses and a lack of resources (facilities, staff and supplies). Resilient, adequately resourced, efficient and accessible health systems can safeguard better the health of the population, which is fundamental to a well-performing economy.

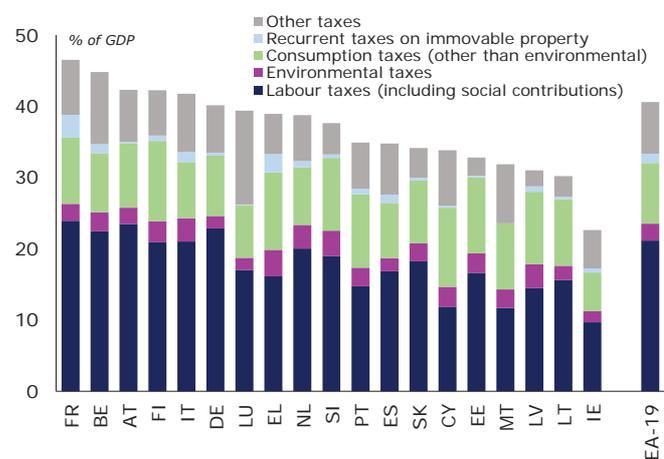
Public investment, which has remained stagnant in net terms for the good part of the last decade, is forecast to increase to some 3-3/4% of GDP in 2021 on the back of decisive policy responses by Member States. This would represent a marked break with the past when public investment was slashed in economic downturns (Graph 17).

Graph 17: Government expenditure, euro area



Source: European Commission 2020 Autumn Forecast, Ameco, European Commission, Taxation trends in the European Union, 2020.

Graph 18: Structure of taxation by economic function of the tax base (2018)



Note: "other taxes" includes all taxes that are not labour, consumption, environmental, or recurrent property taxes (e.g., capital taxes such as on corporate income, capital gains or inheritances). Labour taxes includes employers' and employees' social contributions
Source: European Commission 2020 Autumn Forecast, Ameco, European Commission, Taxation trends in the European Union, 2020.

The Recovery and Resilience Facility and the EU budget has the potential to boost Member States' efforts towards a sustained recovery of investment in the medium term.

⁵⁰ On this see COM(2017) 572, Making Public Procurement work in and for Europe.

⁵¹ The quality of procurement data submitted to TED (Tenders Electronic Daily) and an early adoption of eForms in their broad scope (including voluntary fields) are instrumental to achieve successful twin green and digital transitions. See "Single Market Scoreboard: Performance per policy area – Public Procurement", https://ec.europa.eu/internal_market/scoreboard/performance_per_policy_area/public_procurement/index_en.htm.

Public investment can support the recovery and can also help to address long-term challenges. For example, substantial and coordinated public investments are needed to deliver on the Union's climate objectives, in both adaptation and mitigation, as well as compensatory measures to support those most negatively affected by the transition. In this context, 'green budgeting' tools can help address the challenges of climate mitigation and environmental protection.⁵² Similarly, investments in skills and in improving the digital environment will contribute to the digitalisation of euro area economies and public administration, as well as supporting citizens in adapting to a changing working environment, favouring the reallocation to new growth sectors.

2.3 Revenue Policy

Lower potential growth combined with higher debt makes the role of revenue policies even more crucial. The COVID-19 crisis and the consequent slowdown in economic activity are expected to lead to a fall in the level of total receipts in 2020 in line with the contraction in GDP (Table 2). Incomes have declined, consumption has contracted and some firms are expected to incur large losses thus leading to a significant decline in corporate tax receipts putting a strain on public revenues. Moreover, the VAT Gap⁵³ is projected to increase further in 2020⁵⁴, also due to a sudden decline in the tax base and the possible increase in tax fraud in some sectors of the economy. Finally, tax measures have also been one of the tools used by Member States to respond to the peak of the crisis (Box 1) with the primary aim to lower the pressure on companies' and households' liquidity.

Notwithstanding the challenges arising from the crisis and the immediate pressure on revenue, there is still scope to make tax systems more growth- and environment-friendly going forward. The tax burden in the euro area (at 40.5% of GDP) remains high, and above other advanced economies. Moreover, the overall tax burden is largely skewed towards labour and production factors, with more growth-friendly environmental taxes representing a very small share of tax revenues⁵⁵ (Table 3 and Graph 18). The tax wedge on labour in the majority of euro area Member States remains much higher than the OECD average, corresponding to around 36% of labour costs.⁵⁶ Reducing employee/employer social security contributions or personal income taxes has the potential to stimulate labour supply, create work incentives and support job creation.

⁵² A recent review conducted by the Commission pointed to a limited use of green budgeting practices across Member States, with a variety of different approaches. For more detail, see "Development in Public Finances in the EMU", Report on Public Finances in the EMU 2019 (2020).

⁵³ The VAT Gap is the difference between the expected VAT revenues and VAT actually collected.

⁵⁴ Study and Reports on the VAT Gap in the EU-28 Member States (2020) Final Report www.ec.europa.eu/taxation_customs/sites/taxation/files/vat-gap-full-report-2020_en.pdf.

⁵⁵ Environmental taxes could have a long-lasting positive impact on growth and reduction of negative externalities although they may disproportionately affect low-income individuals, due to increase in prices of basic goods, including heating and electricity.

⁵⁶ For more details, see 2021 Joint Employment Report (2020) and "Tax wedge on labour: shifting tax burden from labour to other forms of taxation", Technical Note for the Eurogroup, ARES (2020).

Table 3. Characteristics of Tax Categories

Tax category	Less detrimental to growth	Distributional impact	Tax governance
Corporate taxes	-	+	-
Capital income taxes	-	+	-
Labour taxes	-	+	+/-
Inheritance and gift taxes	+	+	-
Recurrent property taxes	+	+/-	+
Consumption taxes	+	-	+
Environmental taxes	+	-	+

Note: Tax governance includes tax administration, including tax collection and compliance.

Source: European Commission, Tax policies in the European Union, 2020 Survey; Tax Wedge On Labour: Shifting Tax Burden From Labour. To Other Forms Of Taxation; Technical note for the Eurogroup.

Rethinking the overall tax mix, including labour taxation, and ensuring a level-playing field could support inclusive and sustainable growth. In the current context, redistribution of tax would also ensure a fair burden-sharing of the effects of the crisis. High tax burden on labour, particularly for low-income and second earners, can be an impediment for job creation and labour market participation. At the same time, environmental taxation⁵⁷ can contribute to sustainable growth by incentivising “greener” behaviour by producers and consumers⁵⁸ although they could have adverse distributional effects, by putting a comparatively higher burden on lower-income households, compensation mechanisms may be warranted.⁵⁹

In addition to the risks to the revenue linked to the COVID-19 crisis, tax competition and a race to the bottom in corporate taxation poses several challenges for the euro area. The average euro area top statutory corporate tax rate has been falling steadily in the last two decades, from 27.8% in 2004 to 23.4% in 2020.⁶⁰ Furthermore, corporate taxation systems currently do not ensure that profits are taxed where they are generated, particularly given the increasing digitalisation of the economy. The resulting tax competition can lead to sub-optimal results in terms of resource allocation and investment decisions, while posing problems for economic growth, social fairness and the allocation of employment. Together with tax avoidance, it also risks undermining faith in the fairness of the overall tax system. Recent studies find that tax competition among corporates entails more than EUR 35 billion of corporate tax revenues losses across the EU, annually.⁶¹ Race to the bottom and aggressive

⁵⁷ The share of environmental taxes in total revenues is still well below the 10% 2020 target. See EU Flagship Initiative for a Resource-Efficient Europe.

⁵⁸ See Meyermans, E., et al., “Shifting taxes away from labour to strengthen growth in the euro area”, Quarterly Report on the Euro Area (QREA), Vol. 19, No. 1 (2020)/19 and European Green Deal.

⁵⁹ European Commission (2020), ‘Employment and Social Developments in Europe 2020’.

⁶⁰ “Taxation Trends in the European Union, 2020 edition”, Directorate-General for Taxation and Customs Union, European Commission.

⁶¹ Álvarez-Martínez, M. et al., 2018. How Large is the Corporate Tax Base Erosion and Profit Shifting? A General Equilibrium Approach. *CEPR Discussion Papers 12637* and Tørsløv, T., Wier, L. & Zucman, G., 2018. The Missing Profits of Nations. *NBER Working Paper 24701*. An analysis commissioned by the European Parliament finds that the revenue loss from profit shifting within the EU amounts to about EUR 50-70 billion.

tax planning could also create strong negative spillovers within euro area Member States, through the tax-induced redistribution effects.⁶²

In the context of a growing digital economy, there is evidence that companies with digital business models have lower tax rates than more traditional businesses highlighting concerns around the degree of fairness of the tax system. While it is an internationally agreed principle that profits should be taxed where value is created⁶³, the globalisation and digitalisation of the economy have created a disconnect between where value is created and where taxes are paid, and companies engaged in digital activities often avoid sharing the tax burden needed to finance the public services. In the context of its proposal on the digital service tax, the European Commission had estimated that companies with digital business models had lower tax rate than more traditional businesses, with an effective average tax rate of 9.5% compared to 23.2%.⁶⁴ While a number of jurisdictions have already enacted or considered national services taxes, work is ongoing within the OECD framework to reach a global-consensus based solution to address tax challenges arising from the digitalisation of the economy.⁶⁵ The pandemic has also accelerated the shift towards e-commerce, making it more urgent to make the EU VAT system better suited to the platform economy.⁶⁶

3. Structural issues and reform developments

Well-designed structural policies - consistent with the green and digital transitions - can further support the recovery, enhance economic and social resilience and facilitate the transmission of monetary policy. In recent years, progress in reform implementation has been limited despite efforts to strengthen application through the European Semester. New model simulations provide further evidence on the effects of labour and product market reforms, in terms of material growth benefits over the medium term (Box 2).

BOX 2: Simulation of Policy Mix based on the QUEST model

Along with monetary and fiscal support provided by Member States, structural reforms can ensure a lasting recovery and sustainable growth prospects in the euro area. The Recovery and Resilience Facility provides an opportunity to

⁶² In order to ensure a lasting, efficient and fair approach for international taxation, a number of initiatives have been put in place at the euro area and international levels to ensure fair taxation across countries. Among these, the EU Anti Tax Avoidance Package (2016); the Union list of non-cooperative jurisdictions for tax purposes; the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

⁶³ OECD/G20 Base Erosion and Profit Shifting Project (2013).

⁶⁴ For more details, see “Commission Staff Working Document- Impact Assessment- Accompanying the document Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services”, SWD (2018) 81 final, 21 March 2018.

⁶⁵ Communiqué of G20 Finance Ministers & Central Bank Governors Meeting, 14 October 2020.

⁶⁶ See EU Commission (2020) “Fair and simple taxation” https://ec.europa.eu/taxation_customs/general-information-taxation/eu-tax-policy-strategy/package-fair-and-simple-taxation_en.

undertake needed structural reforms that could have significant growth benefits, as shown in this box that uses DG ECFIN's structural macro model QUEST⁶⁷ to assess the GDP impact of a set of structural reforms included on top of baseline monetary and fiscal support. The simulations illustrate that labour and product market reforms could have material growth benefits over the medium term. The model analysis reflects the following assumptions for the simulated product and labour market reforms:

- Reforms lowering the administrative burden⁶⁸ implying a 2 percentage-point mark-up reduction in the euro area economy together with 0.5% improvement in the level of TFP.
- A 2 pp increase in labour force participation⁶⁹ over a 10-year horizon.⁷⁰
- Structural reforms in the labour and product market are assumed to kick off in mid-2021, when emergency support by Member States starts waning.
- The labour market component is phased in over 20 years, whereas the product market component materialises fully after 5 years.

Most notable results of the simulations (expressed as a deviation from a baseline) are the following (Graph 19):

- Labour and product market reforms start to kick-in by 2021. The growth benefits of these reforms are already visible in the same year, even if only a small part of the associated supply expansion will have materialized at that point. The reforms will take effect only gradually in the scenario; nonetheless, once their effects become more pronounced, structural reforms have a positive effect on GDP in the medium term. Specifically, by 2029 the projected level of GDP is 4.5% higher than in the baseline scenario.
- Structural reforms can add 0.5 percentage points to yearly GDP growth over the decade on average, which appears particularly significant considering the low potential GDP growth prior to the COVID-19 crisis.
- Strengthened product market competition can reduce the profit margins of individual firms and increase efficiency through new entrants in the market. Both elements have positive effects on the level of GDP. Increasing labour force participation through reforms would furthermore translate into a 2% increase in employment (as measured by hours worked) by 2029. Similarly, consumption would benefit from an increase in the participation rate, through higher disposable income.
- In the long-run, even partially closing the gap in terms of structural reforms towards best performing countries could also have significant positive effects

⁶⁷ See Burgert et al. (2020), 'A Global Economy Version of QUEST: Simulation Properties', European Economy Discussion Paper 126.

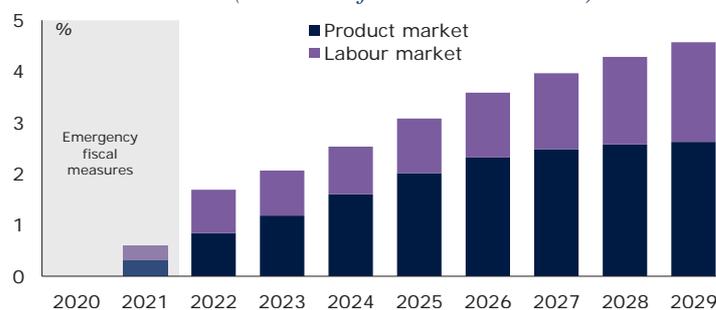
⁶⁸ For instance, policies including product market reforms, reforms to improve the business environment and the justice systems.

⁶⁹ Depending on Member States, there could be different reforms leading to such increase in labour force participation, including reducing early retirement schemes, increasing the provision of child care, strengthening active labour market policies and training/education to improve employability.

⁷⁰ The size of the assumed product and labour market reforms on GDP is purely illustrative, but orders of magnitude are informed by the scope for reforms as measured by halving the performance gap between the euro area average and the best performing EU Member States.

on convergence within the euro area, as the effects may be concentrated in areas and countries lagging behind.

Graph 19: Impact of product and labour market reforms on the level of euro area real GDP (deviation from baseline level)



Source: European Commission.

There are several areas where structural and institutional factors continue hindering growth in the euro area and where wide-ranging reforms could support the euro area objectives of promoting convergence and the functioning of the single currency area while supporting a fair, green and digital recovery.⁷¹ The remaining of this section discusses structural weaknesses and reforms in the following areas:

- i) Single market integration;
- ii) Labour markets and social protection;
- iii) Labour market skills for the digital and green transition;
- iv) Insolvency frameworks;
- v) Administrative and absorption capacity and other drivers of institutional quality;
- vi) Risks of macroeconomic imbalances.

3.1. Single market integration

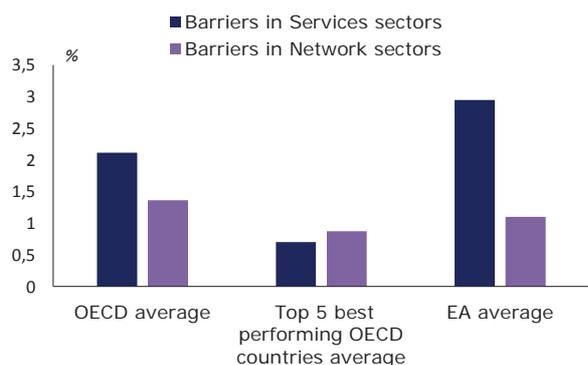
The common currency and the single market have been working in tandem to create better conditions for economic stabilisation and long-term growth. The euro's very rationale has been to facilitate the functioning of the single market. In turn, the single market has the potential to diminish price rigidities that undermine both the monetary policy transmission mechanism and economic resilience in the euro area. Thanks to the single market, the mobility of production factors can allow sectors and regions to limit economic costs (e.g., unemployment) in response to shocks. The deeper integration of financial markets in the euro area can notably enable further risk-sharing (see section 5). At the same time,

⁷¹ The importance of future-proofing the euro area economy through embracing the green and digital transitions is recognised and discussed widely in a number of European Commission documents, including in the Strategic Foresight report on Future-proofing the EU; the documentation on the European Green Deal; the Annual Sustainable Growth Strategy 2021; and the documentation on the Recovery and Resilience Facility.

competitive sustainability requires openness and strong Single Market.⁷² In the longer term, the single market favours exports, investment, innovation and productivity.⁷³

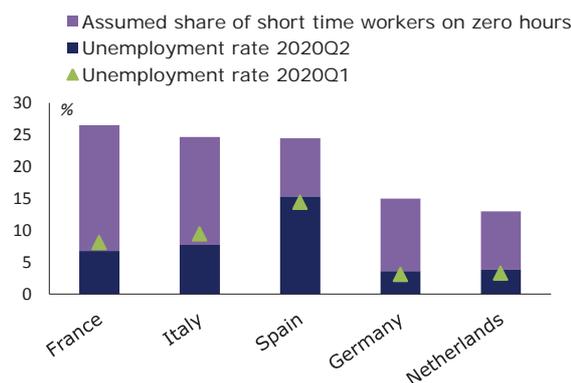
The single market has not fulfilled its full potential yet.⁷⁴ In fact, the European Commission⁷⁵ estimated that, while the share of trade within the single market amounts to about 8-9% of EU GDP, further integration could increase this share to around 12% of GDP.

Graph 20: Product market regulation and barriers in services and network sectors in 2018



Note: The coded information is normalised over a zero to six scale, where a lower value reflects a more competition-friendly regulatory stance. EA-19 average based on population shares. Services sectors include: retail trade, taxis and professions (lawyers, notaries, accountants, architects, civil engineers, estate agents). Network sectors include: energy, transport and e-communications. Source: OECD.

Graph 21: Unemployment rate and share of workers in job retention schemes



Note: The share of short-time workers on zero-hours is assumed to be the half of workers in short-time work scheme (based on the number of applications sent up to the beginning of May 2020). Source: Eurostat and Staff's calculations based on data collected from national institutions and provided by Müller and Schulten (2020), "Ensuring fair short-time work - a European overview", ETUI Policy Brief.

The euro area is relatively at par with other OECD countries when it comes to product market regulation at large, but some barriers persist in services. The euro area fares way below the OECD average with regards to the removal of barriers in services (retail trade and professional services), while it lags behind the best OECD performers in network industries (Graph 20). Persisting barriers have affected negatively intra-EU trade flows both in the goods and the services sectors.⁷⁶ At the same time, the catalyst role played by the pandemic to boost digital usage is likely to benefit digital services sectors and more largely the digital single market. The pandemic, for instance, has had a direct impact on the euro mode of payments as it has accelerated the use of digital and cashless payment methods.⁷⁷

⁷² See for instance COM(2020) 575 final, "Annual Sustainable Growth Strategy 2021".

⁷³ See for instance COM(2018) 772 final, "The Single Market in a changing world. A unique asset in need of renewed political commitment" or London Economics and PwC, (2013), "The cost of non-Europe: the untapped potential of the European Single Market", Final Report, London/Luxembourg.

⁷⁴ For more details, see COM(2020) 93 final, "Identifying and addressing barriers to the Single Market", 22 November 2018.

⁷⁵ For more details, see COM(2020) 94 final, "Long term action plan for better implementation and enforcement of single market rules.", 10 March 2020.

⁷⁶ For more details, see SWD (2019) 444 final, "Single Market Performance Report 2019", 17 December 2019.

⁷⁷ See, for instance, Keynote speech by Fabio Panetta, "On the edge of a new frontier: European payments in the digital age" 22 October 2020.

3.2. Labour markets and social protection

The COVID-19 crisis has had a major impact on labour markets and social conditions.

The recent crisis has triggered a reversal of the employment gains experienced over the past seven years (see Section 1) and contributed to further divergences in labour market indicators. The effect on labour markets have been particularly strong for young workers, due to their relatively higher representation in sectors more affected by the crisis (e.g., tourism), to the widespread presence of precarious forms of contracts, and difficulties entering the labour market. The crisis has also particularly hit sectors with a high share of minimum wage earners and it is likely to have a stronger impact on disadvantaged workers.⁷⁸ Measures taken by Member States⁷⁹, among others, to support job retention, protect incomes and provide liquidity to affected firms, helped workers and households to cope with the crisis, limiting its social consequences and improving the work-life balance in face of mobility restrictions.^{80,81} A number of policies can contribute to ensuring that the social, employment and economic impact of the crisis is mitigated. The role of social dialogue is key in the design and implementation of these policies, including for minimum wages.⁸²

The extensive use of short-time work schemes has so far contained the rise in unemployment that would otherwise have resulted from the sharp economic contraction (see Graph 21 and comparative data in Section 1). Building on positive experience from short-time work schemes in some countries during the Global Financial Crisis, euro area countries have quickly reacted by adjusting and expanding their schemes, or creating new ones.⁸³ Recently, few Member States have started scaling back emergency measures, while others have prolonged or adapted them. These adaptations are meant to target the relevant sectors of the economy without hindering the reallocation of human capital to other sectors of the economy with better growth prospects. Several Member States have adopted measures to increase employee retention and support labour demand by expanding hiring incentives.

⁷⁸ The role of minimum wages in protecting low-wage workers has thus become increasingly important. Cf. Commission proposal for a Directive of the European Parliament and of the Council on adequate minimum wages in the European Union (COM(2020) 682 final) and Impact Assessment (SWD(2020) 245 final).

⁷⁹ Within the European Semester, the 2020 Country Specific Recommendations and the 2020 Employment Guidelines called on Member States to ensure that the social, employment and economic impact of the COVID-19 crisis is mitigated.

⁸⁰ European Commission. Directorate General for Employment, Social Affairs and Inclusion. “Employment and Social Developments in Europe 2020”. (Publications Office 2020). <https://ec.europa.eu/social/main.jsp?catId=738&langId=en&pubId=8342&furtherPubs=yes>.

⁸¹ The Commission’s proposal for a Joint Employment Report 2021 provides detailed evidence on recent employment and social trends, as well as on measures taken by Member States.

⁸² This has recently been highlighted in the Commission proposal for a Directive of the European Parliament and of the Council on adequate minimum wages in the European Union (COM(2020) 682 final). The proposed Directive aims among others at strengthening the involvement of social partners in statutory minimum wage setting and updating, as well as promoting collective bargaining on wage setting. Moreover, Member States may entrust the social partners with the implementation of the proposed Directive.

⁸³ For earlier studies on the positive effects on variability of employment of short-time work schemes, during the Global Financial Crisis, see Arpaia et al (2010), “Short time working arrangements as response to cyclical fluctuations”, European Economy, Occasional paper 64 | June 2010.

Despite large improvements in participation rates and employment during the pre-COVID-19 expansion phase, labour markets in euro area countries suffer from a number of structural weaknesses that have been aggravated by the current crisis. Considerable differences across Member States and categories of workers still persist: gender gaps are wide, both in terms of employment as well as activity rates and earnings, with women earning close to 15% less than men in 2018 and youth unemployment remains persistently high (at 15.6% in 2019, further reaching 16.5% in Q2-2020)); the share of young not in employment, education or training (NEET) remains also persistently high, even though it was decreasing at a relatively fast pace before the crisis. These gaps are widening for particular segments of the labour force such as the youth and third-country workers. In this context, the need to tackle a surge in the number of job-seekers and support their reallocation across occupations or sectors requires effective labour market policies, as well strengthening Public Employment Services (PES) to go beyond traditional ways of working.

The crisis will have a significant impact on social conditions, in particular for vulnerable groups. Those already vulnerable prior to the crisis (such as low paid workers, the low-skilled, workers on temporary contracts, the involuntary part-time and self-employed, and migrant workers) are likely to be hit hardest, also now through unequal access to digital infrastructure and skills. Some groups in particular families with children, the long-term unemployed, people with disabilities, migrants and persons with a migrant background and Roma are relatively more exposed. While decreasing overall, temporary and involuntary part-time jobs remain high in some euro area countries, which contributes to entrenched labour market precariousness and, ultimately, higher risks of poverty and social exclusion.

The COVID-19 crisis is likely to increase inequality in the euro area, following years of steady improvement in social conditions and living standards of households.⁸⁴ By 2019, some 7 million fewer people were living at risk of poverty or social exclusion compared with the 2012 peak. Real GDP per capita increased in all Member States and disposable income inequality has been fairly stable on average, at least until 2018. However, inequality levels are different across Member States and their trends have varied over recent years. Moreover, in the last decades, low wages have not kept up with other trends thus affecting in-work poverty, wage inequality, and the capacity of low-wage earners to cope with economic distress.⁸⁵ Labour related income losses caused by the COVID-19 outbreak, together with the difficulty for welfare transfers to reach all households promptly, may pose serious risks to living conditions of low-income households.

⁸⁴ For more on the social dimension of the impact of the COVID-19 crisis see also the annual European Commission. Directorate General for Employment, Social Affairs and Inclusion. “Employment and Social Developments in Europe 2020” (Publications Office 2020).

⁸⁵ Cf. Impact Assessment accompanying the Commission proposal for a Directive of the European Parliament and of the Council on adequate minimum wages in the European Union, SWD(2020) 245 final.

3.3. Labour market skills for the digital and green transitions

Employment opportunities and working conditions are increasingly tied to workers' skills levels as measured by degree of education. People with higher degree of education tend to have higher activity and employment rates and lower unemployment rates (Graph 22). Across the euro area, the unemployment rate is much higher among low-skilled individuals than among high skilled ones (13.2% against 4.8% in the second quarter of 2020), while participation rates also correlate positively with skills. Better skilled workers tend to earn higher wages, which helps in the light of rising dependency ratios.

The COVID-19 crisis has highlighted the importance of skills and adaptation to new challenges. Workers constantly need new skills, including digital, to navigate the labour market, to move across sectors and tap job opportunities. At the same time, given the expected demographic trends, as well as the twin transitions, the euro area (and EU as a whole) may experience significant skill shortages, which need to be addressed to ensure the necessary labour supply. In addition, with the widespread use of digital technologies across all economic sectors, higher levels of digital skills related to specific technologies such as cybersecurity or artificial intelligence will be necessary for professionals in different areas. In order to reinforce workforce skills, the European Skills Agenda and the Communication on the European Education Area set a number of actions to be followed and several objectives to be fulfilled by 2025, based on well-established quantitative indicators, such as participation in learning opportunities, learning experience for unemployed as well as the share of adults with basic digital skills.⁸⁶ The European Commission's Annual Sustainable Growth Strategy 2021 called for unprecedented investments in re- and upskilling as one of the seven 'European flagships' under the Recovery and Resilience Facility.⁸⁷

Significant digital-skill heterogeneity across the euro area, if not properly addressed by appropriate policies and investments, risks exacerbating further divergences and labour market challenges.⁸⁸ According to the Digital Economy and Society Index (Graph 23), over 2019 the EU countries improved their digital performance in general although the rankings differ amongst countries including for the human capital dimension.⁸⁹ Digitalisation has a distinct impact on labour markets and employment composition, with the risk of worsening job polarisation and skills mismatch.⁹⁰ At the same time, labour supply may benefit from the introduction of online learning technologies, and digital platforms that lower barrier to labour market participation. Digitalisation also contributes to the rise of new work arrangements, thus affecting social protection systems.

⁸⁶ European Skills Agenda for Sustainable Competitiveness, Social Fairness and Resilience (2020).

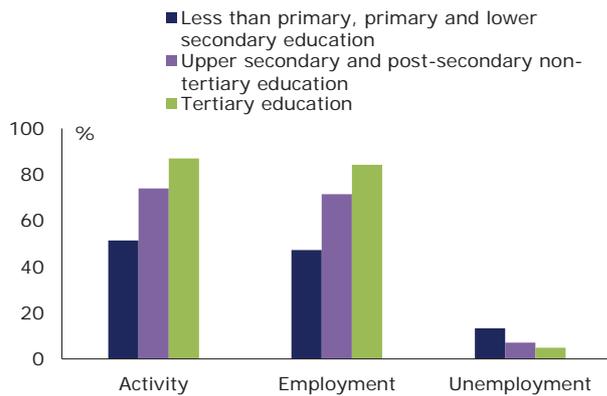
⁸⁷ The 2021 Annual Sustainable Growth Strategy put forward seven flagship initiatives. Those flagships represent common challenges that call for coordinated investments and reforms. These are: (1) Power up, (2) Renovate, (3) Recharge and Refuel, (4) Connect, (5) Modernise, (6) Scale-up, (7) Reskill and upskill.

⁸⁸ For the green and digital transitions, more than just digital skills are required. For more details, see Morandini, M. C., et al., "Facing the Digital Transformation: are Digital Skills Enough?", European Economy, Economic Brief n. 054, June 2020.

⁸⁹ Digital Economy and Society Index, European Commission Digital Scoreboard 2020.

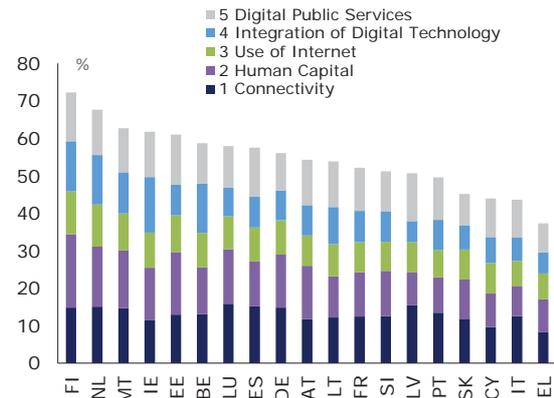
⁹⁰ Petropolus G. et al., "Digitalisation and European welfare states", Bruegel, Blueprint series 30, 2019.

Graph 22: Activity, employment and unemployment rates by educational attainment (2020Q2)



Note: Latest available quarters are 2020Q2 (activity and unemployment) and 2019Q4 (employment). The activity rate is the ratio between the number of active persons (occupied labour force and the unemployed) and the corresponding total population.
Source: Eurostat.

Graph 23: The Digital Economy and Society Index in the euro area, 2020



Note: The DESI2020 ranking is calculated based on EU 28 Member States; in the chart, only the results of euro area countries are included.
Source: European Commission.

The green transition is also an increasingly important driver of labour demand and skills supply across all sectors, as the shift implies structural changes across sectors and occupations. While the impact of the greening of the economy and employment can be expected to take the form of new green skills within existing occupations as well as the creation of new jobs⁹¹ in areas such as clean energy, there is still lack of capacity and investments in green skills.⁹² At the same time, the green transition is expected to have socio-economic consequences for workers employed in transition industries, which may need re-skilling and up-skilling. The Commission initiatives like the Just Transition Mechanism aim to help address these needs.

3.4. Insolvency frameworks

Non-bank insolvency frameworks are important for euro area Member States resilience to shock and to improve risk-sharing within the union. The next phase of the crisis might feature an increase in bankruptcy rates, so it is important that Member States have efficient insolvency frameworks in place, supporting bank lending and economic recoveries while reducing the building-up of non-performing loans (NPLs).⁹³ This is particularly important in a currency union, where the flow of credit within countries and across borders might be more difficult in the absence of other adjustment mechanisms.

General insolvency frameworks differ substantially across countries. Even though based on simplifying assumptions and containing some element of appraisal, World Bank indicators (Graph 24) point to considerable variations across the euro area in terms of length of corporate insolvency proceedings, their cost and outcomes (recovery rates for creditors). The

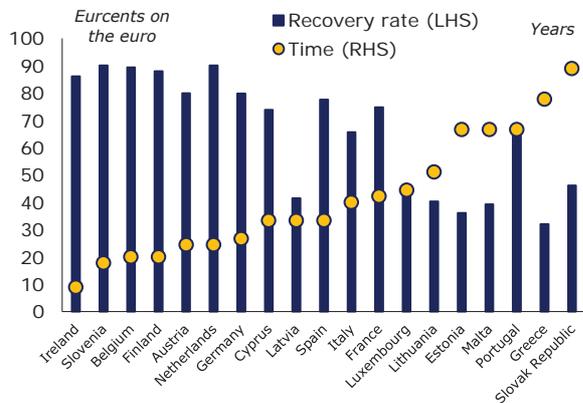
⁹¹ Skills for green jobs: 2018 update. European synthesis report.

⁹² European Skills Agenda for Sustainable Competitiveness, Social Fairness and Resilience includes specific actions to support the twin transition.

⁹³ Ari, A., Chen, S. and Ratnovski, R., “COVID-19 and non-performing loans: lessons from past crises”, ECB Research Bulletin No 71, 27 May 2020 <https://www.ecb.europa.eu/pub/economic-research/resbull/2020/html/ecb.rb200527~3fe177d27d.en.html>.

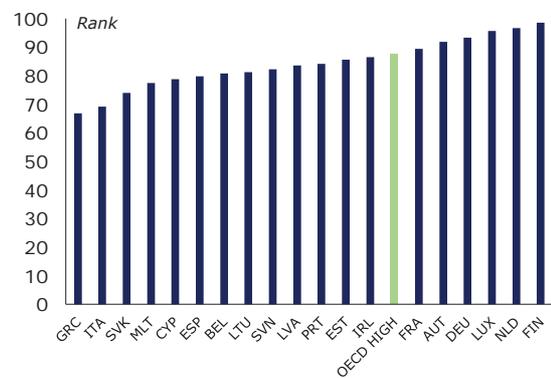
insolvency frameworks differ as a result of distinct societal considerations, legal traditions and financial systems. Although there is no single prescription, a number of broad principles identified in the legal and economic literature⁹⁴ have been translated into best practices.⁹⁵

Graph 24: Efficiency of insolvency frameworks in the euro area



Source: World Bank Doing Business.

Graph 25: Government Effectiveness, euro area and OECD high-income countries, 2019



Source: Worldwide Governance Indicators, World Bank.

The divergence of insolvency frameworks remains an obstacle for cross-border capital flows. Differences in insolvency proceedings contribute to a home bias, as investors shy away from legal risks and costs linked to possible restructuring/insolvency proceedings abroad. Cross-border insolvency proceedings are often inefficient, complex, and expensive, especially for SMEs. It takes about two years on average, with considerable variations between jurisdictions, to resolve a domestic insolvency in the EU. Cross-border proceedings take three years on average and are twice as expensive.⁹⁶

The impact of the COVID-19 crisis may in some countries lead to an increase in bankruptcies, which may in some cases require an adaptation of insolvency frameworks. Despite exceptional measures to contain the impact of the crisis on firms and households, corporate bankruptcies are likely to increase in the coming years in light of a protracted reduction in business activity and profitability. The repayment capacity of households will also be under strain, due to increased joblessness and reduced income prospects. The increase in debt distress may in some cases put a strain on insolvency frameworks in terms of court congestion and a slower than needed workout of bad debt in bank balance sheets. In this context, insolvency frameworks will play a crucial role in the

⁹⁴ See, for instance, Djankov, S., O. Hart, C. McLiesh, and A. Shleifer, "Debt Enforcement around the World", *Journal of Political Economy*, vol. 116, no. 6, 1105-1149, 2008; La Porta, R., Lopez-de-Silanes F., Shleifer A., and Vishny, R. W., "Legal Determinants of External Finance", *Journal of Finance*, vol. 52(3), pp 1131-50, July 1997; Bricongne et al. "Macroeconomic Relevance of Insolvency Frameworks in a High-debt Context: An EU Perspective," *European Economy - Discussion Papers* no. 32, 2016.

⁹⁵ The Eurogroup identified a number of principles including early identification of debt distress and availability of early restructuring procedures. See <https://www.consilium.europa.eu/en/meetings/eurogroup/2016/04/22/>.

⁹⁶ European Commission, Early restructuring and a second chance for entrepreneurs: A modern and streamlined approach to business insolvency, June 2019, https://ec.europa.eu/info/sites/info/files/factsheet_-_a_modern_and_streamlined_approach_to_business_insolvency.pdf.

process of supporting viable firms undergoing temporary problems and providing for the orderly exit of non-viable firms.

The European Commission has emphasised the need for insolvency framework reforms in economic surveillance, and has taken several initiatives to foster best practices.⁹⁷

- In 2019, the **Restructuring and Second Chance Directive** was adopted to promote early restructuring and a second chance for entrepreneurs.⁹⁸ The aim of the directive is to introduce minimum standards among EU Member States for preventive restructuring frameworks available to debtors in financial difficulty and for procedures leading to a discharge of debts incurred by over-indebted entrepreneurs, as well as to provide measures to increase the efficiency of all types of insolvency procedures.
- In the **new action plan on Capital Markets Union**, the European Commission has announced measures to make the outcome of cross border investment more predictable as regard insolvency proceedings. Bearing in mind that different institutional settings – which do not only pertain specifically to insolvency regulation (e.g. efficiency of judicial systems or foreclosure legislation) – affect insolvency outcomes, harmonisation of certain targeted areas of national insolvency rules or their convergence could enhance legal and financial certainty, as well as would facilitate cross-border financial operations in European capital markets. The European Commission will take a legislative or non-legislative initiative for minimum harmonisation or increased convergence in targeted areas of core non-bank insolvency. The plan also foresees regular monitoring of the effectiveness of national loan enforcement regimes through enhanced data reporting that would allow Member States to benchmark their insolvency regimes against those in other Member States and encourage a strengthening of their regimes.
- The European Commission will publish a **Communication** outlining actions that could be taken at the current juncture, in order to address possibly rising NPLs, with a focus on developing secondary markets for distressed assets and reforms of insolvency and debt recovery frameworks.

3.5. Administrative and absorption capacity and other drivers of institutional quality

The issue of administrative quality will be all the more important as the amount of EU funding some of the euro area Member States will have to absorb in the coming years

⁹⁷ The economic literature offers a number of principles to increase the efficiency of non-bank insolvency frameworks. Insolvency framework should ensure an equitable treatment of creditors on the one hand, and a maximisation of the value of the debtor's assets on the other, including the option to liquidate assets as a going concern. It should ensure the continuity of the economic activity through restructuring when it is possible. It should not dissuade risk-taking and entrepreneurship while protecting creditors against dishonest behaviours, including strategic default. Predictability and effectiveness of proceedings are also key to attract investors for distressed securities and boost the secondary markets for NPLs.

⁹⁸ Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on Restructuring and Insolvency). OJ L 172, 26.6.2019.

will be large. The EU grants for investments and reforms available in the next few years will include the European Structural and Investment Funds and Next Generation EU (including high amounts of Resilience and Recovery Facility grants). For some euro area Member States, notably Greece, Slovakia, Latvia, Lithuania, Estonia and Portugal, the sum of all these funds may well represent more than 2% of GDP in annualised terms. Administratively, this will require careful planning and implementation to ensure that EU outlays are efficiently and timely spent on the ground and in line with a coherent economic, social and environmental strategy.

More broadly, sound institutions and economic structures can enhance economic resilience and long-term growth in the euro area. Most Member States are still lagging behind considerably the best performing countries of the OECD, over the quality of national institutions and the efficiency of economic structures.⁹⁹ In terms of government effectiveness, while a number of euro area countries are among the worldwide best performers, the majority score worse than the average of high-income OECD countries (Graph 25). Against this backdrop, there is a large body of economic literature showing that differences in institutions across countries contribute to cross-country differences in income per capita.¹⁰⁰

Strengthening institutional quality at national level can improve the delivery of structural reforms in the euro area.¹⁰¹ There is evidence that measures that improve the institutional framework bring particularly strong long-term benefits and are a prerequisite for reforms in other areas to be effectively implemented. High-quality institutions, particularly those that ensure the efficient and impartial functioning of public administration including insolvency frameworks, effective justice systems and a high degree of transparency and accountability, are also a prerequisite for reforms in other areas (in particular market regulation) to be effectively implemented and yield their full potential.¹⁰²

Selected features of public administrations and governance play an important role for investments.¹⁰³ Cumbersome bureaucracies may delay the distribution of permits and licenses, thus slowing down investments. Second, corruption, or perception thereof is found to negatively impact the investment climate and on economic growth.¹⁰⁴ Corruption creates uncertainty and it is effectively an added “cost”, which hampers the optimal allocation of resources.¹⁰⁵ In the euro area, there is a positive (unconditional) correlation between a

⁹⁹ “Increasing resilience and long-term growth: the importance of sound institutions and economic structures for euro area countries and EMU”, ECB Economic Bulletin, Issue 5, 2016.

¹⁰⁰ The term institution is construed broadly, to cover a variety of aspects, such as the enforcement of property rights (North, 1973), the rule of law including the system of checks and balances on the executive power (Levy, 2007) and the existence of an efficient public sector (World Competitiveness report, 2015).

¹⁰¹ See 2021 Annual Sustainable Growth Strategy (2020).

¹⁰² Through the new Technical Support Instrument, the European Commission will support Member States in developing and implementing a coherent set of reforms to support the recovery and consolidate strong, long term growth. See <https://www.consilium.europa.eu/en/press/press-releases/2020/07/22/council-agrees-its-position-on-an-instrument-to-support-implementation-of-reforms-for-a-sustainable-recovery/>.

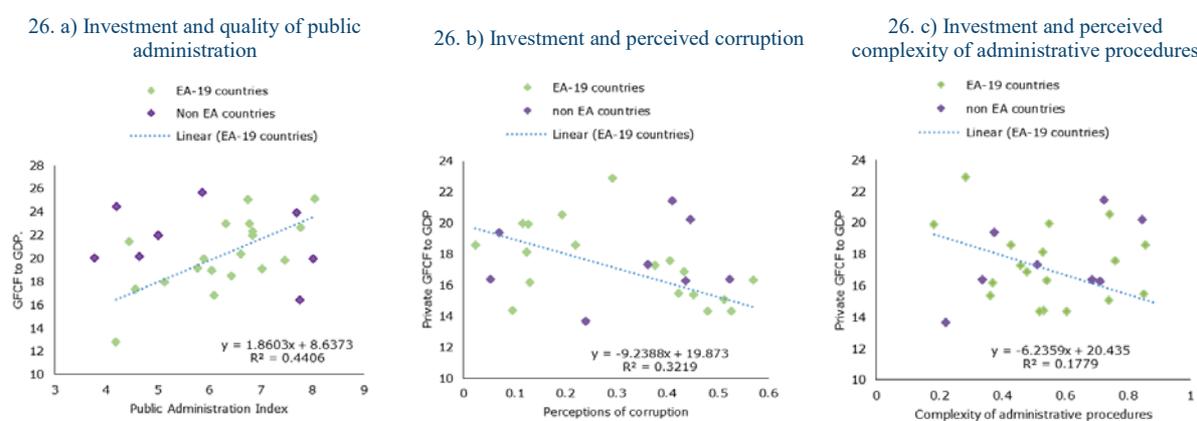
¹⁰³ Investment is construed broadly, to include both tangible and intangible assets (e.g., human capital).

¹⁰⁴ See for example Mauro (1995) who concludes that corruption is found to lower investment, thereby lowering economic growth.

¹⁰⁵ See Global Competitiveness Report (2015-2016) and references therein.

measure of the quality of public administration and the ratio of gross fixed capital formation to GDP (Graph 26a). In addition, investment appears to be also negatively correlated with people's perceptions of corruption (Graph 26b) and with business' perceived complexity of administrative procedures (Graph 26c).¹⁰⁶ Improving the governance structure and building-up the necessary administrative capacity are crucial to provide a regulatory environment conducive to investment. Planning and implementing ambitious investment projects including for the achievement of the green and digital transitions requires specific skills, including the ability to plan and execute strategic investments to steer long-run technological developments.

Graph 26: Relationship between investment and quality of public administration (a), perceived corruption (b) and perceived complexity of administrative procedures (c). EU28 and EA19 countries



Source: European Commission.

Notes: Average gross fixed capital formation to GDP ratio over 2010-2019; EU28 and Euro area-19 countries. PAC: European Commission's public administration composite index, based on (OECD SIGMA, 2017); Average of 2017 and 2019 values. The perception of corruption indicator is taken from the Special EuroBarometer on corruption numbers 79.1, 88.2 and 92.4; The complexity of administrative procedures indicator is taken from the Flash Eurobarometer numbers 428, 457 and 482.

3.6. Risks of macroeconomic imbalances

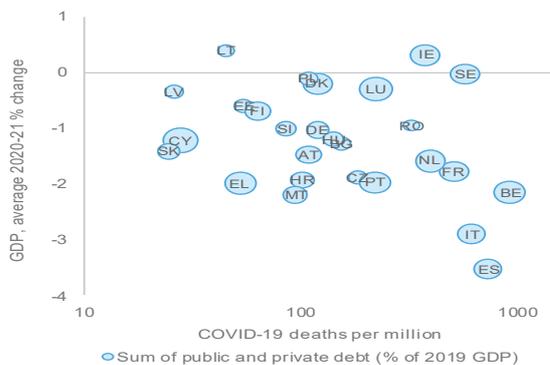
The COVID-19 crisis could further exacerbate existing imbalances across the euro. The impact of the pandemic and the associated recession has generally been stronger in countries already characterised by large stocks of private or public debt (Graph 27). The major drop in incomes in 2020 is expected to be only partially offset in the subsequent years, with nominal GDP remaining below levels observed before the COVID crisis. This automatically implies growing debt-GDP ratios. Both private and public debts will also grow because of missing revenues and increased borrowing needed by corporations and the public sector to cushion the recession. Although the dynamic of household debt shows a relatively contained development, corporate debt is expected to increase considerably across the board in 2020, also on account of liquidity needs.¹⁰⁷

¹⁰⁶ The EIB investment report 2019-2020 highlights that lack of administrative capacity is a major investment barrier. See <https://www.eib.org/en/publications/investment-report-2019>.

¹⁰⁷ On this issue, see 2021 Alert Mechanism Report (2020).

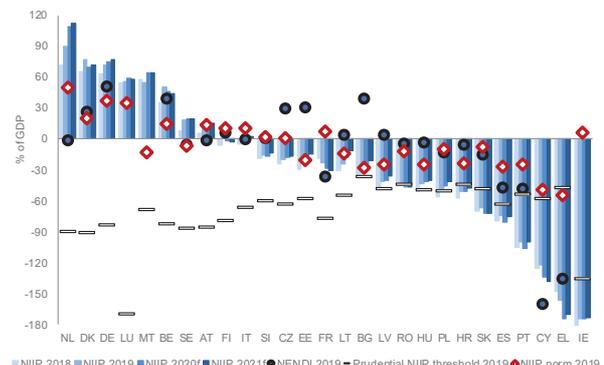
The COVID-19 outbreak is likely to have a negative impact on income prospects for households and corporations, and could translate into debt distress as well as a higher share of non-performing loans. The ensuing deterioration of bank balance sheets could compound the narrow profitability margins in the banking sectors constraining lending to the real economy, which in turn could adversely affect GDP growth, amplifying the initial problems with NPLs (See also 4.1). Furthermore, in a deeply economically-integrated area, elevated NPL ratios may pose cross-borders risks. Market tensions in one country are likely to constrain credit supply and economic growth in the euro area as a whole. These imbalances can hinder the smooth functioning of EMU if not properly addressed. Finally, housing markets also pose a risk going forward following a sustained increase in house prices – including evidence of overvaluation – in many Member States which may lead to downward corrections on the back of falling labour incomes. These downward corrections, especially if taking place in a disorderly fashion, may affect collateral valuation and therefore bank balance sheets distress.¹⁰⁸

Graph 27: Recessions, COVID-19 death toll, and debt



Source: Eurostat, ECDC for COVID-19 deaths

Graph 28: Net international investment positions (NIIP) 2018-2021 and benchmarks in 2019



Source: Eurostat and Commission services calculations.
 Note: NIIP in line with fundamentals (NIIP norms) are obtained as the cumulation over time of current account norms. NIIP prudential thresholds are determined from the maximisation of the signal power in predicting a balance of payment crisis, taking into account country-specific information summarised by per-capita income.

In a number of countries, Net International Investment Positions (NIIPs) remain large and negative and the COVID-19 crisis is likely to halt improvements in recent years (Graph 28). In countries such as Cyprus, Greece, Ireland, and Portugal, NIIPs are beyond the NIIP norms and respective prudential threshold. These four countries, together with Spain, show a strong incidence of debt liabilities in their NIIPs and in 2020, the expected strong decline in GDP will negatively affect their NIIP-to-GDP ratio.¹⁰⁹ Moreover, countries with larger stocks of net external liabilities are more dependent on sectors highly impacted by the crisis, notably tourism.

¹⁰⁸ Although house price growth remained rather sustained (including in early 2020), quarterly data, estimates of price levels from quotations by sellers and model-based house price forecasts point to a softening of housing markets. For more details, see 2021 Alert Mechanism Report (2020).

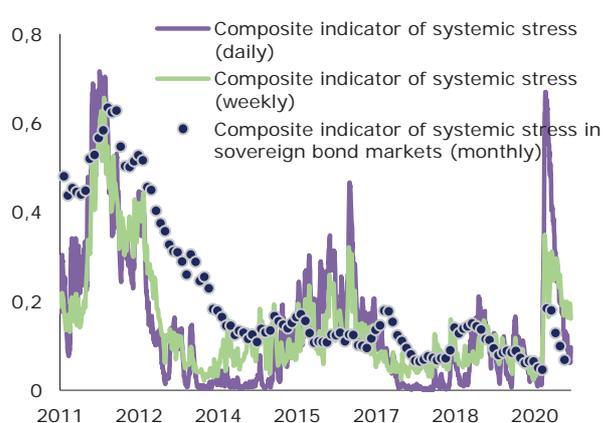
¹⁰⁹ On this issue, see 2021 Alert Mechanism Report (2020).

4. Macro-financial Stability

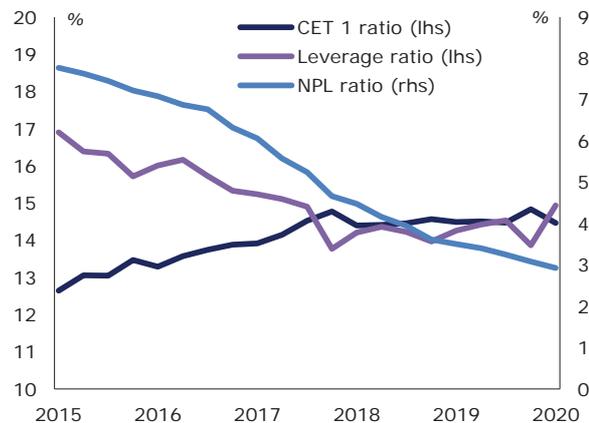
4.1. *Financial market developments*

The economic and financial implications of the pandemic and subsequent containment measures have been muted, following some initial financial market stress. The worsening macroeconomic and earnings outlook led to sharp price corrections in February-March 2020, which were widespread across regions and asset classes and were accompanied by sharp increases of market volatility (Graph 29). Concomitant to the rapid market sell-off, market financing conditions tightened as credit risk premia increased, with euro area non-financial corporates' investment grade bond yields edging up in April to their highest levels since early 2014. The deterioration in corporate bond market liquidity was particularly pronounced in the high-yield segment, as mirrored in a sharp increase in bid-ask spreads to levels above the peak of the Global Financial Crisis. At the same time, liquidity conditions deteriorated in many market segments amid a general flight to liquidity, which initially also affected high-quality asset markets.¹¹⁰ In subsequent months, market conditions have eased and stock markets have recovered much of the initial losses, fueled by decisive governmental and central bank action.

Graph 29: Systemic stress in the euro area



Graph 30: Bank stability indicators



Note (Graph 26): Domestic banking groups and stand-alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches, All institutions.
Source: ECB – CISS database (Graph 25), ECB - CBD2 - Consolidated Banking data (Graph 26).

Euro area banks entered the current crisis with stronger capital levels, better liquidity positions and more stable funding structures compared to the onset of the 2008 Global Financial Crisis, increasing their capacity to absorb potential losses and to maintain lending. Euro area banks' CET1-ratios further strengthened to 14.8% at the end of 2019, which was mainly achieved via retained earnings (Graph 30). Euro area banks' holdings of High Quality Liquid Assets (HQLA) also increased significantly over the past years, mainly

¹¹⁰ For instance, the bid-ask spread for German Bunds more than doubled in March and April, albeit from low levels, while sovereign bond spreads in the euro area increased significantly. At the same time, the Euribor 3m spread over Eonia increased substantially.

on account of larger central bank reserve holdings following the Eurosystem's asset purchases. Meanwhile, euro area banks continued their steady reduction of non-performing loans (NPL) even through the very early stage of the pandemic, with the euro area NPL ratio declining to its lowest level at 2.9% in Q1 2020, compared to 3.6% at the end of 2018.¹¹¹ Some national NPL ratios still remain far apart from the euro area average and continue to require attention. NPL volumes are likely to increase substantially as a result of the coronavirus outbreak, in particular in the Member States and for loans to sectors most affected by the pandemic. However, given the various government guarantee schemes and debt moratoria in combination with the recently announced SSM flexibility regarding the supervisory treatment of NPLs¹¹², such an increase could come with some delay.

The crisis is expected to put further pressure on banks' already low profitability levels.

With the pandemic outbreak, euro area bank valuations saw strong downward pressure in anticipation of the pandemic's effect on banks' balance sheets and their expected profitability¹¹³ (Graph 31). This might impact their intermediation capacity going forward, which is important to maintain in order to support the recovery. On the funding side, banks' bond funding costs increased at the outset of the pandemic, in particular for riskier instruments such as unsecured and contingent convertible bonds, but have moderated again somewhat in subsequent months. Both unsecured and secured interbank markets overall showed resilience during the market turbulences, in particular when compared to the Global Financial Crisis. Swift and sizeable central bank interventions such as additional refinancing operations and net asset purchases significantly contributed to that. Consequently, short-term funding remained ample for euro area banks and private sector deposits continue to provide euro area banks with a stable and abundant source of funding.¹¹⁴

Non-financial corporations' credit demand surged in the first half of 2020 in the face of mounting liquidity shortages, while banks have so far kept their credit standards largely unchanged.¹¹⁵ Ample central bank liquidity provision, as well as fiscal measures such as government guarantees, allowed banks so far to satisfy the growing credit demand while maintaining overall favourable lending conditions. Consequently, the annual growth

¹¹¹ Faster corrections were observed in Member States with the highest stock of such loans. In Greece, the NPL ratio has decreased but it still remains the highest across the euro area, around 35%. Similarly, Cyprus has recorded notable improvements that translated into its NPL ratio falling below 20%. In Italy and Portugal the NPL ratio has declined markedly in the last years with moderate reductions in 2019, to below 7%. On this see also the 2021 Alert Mechanism Report (2020).

¹¹² The Single Supervisory Mechanism (SSM) announced on 20 March would exercise flexibility regarding the classification of debtors as "unlikely to pay" when banks call on public guarantees granted in the context of coronavirus. Furthermore, a flexible approach would be applied regarding loans under COVID-19 related public moratoriums.

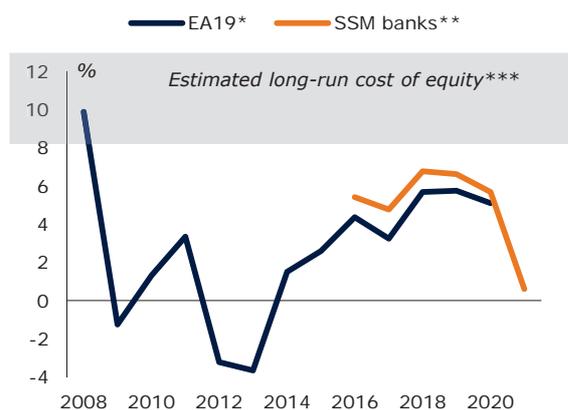
¹¹³ Quarterly data for EU-banks under SSM supervision show a steep decline in those banks' return on equity in the first half of the year 2020, reaching 0.01% in the second quarter.

¹¹⁴ In some euro area countries, interest rates on corporate deposits have entered negative territory, thus supporting banks' net interest margin in an environment of fluctuating asset prices.

¹¹⁵ While the second quarter saw a considerable loosening of credit standards on corporate loans in the euro area, during the third quarter the opposite direction of standards led to overall unchanged results over the course of the year.

rate of loans¹¹⁶ to non-financial corporations increased sharply from March on (Graph 32), despite many firms postponing larger investment projects, as corporates substantially increased their demand for short-term loans and drew on existing credit lines in the face of liquidity shortages and the precautionary build-up of liquidity buffers. Corporates' net long-term bond issuance surged between April and June, almost exclusively as a result of investment-grade issuance.

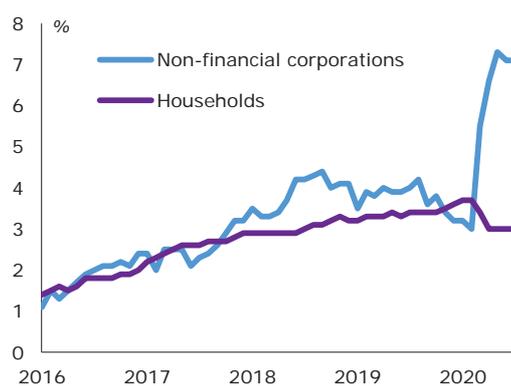
Graph 31: Banks' return on equity



Note: *Domestic banking groups and stand-alone banks. **Single Supervisory Mechanism (SSM) Banks quarterly data have been aggregated on a yearly average. The data-point related to 2020 corresponds to the average of 2020Q1 and 2020Q2. ***Required RoE as self-reported by banks in the semi-annual Risk Assessment Questionnaire of the EBA, Spring 2020.

Source: ECB.

Graph 32: Loans to the private non-financial sector*, euro area



Note: *Annual growth rates, loans adjusted for sales and securitisation as well as for positions arising from notional cash pooling services provided by MFIs. Source: ECB.

Some parts of the non-bank financial sector experienced valuation losses and large outflows, which have been only partly recovered. The substantial market re-pricing at the onset of the corona crisis, which was particularly pronounced in the high-yield segment, led to significant valuation losses also for non-banks. Subsequently, investment and money market funds experienced large outflows in a relatively short period amid a general flight to safety, squeezing liquidity and threatening the short-term funding.¹¹⁷ ECB interventions such as the PEPP announcement, but also the inclusion of non-financial commercial paper in the list of eligible assets under its Corporate Sector Purchase Programme (CSPP), stabilized markets and led to some recovery in non-banks' valuations. Euro area insurers and pension funds were initially less affected by valuation losses due to their comparatively conservative portfolio mixes. However, given their already strained profitability situation, the combination of falling asset prices and the prospect of an even longer period of very low interest rates poses a challenge going ahead.

¹¹⁶ Adjusted for sales and securitisation and the impact of notional cash pooling.

¹¹⁷ Between 12-18 March, outflows from euro area money market funds were the second highest on record, surpassed only in September 2008.

4.2. Risks to macro-financial stability

Euro area banks have withstood the first wave of the pandemic shock, but its full impact is still uncertain.¹¹⁸ A recent ECB vulnerability analysis of banks under SSM supervision suggests that the euro area banking sector is capable of withstanding the initial pandemic-induced stress.¹¹⁹ However, a worsening of the economic situation would impact banks' capital position more severely. Specifically, under the baseline scenario (i.e. real GDP shrinking by 8.7% in 2020), banks' CET1 ratio would be around 1.9 percentage points lower by the end of 2022, whereas under a more severe scenario (i.e. real GDP shrinking by 12.6% in 2020) it would shrink by 5.7 percentage points. For orientation, the Commission's Autumn forecast estimates real GDP in the euro area to contract by 7.8% in 2020, however, these estimates are surrounded by significant downside risks.

Prolonged government loan guarantee schemes could protect the banking sector, but also represent contingent liabilities for Member States' budgets. While general support to the private sector during the pandemic and loan guarantees, in particular, are helping solvent firms and households stay liquid in times of market stress, a substantial amount of defaults is still to be expected as a result of the pandemic.¹²⁰ Whether and when these defaults on loans show up on banks' balance sheets will to some extent depend on the overall duration of these guarantees. While an early end obviously risks substantially increasing NPL ratios and tighter credit conditions¹²¹, the guarantees might be increasingly activated if those schemes persist for some time, thereby effectively weighing on government debt. Higher sovereign debt as a result of realized loan losses covered by guarantees in turn could reignite market concerns about public debt sustainability in some Member States, with negative effects on those countries' financial sector and real economy. Furthermore, given the high concentration and home bias of sovereign debt in banks', insurers' and pension funds' portfolios, solvency ratios of euro area financial institutions could also be adversely affected.

The non-bank financial sector's exposure to corporate bonds makes it vulnerable to a deterioration of corporate sector solvency, which in turn could hinder market access in particular for riskier borrowers. The financial sector could see further valuation losses following corporate rating downgrades, which might come with some delay (see above). Non-banks, in particular, have large exposures to corporate bonds, including high-yield bonds and those that narrowly fulfil investment grade status (BBB) and would thus be particularly

¹¹⁸ In a typical recession, the decline in corporate fundamentals takes up to three years to translate into higher bank NPLs (see the box entitled "Do corporate fundamentals explain differences in sectoral NPLs?", Financial Stability Review, ECB, May 2019).

¹¹⁹ ECB Banking Supervision, results overview of "COVID-19 Vulnerability Analysis", 28 July 2020, https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728_annex~d36d893ca2.en.pdf

¹²⁰ Moreover, a worsening of corporates' financial conditions interacts closely with households' ability to repay debts, which in turn could reinforce growth of banks' non-performing assets.

¹²¹ Indeed, according to the 2020Q2 ECB Bank Lending Survey, banks expect their credit standards for non-financial corporations to tighten considerably in the third quarter, closely connected to their expectations of expiring state guarantee schemes for loans in some large euro area countries.

affected by downgrades.¹²² If such a downgrade were to trigger further rebalancing towards safer and more liquid assets, it would drive up market financing costs, in particular for the most vulnerable and leveraged borrowers, and might impair their market access. Indeed, since February, non-financial corporations' issuance of high yield bonds has stagnated after strong increases over recent years, while investment grade bond issuance surged since April in the context of ECB monetary policy decisions. However, disruptions in high-yield corporate bond markets can easily spillover to other market segments and adversely impact market financing conditions for the whole corporate sector.

A prolongation of insolvency moratoria and continued forbearance of non-performing loans entails difficult decisions. While insolvency moratoria can prevent immediate and large-scale bankruptcies by giving vulnerable corporations and households some time to benefit from the recovery, they also come with risks, in particular if these schemes persist for an extended period of time and the economic recovery is weaker than expected. Non-viable businesses under solvency pressures might be incentivized to take more risks, potentially making the eventual losses under bankruptcy worse. This in turn could undermine business confidence ex-ante and also impact credit provision to healthy firms. Lastly, delayed bankruptcies as a result of loan repayment moratoria could lead to a misallocation of funds to non-viable borrowers. Against this background, the Commission has welcomed a list of 'best practices', agreed by the financial sector and consumer and business organisations, which also covers payment moratoria and credit guarantees.¹²³

5. The EU recovery plan: its impact on EMU and the international role of the euro

The EU recovery plan, Next Generation EU, beyond its short-term stabilisation function and its role in supporting the recovery post-crisis, has the potential to permanently change the EMU. The collective action taken at the EU level has reassured markets and the policies are likely to increase the euro area's growth potential and resilience to future shocks. With a significant portion of the debt issuance as green bonds, the recovery plan has the potential to accelerate the EU's decarbonisation and clean energy transition. Finally, given the increase in the issuance of high-quality, euro-denominated debt, the recovery plan can strengthen the euro's role as an international reserve currency particularly if coupled with ambitious EMU reforms.

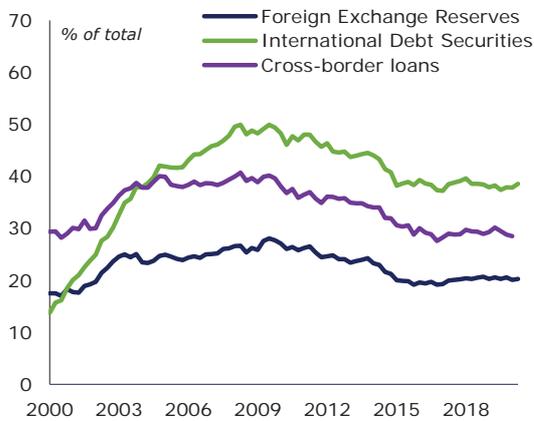
5.1. Impact of the European recovery plan on the international role of the euro

The international role of the euro has remained broadly stable in recent years. The euro is the number two currency in the world although, contrary to the US dollar, with a largely

¹²² According to the ECB, at the end of 2019, euro area non-bank financial institutions (including MMFs) held around EUR 330 billion of high-yield and non-rated and around EUR 280 billion of BBB-rated debt securities issued by euro area NFCs, whereas euro area banks held around EUR 40 billion and EUR 30 billion, respectively. Euro area non-banks also held around EUR 240 billion of debt issued by NFCs belonging to sectors particularly badly hit by the coronavirus-related restrictions.

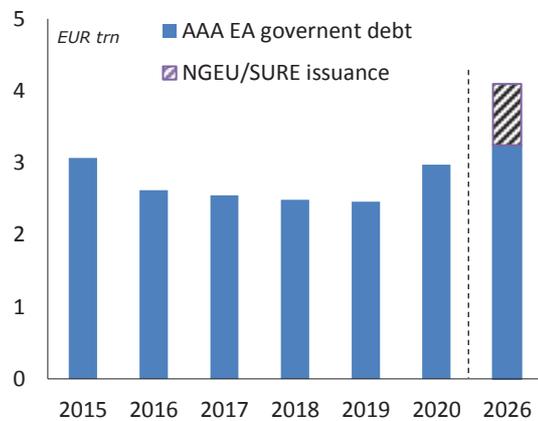
¹²³ See https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/00714-best-practices-mitigate-impact-pandemic_en.pdf.

Graph 33: Euro denominated share of foreign exchange reserves, international debt securities and cross-border loans



Source: IMF Database, BIS Database. Own computations.

Graph 34: Current and projected AAA-rated euro area government debt and recovery package issuance



Note: Unless indicated otherwise, the data presents outstanding amounts at the end of the year. For the projections, countries considered rated AAA are those rated at this grade in Q2 2020 (i.e. DE, LU and NL).
Source: Bloomberg, Commission services.

regional character. The latest assessment by the ECB covering 2019 shows that the euro’s share in outstanding international loans increased while the share of the euro in outstanding international debt securities declined compared to 2018.¹²⁴ The share of the euro in global foreign exchange reserves (Graph 33) and in outstanding international deposits as well as the use of the euro as an invoicing currency for extra-euro area transactions in goods remained broadly stable. Likewise, the stock of euro banknotes circulating outside the euro area remained largely unchanged. Strengthening the economic and financial autonomy of the EU including through an enhanced international role of the euro is part of the Commission’s agenda¹²⁵, and a Communication in this regard will be released shortly as indicated in the Commission’s revised work program.

The common response by the EU to the crisis has increased the overall resilience of all Member States including those in the euro area and provided strong reassurances to markets. Overall, credit rating agencies have identified the Next Generation EU agreement as a net supportive factor of Member States’ sovereign ratings.¹²⁶ On top of its macroeconomic effects, the sizeable issuance of safe, euro-denominated debt resulting from the recovery package can be an important contributing factor towards further financial markets development and integration. For example, as banks complement domestic government bond holdings with EU debt, it could facilitate portfolio diversification and help

¹²⁴ European Central Bank. “The international role of the euro”, June 2020, <https://www.ecb.europa.eu/pub/ire/html/ecb.ire202006~81495c263a.en.html>.

¹²⁵ See, for example, Political guidelines for the next European Commission 2019-2020. https://ec.europa.eu/commission/sites/beta-political/files/political-guidelines-next-commission_en.pdf.

¹²⁶ See, for example, Fitch ratings. ‘EU Recovery Fund Is a Step Towards a More Resilient Eurozone’, 5 August July 2020. <https://www.fitchratings.com/research/sovereigns/correct-fitch-ratings-eu-recovery-fund-is-step-towards-more-resilient-eurozone-05-08-2020> and S&P Global ratings. ‘What The EU Recovery Fund Breakthrough Could Mean For Eurozone Sovereign Ratings’. <https://www.spglobal.com/ratings/en/research/articles/200722-what-the-eu-recovery-fund-breakthrough-could-mean-for-eurozone-sovereign-ratings-11584176>

sever the direct nexus between banks and sovereigns.¹²⁷ Furthermore, common issuance is likely to strengthen liquidity conditions on sometimes strained repo markets and improve the uniform transmission of monetary policy through the provision of high-quality liquid collateral.¹²⁸ Lastly, the EU issuance can lend further support to the development of a single securities market in the EU, thereby contributing to enhanced private sector risk-sharing via the capital markets.

Next Generation EU can increase the international standing of the euro through an enhanced supply of euro-denominated safe assets. The envisaged issuance of up to EUR 850 billion compares to around EUR 2.2 trillion outstanding euro-denominated debt securities with an AAA rating at the beginning of 2020 thus representing a significant increase in high-rated euro-denominated debt (Graph 34). Common issuance of the intended size will add depth and liquidity to the market for high-quality, euro-denominated debt securities, making the euro more attractive as a reserve currency. It could likewise support a larger total international investor exposure to the EU by providing the low-risk component of balanced portfolios. The long foreseen time period over which funds raised under NGEU are to be repaid – i.e. not before 2028 and not after 2058 – should ensure a sizeable market presence of the EU for a significant period of time. Furthermore, given the proposed coverage of debt repayments through the EU budget, the high rating for common EU issuance is expected to be preserved. The quick development of sustainable finance, and in particular of green bonds around the world, can favour the euro and increase the attractiveness of the euro area. Indeed, today, green bonds are in majority euro-denominated, and the sustainable investment targets of EU’s recovery plan, and the development of an EU green bond standard can lead to an even more developed sector.

Technological developments and the rise of digital currencies open new possibilities and challenges for the euro. The COVID-19 crisis has accelerated the digital transformation (see section 1) and the use of digital and cashless payment methods. Going forward, any innovation related to the digitalisation of money and payment systems might also have implications for the international role of the euro. To this end, the Commission adopted its Digital Finance¹²⁹ and Retail Payment Strategies¹³⁰, containing elements supporting the international role of the euro and the EU’s economic and financial autonomy. The possible future issuance of central bank digital currencies (CBDC) including by the ECB can help to increase further the efficiency of payment infrastructure but needs to be further assessed against its implications for monetary policy, financial stability and competition.¹³¹

¹²⁷ 28% of outstanding EU benchmark issuances are currently held by banks. See European Commission investor presentation of 28 September, https://ec.europa.eu/info/sites/info/files/economy-finance/eu_investor_presentation_en.pdf.

¹²⁸ See, for instance, ECB (2020). “Financial Integration and Structure in the Euro Area”, March 2020.

¹²⁹ See COM(2020) 591 final, “Communication on a Digital Finance Strategy for the EU”, 24 September 2020. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0591&from=EN>.

¹³⁰ See COM(2020) 592 final, “Communication on a Retail Payment Strategy for the EU”, 24 September 2020. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0592&from=EN>.

¹³¹ See ECB, “Report on a digital euro”, October 2020. https://www.ecb.europa.eu/pub/pdf/other/Report_on_a_digital_euro~4d7268b458.en.pdf.

5.2. Remaining missing elements of the EMU architecture

Important gaps remain in the architecture of the Economic and Monetary Union (EMU). While the Global Financial Crisis gave a strong momentum to reform, the political will to push towards completing the EMU has slowed somewhat in the second half of the last decade, against the backdrop of a more favourable economic context. Important elements are still missing, such as complete Banking Union and Capital Markets Union.

Completing the Capital Markets Union is a key priority of the Commission. The final Report of the High Level Forum on the Capital Markets Union has underlined that a complete CMU is key to rebuild the EU's economy following the pandemic, to mobilise long-term investments in new technologies and infrastructure, to tackle climate change and to deliver Europe's New Green Deal and Digital Agenda. A complete CMU is also a precondition for a stronger international role of the euro.¹³² The Commission adopted a Capital Markets Union action plan in September 2020 which aims at integrating national capital markets into a genuine EU-wide single market for capital. This is coupled with objectives of supporting the green, digital, and resilient economic recovery by making financing more accessible to European companies, and making the EU a safer place for individuals to save and invest long-term.

Despite the significant progress and efforts made, the Banking Union is not complete. Today, the EU banking sector is better prepared to withstand economic shocks than it was prior to the Global Financial Crisis. A significant amount of risk-reduction has taken place in the last decade, and overall, banks are better capitalised and less leveraged. However, there remains scope for further strengthening it in a number of areas. A stronger Banking Union would bring benefits in terms of ensuring Europe's economic and financial sovereignty, private risk-sharing, financial integration, financial stability and economic growth. For example, there is still room to improve the integration of the banking sector given the low levels of cross-border consolidation and the potential to strengthen the volume of cross-border loans and deposits in the euro area.

Discussions are also ongoing on how to progress on several elements of the Banking Union. In December 2018, the Heads of State or Government called for the work on the Banking Union to advance, and in particular to define a roadmap for starting political negotiations on the European Deposit Insurance Scheme (EDIS). In addition, the Banking Union will not be complete until a fully robust system for dealing with ailing banks has been put in place. In this regard, Member States have already agreed that the **European Stability Mechanism** will provide a common backstop to the Single Resolution Fund in the form of a credit line.¹³³ EU's Heads of State or Government agreed to introduce the backstop by 2023

¹³² See "A new vision for Europe's capital markets", Final report of the High Level Forum on the Capital Markets Union, June 2020, https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf.

¹³³ The Single Resolution Fund (SRF) may be used to ensure the efficient application of resolution tools and it is financed by the banking sector. A common backstop to the SRF is an essential element to ensure that the EU's single resolution mechanism is sufficiently robust and maintains real credibility. If the Single Resolution Fund

at the latest, while an early introduction is currently under discussion. As a last resort, the common backstop will support bank crises management within the Single Resolution Mechanism, and will be repaid via contributions from the European banking sector.

The Commission's Economic Governance Review is set to assess the effectiveness of the current framework of economic and fiscal surveillance. While the existing framework for economic surveillance, including the six-pack and two-pack legislation, has helped reduce public deficits and debt levels and address macroeconomic imbalances in the past, it has grown increasingly complex over the years, also reflecting the fact that the economic context has significantly changed since the rules were established. At the same time, it has not prevented overall high public debt levels in some Member States, frequently pro-cyclical fiscal policies and a less growth-friendly composition of public finances. Against this background, in February 2020, the Commission launched a review of the effectiveness of the economic surveillance framework that aims to assess strengths and weaknesses of the current framework with regard to past developments and consider possible changes to meet future challenges. With the deep recession, activation of the general escape clause of the Stability and Growth Pact, and new policy instruments agreed at the EU level, the context of the debate has changed radically. The review has been put on hold in light of the pandemic, but the Commission will return to it once the immediate crisis is over and lessons can be drawn from the recent experience.

The establishment of the European Stability Mechanism (ESM) during the sovereign debt crisis was a major milestone on the way towards a more stable EMU. In the context of the current crisis, the ESM established a further preventive backstop via its Pandemic Crisis Support that is based on its Enhanced Conditions Credit Line (ECCL) available to all euro area countries. However, the ESM remains an intergovernmental organisation. In December 2017, the European Commission proposed for the ESM to be incorporated in the EU legal framework establishing the European Monetary Fund (EMF).¹³¹ The Commission made its proposal due to the firm belief that the ESM should become a full part of the European Union given its euro area wide goal. The integration would further strengthen the ESM's institutional anchoring and improve its synergies within the EU legal framework, in particular to articulate its role with the competences of economic policy coordination conferred on the Union, in terms of cooperation with the Commission, transparency and efficiency of the EU's financial resources. It would also equip the ESM with a dedicated political accountability mechanism before the European Parliament. In addition, this would also ensure that the ESM is subject to the same legal scrutiny that other institutions acting for the European public good face before the European Court of Justice. In contrast, the recent Next Generation EU proposal was firmly set within the EU legal framework, a move that clearly strengthens the EU and EMU institutional set-up.

were to lack the resources needed to deal with a bank crisis, a reserve of additional funds would be available from which it can borrow as a last resort.