Council of the
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**NOTE**

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| From: | General Secretariat of the Council |
| To: | Permanent Representatives Committee/Council |
| Subject: | European Semester 2017: Council Recommendation on the economic policy of the euro area<br>- Transmission to the European Council |

Delegations will find attached the text of the recommendation on the economic policy of the euro area.

The General Affairs Council of 7 March 2017 is invited to transmit the recommendation to the European Council in accordance with Article 121(2) of the Treaty on the Functioning of the European Union (TFEU). The Council will proceed to the formal adoption of the text in the annex after the European Council has discussed its conclusions on it, in accordance with Article 121(2) TFEU.

Recommendation for a

**COUNCIL RECOMMENDATION**

**on the economic policy of the euro area**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 136 in conjunction with Article 121(2) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Economic and Financial Committee,

Having regard to the opinion of the Economic Policy Committee, Whereas:

(1) Economic recovery in the euro area continues, but remains fragile. There has been significant progress in recent years: since 2015, euro area GDP has recovered its pre-crisis level in real terms and unemployment has declined to its lowest level since 2010-11. However, aggregate demand is sluggish, inflation is well below target, in spite of very accommodative monetary policy by the European Central Bank, and growth is hindered by the legacies of the crisis, such as persisting macroeconomic imbalances and a high level of indebtedness in all sectors of the economy, which require deleveraging and reduce resources available for consumption and investment. Additionally, while the growth potential of the euro area economy has been on a long-term downward trend, that trend has been further accentuated by the crisis. In spite of signs of improvement, the persistent investment gap and the high level of unemployment create the risks of further dampening growth prospects. The asymmetric nature of the rebalancing in the euro area economy has continued, with only net debtor countries correcting their imbalances, and is resulting in an increasing current account surplus. In the framework of the global agreement within the G20, the euro area Member States are called to use all policy tools, including fiscal and structural - individually and collectively – to achieve strong, sustainable, balanced and inclusive growth.

(2) Ambitious structural reforms should facilitate the smooth and efficient reallocation of human and capital resources, help to address the challenges of the ongoing technological and structural changes. Reforms that create an enabling business climate, complete the Single Market and remove barriers to investment are necessary. Those efforts are crucial for increasing productivity and employment, strengthening convergence and enhancing the growth potential and adjustment capacity of the euro area economy. Structural reform implementation, by creating efficient markets with responsive price mechanisms, would support monetary policy through facilitating its transmission to the real economy. Reforms that remove investment bottlenecks and support investment can bring a double benefit by supporting economic activity in the short term and creating capacity for long-term sustainable and inclusive growth. Reforms that improve productivity are particularly important for the Member States with large deleveraging needs linked to high external debt, as faster growth helps to reduce the debt as a share of GDP. Boosting price- and non-price competitiveness would further contribute to external rebalancing in those countries. Member States with large current account surpluses can contribute to euro area rebalancing by introducing measures, including structural reforms, that facilitate channelling the excessive savings to domestic demand, in particular by strengthening investment. The current environment of low interest rates also offers additional opportunities in this regard, notably in countries with significant fiscal space.

(3) Better coordination of the implementation of structural reforms, including those prescribed in the country-specific recommendations and those needed to complete the Economic and Monetary Union (EMU), can create positive spillovers in the Member States and strengthen their positive short-term effects. Eurogroup thematic discussions have proved valuable for building common understanding of reform priorities in the euro area, sharing best practices, promoting reform implementation and structural convergence. They should continue in the Eurogroup, strengthening them where possible, including by making effective use of agreed common principles and benchmarking. These discussions should continue without prejudice to ongoing discussions in relevant Council formations, and while recognising the EU-wide relevance and nature of common challenges and experiences where applicable. The National Productivity Boards, to be established in response to the Council recommendation adopted on 20 September 2016,[1] can also contribute to fostering the ownership and implementation of the necessary reforms at the national level.

[1] OJ C 349, 24.9.2016, p. 1.

(4) A strong coordination of national fiscal policies, based on common rules, is essential to arrive at an appropriate aggregate fiscal stance and for the proper functioning of the monetary union. The common fiscal rules are geared towards pursuing debt sustainability at the national level, while providing room for macroeconomic stabilisation. The national and aggregate fiscal stances of the euro area have hence to balance the double objective of ensuring long-term sustainability of national public finances and short-term macroeconomic stabilisation at both country and the euro area level. At the current juncture of high uncertainty about the strength of the recovery and the level of spare capacity in the economy, when monetary policy has delivered substantial accommodation, fiscal policy at the euro area level is necessary to complement monetary policy in supporting demand, notably investment, and moving out of low inflation while taking due account of ongoing debt sustainability concerns. The effectiveness of fiscal policy, including of spillover effects across countries, is enhanced by the context of low interest rates. For 2017, the Commission considers that a fiscal expansion of up to 0.5% of GDP is desirable at the level of the euro area as a whole in the present circumstances[2]. The Eurogroup in July 2016 concluded, on the basis of Commission analysis, that the broadly neutral aggregate fiscal stance in 2017 strikes an appropriate balance. In December 2016 the Eurogroup underlined the importance to strike an appropriate balance between the need to ensure sustainability and the need to support investment to strengthen the fragile recovery thereby contributing to a more balanced policy mix. At the same time, government debt remains high and there is still a need to make public finances sustainable in the medium term in a number of Member States. For this reason, it is necessary to ensure appropriate differentiation of fiscal efforts across the Member States, taking into account fiscal space and the spillovers across euro area countries. Member States which are over-achieving their fiscal objectives could use their favourable budgetary situation to further strengthen their domestic demand and growth potential, depending on country specific circumstances, while respecting the medium-term objective, the national budgetary prerogatives and national requirements.

[2] See COM(2016) 727 final,16.11.2016.

For instance, guarantees to the European Fund for Strategic Investments are a particularly effective way for Member States with fiscal space to maximise the impact on the real economy and recovery in the euro area. Member States that need further fiscal adjustments under the preventive arm of the Pact should make sure to be compliant with the Stability and Growth Pact's requirements for the coming year. Under the corrective arm of the Pact, Member States need to ensure a timely and durable correction of their excessive deficits which provides fiscal buffers against unforeseen circumstances. Member States should pursue fiscal policies in full respect of the SGP, while making best use of the flexibility embedded within the existing rules. Structural reforms, in particular those that increase productivity, would support growth and improve sustainability of public finances. In addition, a decisive improvement of the composition and management of national budgets, on both the revenue and expenditure sides, by shifting resources towards tangible and intangible investment would increase the impact of budgets on demand in the short term and productivity in the longer term. Effective national fiscal frameworks are necessary to strengthen the credibility of Member States' policies and help strike the right balance between short-term macroeconomic stabilisation, debt sustainability and long-term growth.

(5) Labour markets continue to recover gradually in the euro area, with a steady reduction of unemployment. However, the rates of long-term unemployment and youth unemployment remain high while poverty, social exclusion and inequality remain a serious concern in several Member States. Despite progress with reforms to improve the resilience and adjustment capacity of labour markets, significant differences persist across the euro area, which continue to challenge the smooth functioning of the euro area. Well-designed, fair and inclusive labour market, social protection and tax and benefit systems are necessary for a frictionless and constant reallocation of labour towards more productive activities, to support the (re)integration of those who are affected by transitions between jobs or are excluded from the labour market, to reduce segmentation, and promote economic and social convergence, including by increasing the chances of quality employment. They will also result in more effective automatic stabilisation and stronger, sustainable and inclusive growth and employment which are important for addressing the social challenges in the euro area. Necessary reforms encompass: (i) changes in employment protection legislation aiming at reliable contractual arrangements, that provide flexibility and security for both employees and employers, promote labour market transitions, avoid a two-tier labour market and allow for labour cost adjustment when needed, an area where reform efforts have in recent years been particularly intense; (ii) enhancement of skills by improving the performance and efficiency of education systems and comprehensive lifelong learning strategies, focusing on labour market needs; (iii) effective active labour market policies, to help the unemployed, including the long-term unemployed, re-enter the labour market and increase labour market participation and (iv) modern, sustainable and adequate social protection systems that contribute effectively and efficiently throughout the life-cycle to both social inclusion and labour market integration. Moreover, shifting taxation away from labour, in particular for low-income earners, and ensuring equitable tax systems can improve labour market outcomes. Euro area Member States that have implemented such reforms are more resilient and demonstrate better employment and social performance. The design of such reforms needs to take into account their potential social impact.

(6) The establishment of the Banking Union has progressed, but it remains unfinished. In line with the roadmap of June 2016, work is set to continue to complete the Banking Union with regard to risk reduction and risk sharing, including a European deposit insurance scheme and making the common backstop for the Single Resolution Fund operational at the latest by the end of the Fund's transitional period. While the overall resilience of the euro area banking sector has increased since the crisis, pressure on banks has mounted due to a number of factors, such as high levels of non-performing loans, inefficient business models and overcapacity in some Member States, all resulting in low profitability and, in some cases, challenges to viability. That pressure impairs banks' ability to provide lending to the economy. Risks also extend to the real economy, where the level of public and non-financial private debt in some Member States remains elevated. There is a need for a continued orderly deleveraging in the private sector through working out, servicing and if necessary restructuring of debt of viable debtors under distress, and by resolving stocks of non-viable debt, so that capital can be reallocated more quickly and efficiently. In this context, dealing with still elevated levels of non-performing loans and following common principles in the design of insolvency frameworks for businesses and households, including by improving national insolvency procedures and out-of-court settlement frameworks, constitute key components of a successful and growth-friendly deleveraging process.

(7) Over the last year, some progress has been made on the initiatives presented in the Five Presidents' Report on completing Europe's EMU, such as the increased role of the euro area dimension in the European Semester, the recommendation on the National Productivity Boards and the establishment of the European Fiscal Board within the Commission. Work is also ongoing on improving transparency and reducing complexity of fiscal rules. Moreover, in November 2015, the Commission issued a proposal for a European Deposit Insurance Scheme. Moreover, there are broader challenges to address in the light of the Five Presidents' Report. The Commission has announced its intention to present in March 2017 a White Paper on the future of Europe, which will also include the future of EMU. Agreeing on an operational way forward requires a shared sense of ownership and a common sense of purpose among all euro area Member States and EU institutions, and also among non-euro area Member States, as a strong EMU will help to address the challenges facing the EU more forcefully and will have a positive impact on non-euro area Member States as well. In this regard, it will be important for discussions on completing EMU to be conducted in a manner that is open and transparent towards non-euro area Member States, in full respect of the EU's internal market, and for relevant initiatives to be open to non euro area Member States on an equivalent basis where appropriate.

(8) The Employment Committee and Social Protection Committee have been consulted on the employment and social aspects of this recommendation.

HEREBY RECOMMENDS that euro area Member States take action, individually and collectively, within the Eurogroup in the period 2017-2018 to:

1. Pursue policies that support sustainable and inclusive growth in the short and the long term, and improve adjustment capacity, rebalancing and convergence. Prioritise reforms that increase productivity, improve the institutional and business environment, remove bottlenecks to investment, and support job creation. Member States with current account deficits or high external debt should raise productivity while containing unit labour costs. Member States with large current account surpluses should implement as a priority measures, including structural reforms and fostering investment, that help to strengthen their domestic demand and growth potential.

2. Aim for an appropriate balance in fiscal policies between the need to ensure sustainability and the need to support investment to strengthen the recovery, thereby contributing to an appropriate aggregate fiscal stance and a more balanced policy mix. Member States that, according to the Commission assessment, are at risk of not meeting their obligations under the SGP in 2017 should, on that basis, take, in a timely manner, additional measures to ensure compliance. Conversely, Member States that have outperformed their medium-term objectives are invited to continue to prioritise investments to boost potential growth while preserving the long-term sustainability of public finances. Member States that are projected to be broadly compliant with the SGP in 2017 should ensure compliance with the SGP within their national budgetary processes. Pursue fiscal policies in full respect of the SGP, while making the best use of the flexibility embedded within the existing rules. Overall, Member States should improve the composition of public finances, by creating more room for tangible and intangible investment and ensure the effective functioning of national fiscal frameworks.

3. Implement reforms that promote competitiveness, job creation, job quality, resilience and economic and social convergence, underpinned by an effective social dialogue. They should combine: (i) reliable labour contracts which provide flexibility and security for employees and employers; (ii) quality and efficient education and training systems and comprehensive lifelong learning strategies targeted at labour market needs; (iii) effective active labour market policies to support labour market participation; (iv) modern, sustainable and adequate social protection systems that contribute effectively and efficiently throughout the life cycle to social inclusion and labour market integration. Shift taxes away from labour, particularly for low-income earners and in Member States where cost competitiveness lags behind the euro area average, and make it budgetarily neutral in countries without the fiscal room for manoeuvre.

4. In line with the roadmap of June 2016, continue work to complete the Banking Union with regard to risk reduction and risk sharing, including a European deposit insurance scheme and making the common backstop for the Single Resolution Fund operational at the latest by the end of the Fund's transitional period. Devise and implement an effective euro-area wide strategy to complement prudential supervisory action to address viability risks within the banking sector, including as regards the high level of non-performing loans, inefficient business models and overcapacity. In Member States with large stocks of private debt, promote orderly deleveraging.

5. Make progress on completing EMU, in full respect of the EU's internal market and in an open and transparent manner towards non-euro area Member States. Further advance the ongoing initiatives and work on the longer-term issues for EMU, taking due account of the forthcoming Commission White Paper on the future of Europe.

Done at Brussels,

*For the Council*
*The President*