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COMMUNICATION FROM THE COMMISSION

TO THE EUROPEAN PARLIAMENT, THE COUNCIL AND THE EUROGROUP

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

This Communication summarises the results of the in-depth reviews (IDRs) to assess whether imbalances and excessive imbalances exist in a number of EU Member States. (*) *It also elaborates on the euro area dimension of macroeconomic imbalances and how several policy challenges have to be addressed in a euro area-wide context. In addition, to contribute to integrated surveillance, the Communication also discusses fiscal developments: for the countries concerned, the Commission updates its assessment of November 2013 when it discussed the Draft Budgetary Plans.* (**)

The IDRs discuss relevant features of the Member States' economies, in particular the evolution of their external accounts, savings and investment balances, effective exchange rates, export market shares, cost- and non-cost competitiveness, productivity, private and public debt, housing prices, credit flows, financial systems, unemployment and other variables. The assessment of imbalance or excessive imbalances considers the situation of each economy at a given moment, the dynamics in each of those issues, as well as, when appropriate, the recent policy actions.

The IDRs illustrate that the challenges that the EU economies face have been changing. When the Macroeconomic Imbalance Procedure (MIP) was created, and during the previous rounds of its implementation, the main challenges were related to the unsustainable current account deficits, losses in competitiveness related to previously very dynamic labour costs, private debts and high housing prices. The main challenges of a cross-country nature now also concern the impact that deleveraging in many countries has on medium-term growth; the sustainability of private and public debts and of the external liabilities in a context of very low inflation; the need to ensure an adequate flow of credit to viable activities – particularly in the non-tradables sector – in the vulnerable economies under a fragmented financial system; and the very high level of unemployment in many economies.

On the basis of the IDRs, the Commission has identified imbalances in ***Belgium****,* ***Bulgaria****,* ***Germany****,* ***Ireland****,* ***Spain****,* ***France****,* ***Croatia****,* ***Italy****,* ***Hungary****,* ***Netherlands****,* ***Slovenia****,* ***Finland****,* ***Sweden****, and the* ***United Kingdom****. Among those Member States,* ***Croatia****,* ***Italy*** *and* ***Slovenia*** *are experiencing excessive imbalances. In the case of* ***Spain****, the Commission considers that a significant adjustment has taken place over the last year and that, on current trends, imbalances will continue to abate over time; while this is the basis to conclude that imbalances are no longer excessive in the sense of the MIP, the Commission stresses that substantial risks are still present.*

*The drivers of imbalances and the risks they raise are different from one economy to another. Policies should be adapted to the challenges of each economy and appropriate monitoring is necessary. In line with the Council Recommendation addressed to the Euro Area, the Commission intends to put in motion a specific monitoring of the policies recommended by the Council to the Member States with excessive imbalances (****Croatia****,* ***Italy*** *and* ***Slovenia****), as well as for countries where imbalances require decisive policy action (****Ireland****,* ***Spain*** *and* ***France)****.* (***) *In the case of* ***Ireland*** *and* ***Spain*** *this monitoring will rely on post-programme surveillance.*

For ***Denmark*** *and* ***Malta****, the Commission considers that, compared to the last year, the risks have abated or are better controlled; imbalances in the sense of the MIP are no longer identified in these countries. Moreover, while a number of features of the* ***Luxembourg*** *economy, including its large financial sector, require attention, they do not constitute imbalances in the sense of the MIP.* (****)

The strengthening of the recovery and strong policy implementation should facilitate the unwinding of imbalances and excessive imbalances in other economies in the coming years. Having said this, imbalances are long-lasting phenomena and it may take time before the appropriate policies result in a decisive reduction in the macroeconomic risks under the MIP surveillance. Thus, identifying imbalances or excessive imbalances for an economy for several years is not passing a judgement on the policies adopted, but signalling that risks remain, and that strong vigilance in relation to imbalances and relevant policy implementation is necessary. However, for some countries, it should be noted that the persistence of imbalances is also related to the slow implementation of the country-specific recommendations under the European Semester.

Regarding fiscal developments, the situation has continued to improve both in the EU and the euro area due to continued consolidation efforts. However, the latest forecasts show that for **France** *and* **Slovenia,** *there are risks that the consolidation effort may not be strong enough to ensure that the correction of excessive deficits remains on track. Thus, the Commission is addressing Recommendations, under Article 11 of the Regulation No 473/2013 to these Member States.*

The Commission expects that the Member States take the findings of the IDRs and the fiscal forecasts into account in their National Reform Programmes (NRPs) and Stability and Convergence Programmes (SPs and CPs). Member States in excessive imbalances should, in particular, set out a comprehensive and detailed policy response in their forthcoming NRPs and SPs and CPs. The Commission is ready to cooperate closely with these Member States in preparing this response, in full respect of national processes. The two Member States to whom the Communication is addressing a Recommendation to ensure that the correction of excessive deficits remains on track are expected to report on actions responding to such Recommendation in a dedicated section of the their SPs. The NRPs and SPs and CPs for all Member States will be assessed in June 2014, as part of the European Semester of Economic Policy Coordination, to determine whether they are adequate in view of the challenges. For those Member States in excessive imbalances (Italy, Croatia, Slovenia), if the Commission considers that the proposed policy response is inadequate in view of the challenges, it would recommend to the Council that the Member State concerned take corrective action under the corrective arm of the MIP. If necessary, subsequent procedural steps under the EDP will also be taken at the beginning of June.

(*) This Communication fulfils the requirement of Articles 6(1) and 7(1) of Regulation (EU) No 1176/2011, according to which the Commission informs the European Parliament, the Council and the Euro Group about the outcome of the IDRs. The IDRs for seventeen Member States are published at the same time as this Communication (see *European Economy-Occasional Papers*). In the sense of the MIP, imbalances are trends giving rise to developments which adversely affect the functioning of the economy of a Member State, or the monetary union, or the Union as whole; excessive imbalances are severe imbalances, including those that could jeopardise the proper functioning of the economic and monetary union.
(**) COM(2013) 900, 15.11.2013.
(***) See CSR5 of Council Recommendation (2013/C 217/24) of 9 July 2013 (OJ C 217, 30.7.2013, p. 97).
(****) In the Alert Mechanism Report of November 2013, the Commission considered that no specific action in the context of the MIP was necessary for the Czech Republic, Estonia, Latvia, Lithuania, Austria, Poland and Slovakia. The macroeconomic surveillance for all these Member States will continue in the context of the European Semester. Moreover, the MIP does not apply to Member States which are implementing macroeconomic adjustment programmes supported by financial assistance: Greece, Cyprus, Portugal and Romania; the enhanced monitoring of their imbalances and policies will continue in the context of their programmes.

SYNOPTIC TABLE
INTEGRATED SURVEILLANCE OF MACROECONOMIC AND FISCAL IMBALANCES
(Member States for which an IDR has been prepared)

	MIP		SGP
	Finding	**Follow-up**	
BE	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Excessive deficit, deadline for correction: 2013
BG	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Not yet at MTO
DE	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Overachieving MTO
DK	No imbalance	Recommendations to be adopted under the European Semester	Excessive deficit, deadline for correction: 2013
IE	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues. Specific monitoring: post-programme surveillance	Excessive deficit, deadline for correction: 2015
ES	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues. Specific monitoring: post-programme surveillance	Excessive deficit, deadline for correction: 2016
FR	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues. Specific monitoring to be put in motion	Excessive deficit, deadline for correction: 2015 The Commission adopts today a recommendation (*)
HR	Excessive imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues. Decision to be taken in June on subsequent steps under the MIP. Specific monitoring to be put in motion	Excessive deficit, deadline for correction: 2016
IT	Excessive imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues. Decision to be taken in June on subsequent steps under the MIP. Specific monitoring to be put in motion	Not yet at MTO
LU	No imbalance	Recommendations to be adopted under the European Semester	Overachieving MTO
HU	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Not yet at MTO
MT	No imbalance	Recommendations to be adopted under the European Semester	Excessive deficit, deadline for correction: 2014
NL	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Excessive deficit, deadline for correction: 2014
SI	Excessive imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues. Decision to be taken in June on subsequent steps under the MIP. Specific monitoring to be put in motion	Excessive deficit, deadline for correction: 2015 The Commission adopts today a recommendation (*)
SE	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Overachieving MTO
FI	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Not yet at MTO
UK	Imbalance	Recommendations to be adopted under the European Semester, including on MIP-related issues	Excessive deficit, deadline for correction: 2014-5

(*) The Recommendations under the '2-pack' (Reg. No 473/2013) regarding measures to be taken in order to ensure a timely correction of its excessive government deficit only concern euro area Member States.
MTO: Medium-term fiscal objective.
Euro area Member States for which an IDR was prepared are shaded.

1. INTRODUCTION AND MAIN FINDINGS

Over the last years, the EU economic governance has been significantly strengthened. It now provides for a coherent annual cycle of economic policy co-ordination in Europe, with more integrated steps for the euro area. The European Semester has become key for delivering reforms, ensuring that Member States co-ordinate their economic policies and their efforts to promote growth and jobs.[1]

Together with the reinforced Stability and Growth Pact, with its focus on sustainable public finances, the Macroeconomic Imbalances Procedure (MIP) is at the heart of the EU's strengthened economic governance. The Macroeconomic Imbalances Procedure (MIP) is designed to help detect, prevent and correct problems at an early stage. At the start of the fourth European Semester in November 2013, in its Alert Mechanism Report (AMR), the Commission screened all the EU Member States for possible macroeconomic imbalances on the basis of a scoreboard of indicators and identified 16 cases where an in-depth review was warranted. After the successful conclusion of its macroeconomic adjustment programme, Ireland is also included on the invitation of the ECOFIN Council of February 2014. On the basis of these in-depth analyses, the Commission drew conclusions on the existence of imbalances and their nature.

Overall, the analysis shows that macroeconomic imbalances, which have been built up over many years, are gradually receding. Imbalances are no longer identified as excessive in one country, while imbalances are no longer identified in two others. However, in some cases, new concerns have arisen, which require closer attention. The Commission expects that those three Member States, for which it has concluded that imbalances are excessive, will act swiftly and decisively and include comprehensive and detailed policy measures in their forthcoming National Reform Programme and Stability and Convergence Programmes. Member States, for which the Commission has concluded that imbalances exist, are invited to take the findings of the in-depth reviews into account in their National Reform Programmes and Stability and Convergence Programmes. On this basis and in the context of the European Semester, in June the Commission will make policy recommendations for the correction of these imbalances and the prevention of new ones.

As part of its continuous monitoring of obligations under the excessive deficit procedure, the Commission today also makes use of a new instrument under the strengthened Stability and Growth Pact and draws the attention of two euro area Member States to the risk of non-compliance with the budgetary target recommended for this year. In the context of the European Semester in June, the Commission will reassess the overall situation as regards the obligations under the Stability and Growth Pact and, where necessary, propose the appropriate steps to the Council.

[1] Commission Communication "Taking stock of the Europe 2020 strategy for smart, sustainable and inclusive growth", COM(2014)130, 5.3.2014.

2. ECONOMIC RECOVERY BUT CONTINUED NEED FOR REFORM

The economic recovery is gaining ground. On the basis of the latest forecast[2], the European economy will grow 1.5 per cent in 2014 and 2.0 per cent in 2015. For the first time in several years, the growth projections have been revised upwards for several countries. A number of imbalances-related headline data, including the external and fiscal accounts, competitiveness and trade indicators, and overall indebtedness, are improving. In many countries, the housing price cycles have bottomed out and turned moderately upward. The unemployment rate has stabilised and has been slowly declining in several economies, though unemployment and other indicators of social stress remain too high in many countries. The correction of imbalances, which results from politically complex policy measures as well as socially painful adjustment by economic agents, has contributed to improving the fundamentals and has supported a gradual recovery, which then helps in reducing macroeconomic risks. However, the recovery is still fragile and uneven. It is only in 2014 and 2015 that the EU and euro area, respectively, will return to the real activity levels recorded in 2007, and for some Member States this will take longer.

The IDRs illustrate that the challenges faced by the economies under review have been changing. When the MIP Regulation was put forward by the Commission and later adopted, and during the first two rounds of its implementation, the main challenges were related to unsustainable current account deficits, losses in competitiveness linked to previously very dynamic labour costs, private debts and high housing prices. While many 'flow' imbalances, like the current account deficits have been overcome, this is not yet the case of 'stock' imbalances, like the external liabilities. The main challenges of a cross-country nature now concern the lingering impact that deleveraging pressures in many countries have on medium-term growth; the sustainability of private debts and of the external liabilities in a context of very low inflation and slow growth; the implications of the euro area shifting to a relatively large current account surplus; and the need to provide credit to viable investments in the vulnerable economies, under a fragmented financial system. Moreover, the very high level of unemployment in many economies represents a major policy and social challenge.

The policy responses to the changing set of challenges should also consider the euro area dimension of imbalances. Macroeconomic imbalances are, first and foremost, harmful for the economies of the Member States concerned, which have therefore an interest in reducing the associated risks. These risks concern external, and public and private debt, sustainability; the ability to compete in the world markets and ultimately the capacity to generate strong medium-term growth and create jobs. However, the interdependence among the economies implies that imbalances spill over across countries, and the losses in efficiency in one Member State also lead to foregone welfare in its partners. There are several channels through which the macroeconomic situation and policy action in one Member State affect their partners: trade, financial and monetary linkages, structural reforms and confidence and uncertainty[3].

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2 See the Commission services' winter forecasts, of 25 February 2014, *European Economy*, 2 (2014).

3 See 'Cross-Border Spillovers in Confidence,' *Quarterly Report on the Euro Area*, 2013 (3), 26-30, and 'Assessing the Impact of Uncertainty on Consumption and Investment'. *Quarterly Report on the Euro Area*, 2013 (2), 7-16, and 'The Economic Effects of Policy Uncertainty, ' box I.1 in *European Economy*, 2014 (2); 28-30.

In the framework of the MIP, given the interdependence of the economies, several challenges need to be seen against a euro area-wide context:

- **Policies for growth.** After several years of recession or slow growth, the euro area has now entered a fragile recovery phase. Given the interconnectedness of the Member States, and the constraints many of them face, a boost to economic activity and medium-term outlook is expected to come from continuing structural reforms aiming at boosting competitiveness and adjustment in the vulnerable economies and, for the larger and less indebted Member States, policies to increase domestic demand and potential growth. Policies that contribute to an increase in investment are critical as they boost demand in the short term, and increase potential growth in the future[4].

- **Financial fragmentation** consists in differences in the functioning and performance of financial markets of different jurisdictions. It leads to divergent interest rates and credit conditions for businesses and households depending on their country of residence, which go beyond those justified by economic fundamentals. Making sure the financial system provides financing for viable investment projects is necessary for the reallocation of resources between sectors among the most vulnerable Member States[5] and to restore smooth 'downhill' financial flows to the euro area's periphery.

- **Indebtedness and very low inflation**. Price stability, defined by the ECB as an inflation rate of below but close to 2 per cent over the medium term, is important for medium-term growth. The Commission Winter Forecast points to a protracted period of low inflation, which could have adverse implications for economic activity and debt levels. Moreover, very low inflation implies an adequate degree of nominal flexibility to bring about the real wage adjustment which may be necessary in some cases to reduce unemployment.

- **Rebalancing in a difficult economic context**. The euro area is going through a rebalancing process which is well advanced, but not yet complete. For a number of Member States, this means regaining competitiveness via an internal devaluation, *i.e.* wage moderation, productivity gains and reduction of other production costs relative to trading partners. This together with an ambitious broader reform agenda is a necessary process to recover competitiveness both inside the monetary union and worldwide but with considerable social costs. Compared to the economic adjustment in some economies after the creation of the monetary union, the challenge of recovering competitiveness has been magnified by the low economic activity in the EU as a whole and globally. The necessary adjustments in labour costs depend not only on the specific situation of each Member State, but also on the behaviour of the competitors' labour costs inside and outside the euro area, and the nominal exchange rate of the euro. The euro exchange rate is not a policy target. Upward pressures on the exchange rate could be the result of internal developments or external developments. There is a risk that competitiveness gains earned through very difficult policy adjustment may be undone by an appreciation of the euro nominal exchange rate. While overall demand in the euro area is still weak, according to the Commission Winter Forecast the recovery is expected to become increasingly driven by

[4] See 'The Euro Area's Growth Prospects over the Coming Decade' and 'The Growth Impact of Structural Reforms,' *Quarterly Report on the Euro Area*, 2013 (4), 7-16 and 17-27, and 'Post-Crisis Total Factor Productivity in the EU,' box I.2 in *European Economy,* 2014 (2); 31-4.

[5] See 'Drivers of Diverging Financing Conditions Across Member States,' *Quarterly Report on the Euro Area*, 2013 (1), 19-25, and 'Financial Fragmentation and SMEs' Financing Conditions, box I.2, *European Economy*, 2013 (7): 20-3.

domestic demand and to spread across Member States, which could help alleviate upward pressures.

Actions to address macroeconomic imbalances and divergences in competitiveness are required in all Member States, particularly in the euro area. As established in the specific recommendations for the euro area Member States[6], they should take action, individually and collectively in the framework of the Euro Group, and take responsibility for the aggregate policy stance in the euro area to ensure the good functioning of the euro area and to increase growth and employment. The coordination should contribute to ensuring that the pace of fiscal consolidation is differentiated according to the fiscal and macroeconomic situation of the Member States. Fiscal and productivity-enhancing measures should promote further rebalancing in the euro area, and address distortions to the savings and investment behaviour in Member States. In order to tackle the social consequences of the crisis and the rising unemployment levels, further reforms are necessary (*e.g.* to facilitate access to employment, prevent early withdrawals from the labour market, reduce the cost of labour and combat labour market segmentation).

Completing the Banking Union remains the cornerstone to restore confidence in the financial sector and reduce market fragmentation. This will in turn foster the flow of credit to the real economy, particularly to SMEs, traditionally more dependent on bank finance. The upcoming definitions regarding liquidity rules for banks in the context of the delegated acts of the capital requirements legislation should equally ease access to finance for the real economy. Further balance sheet repair and consolidation of the banking system needs therefore to be promoted; the forthcoming comprehensive assessment of banks' balances sheets by the ECB will be key in this respect.

The growth contribution of large Member States is important. Among the largest euro area Member States, the policy priorities should be on strengthening domestic demand and medium-term growth in *Germany*, addressing bottlenecks to medium-term growth while working on structural reforms and fiscal consolidation in *France* and *Italy*, and continuing the orderly deleveraging and structural transformation of the economy that will contribute to sustainable growth, and addressing social issues in *Spain*.

6 Council Recommendation (2013/C 217/24) of 9 July 2013 (OJ C 217, 30.7.2013, p. 97).

3. MAIN CROSS COUNTRY FINDINGS

The IDRs provide a fuller insight into a number of cross-country developments, already discussed in the Alert Mechanism Report[7]. Several imbalances and risks remain a distinct feature in a number of Member States. The IDRs illustrate, in particular, that:

- **Large external liabilities remain a vulnerability.** Over the latest quarters, current account deficits have been further reduced in countries which experienced high deficits in the pre-crisis period. In some countries, such as *Bulgaria*, *Spain*, *Croatia* and *Hungary* the current accounts have swung into surplus, and in the case of *Ireland* and *Slovenia* into very large surplus. The improvement in the current balance in these Member States is due to gains in competitiveness facilitated by adjustment in labour costs, but also due to a compression of domestic demand in those countries. However, in terms of stocks, the net external liabilities remain very high in some of the countries under review. This is particularly the case for *Ireland*, *Spain*, *Croatia* and *Hungary*, where the negative net international investment position (NIIP) is close to, or above, annual GDP, but the NIIP is also very high in *Bulgaria*. Concerns over external sustainability vary across countries and also depend on the type of their gross and net liabilities. In particular, the high share of FDI attenuates the risks in *Bulgaria*, *Ireland* and *Hungary*[8]. Much of the improvement in current accounts has not been cyclical and, therefore, is not expected to disappear with the recovery[9]. Yet to ensure external sustainability of the most indebted economies, the current account adjustment will have to continue, with surpluses or low deficits persisting over an extended period of time. The structural reduction in demand in most vulnerable countries illustrates the need for productivity gains, supported by growth-enhancing reforms; otherwise, economic activity would remain anaemic for a long period, in particular in the most indebted economies.

- **In recent years, there have been substantial deteriorations in the external flows of a few countries.** This is the case of *France* and the *United Kingdom*: the latter currently posts the largest current account deficit in the EU. Although these economies have relatively low levels of net external liabilities and their external sustainability is not at risk, increasing divergences might engender specific risks to their economies if their external deficits continue to widen.

- **Persistent very large current account surpluses often reflect subdued domestic demand dynamics**. A country with a current account surplus transfers consumption from today to tomorrow by investing abroad. In turn, a country with a current account deficit can increase its investment or consumption today but must transfer future income abroad to redeem the external debt.[10] Surpluses are very high in *Germany*, *Luxembourg*, *Netherlands* and *Sweden*, while the surplus in *Denmark* is also high. Their surpluses are associated with strong export performance as compared with imports, the moderate growth of the latter is in line with that of domestic demand. The accumulation of moderate surpluses is a welcome development given the need for saving part of current income to

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7 COM(2013) 790 final, 13.11.2013.

8 See 'The Role of FDI in Preventing Imbalances in the Euro Area,' *Quarterly Report on the Euro Area*, 2013 (2), 17-25.

9 See 'The Cyclical Component of Current Account Balances,' box I.3 in *European Economy*, 2014 (2); 35-8.

10 See 'Current Account Surpluses in the EU,' *European Economy*, 2012 (9).

cope with the challenge raised by the demographic outlook[11], and provide savings to be invested abroad. To the extent that the high surpluses result from large domestic investment gaps, they also hamper the medium- to long-term economic outlook. The nature of the surpluses is not identical in all these countries; while surpluses are associated with deleveraging in *Denmark*, the *Netherlands* and *Sweden* where households and non-financial corporates register high debt levels, this is much less the case in *Germany*. The trade surplus of *Germany* vis-à-vis the rest of the world has increased, while it has decreased with the rest of the euro area. The latter is a favourable development, but which need to be put in perspective: the change vis-à-vis the euro area owes more to a reduction in imports by the euro area periphery than an increase in *German* imports. Moreover, part of the reduction in the intra-euro area surplus has to do with other 'surplus countries.' An increase in domestic demand through an acceleration of investment, would reduce the surplus, boost potential growth, and could contribute to the recovery and to the ongoing adjustment in the euro area.

- **Cost competitiveness remains a crucial issue.** This is particularly the case for the countries that used to have the largest current account deficits, and need to secure their external sustainability, such as *Bulgaria*, *Spain and Hungary*, or that have experienced large losses in export market shares in recent years, such as *Croatia*, *Italy* or *Finland*. Competitiveness and export performance is particularly relevant for the economic outlook of several economies as, given the deleveraging needs in the private sector and the fiscal consolidation needs, net exports or export-oriented investments are likely to be the important demand components supporting growth in the medium term. Unit labour costs (ULC) continue to adjust in several Member States most affected by competitiveness and unemployment. Among the Member States under review, the largest adjustment in the latest years has taken place in *Ireland* and *Spain*. The ULC adjustment has been driven by intensive market and competitiveness pressures leading to reductions in the nominal remuneration in several sectors, labour shedding, as well as productivity improvements. The adjustment has been comparatively much smaller in *France, Italy* and *Slovenia*. For several countries, ULC have fallen by more than export and GDP deflators. This may be compatible with the rebalancing to the extent that increased mark-ups contribute to incentivising the tradable sector to expand[12]. Despite the ongoing adjustment in real wages, the labour market adjustment has so far taken place predominantly in terms of labour shedding and much reduced job finding rates. This resulted in sharp increases in unemployment and an overall lengthening of unemployment spells[13] with social consequences and implications for potential growth that need to be taken into account in the policy responses.

- **The IDRs also emphasise the role of non-cost competitiveness.** For most Member States, non-cost competitiveness appears to be as important in explaining trade performance as cost competitiveness. Non-cost factors include the export composition and technological content, geographical diversification of exports, firms' structure, business environment and innovation. The IDRs discuss how Member States such as *Belgium, Denmark, Italy, France, Croatia, Hungary, Finland* and the *United Kingdom* face the challenge of improving their export performance and restoring non-cost competitiveness.

[11] See 'Ageing Report,' *European Economy*, 2012 (2) and 'Fiscal Sustainability,' *European Economy*, 2012 (8).

[12] 'Labour Costs Pass-Through, Profits and Rebalancing in Vulnerable Member States,' *Quarterly Report on the Euro Area*, 2013 (3), 19-25.

[13] See 'Labour Market Developments in Europe,' *European Economy*, 2013 (6).

Exports of services often mitigate poorer performance in the exports of goods for several of the countries reviewed in the IDRs, like *Belgium*, *Denmark*, *Croatia*, *Luxembourg*, *Sweden*, *Slovenia* and the *United Kingdom*. Stagnating productivity growth has been identified as a protracted problem in *Belgium* and *Italy*, which aggravates the risks related to external or internal imbalances. Improvements in both costs and non-cost competitiveness are crucial given the declining trend in world export market shares among the advanced economies.

- **Deleveraging is occurring in the private sector, but private debt stocks remain high in several economies.** The need for households and non-financial corporates, as well as financial corporates, to downsize their balance sheets and cut down their liabilities has had a negative impact on private consumption and investment. The credit flow to the private sector has been affected by unfavourable demand and supply conditions[14]. The latter includes the deleveraging in the financial sector itself, a fragmented financial sector and lingering policy uncertainty which affected investment decisions. The low level of corporate investment constitutes an obstacle to the shift of resources to the most productive sectors and export-oriented industries, and constrains medium-term growth[15]. At the same time, the deleveraging of households and non-financial and financial corporates has contributed to the improvement in the current account in several Member States under review, such as *Spain* and *Slovenia*, and contributed to the large surpluses in *Denmark*, *Netherlands* and *Sweden*. Moreover, the low inflation rates, which for several Member States are a crucial component of their strategy to recover competitiveness, may make the deleveraging efforts of the private sector more challenging in some countries.

- **The housing market adjustment appears to be bottoming out in a number of countries.** Most EU housing markets have been in a phase of correction after a particularly long bull cycle. In some countries, notably *Denmark*, *Ireland*, *Spain*, and the *Netherlands*, the cumulated reduction in the real price of residential assets has been substantial. In *Spain* and *Ireland*, the adjustment in housing prices has gone in tandem with the downsizing of construction sectors, aggravating unemployment. It contributed to the increase in non-performing loans and the deterioration in banks' balance sheets, requiring increased provisions and the transfer of problematic assets to dedicated asset management firms. While further downward adjustments cannot be excluded for some countries under review, the available data suggest that, for most countries the cycle has bottomed out and there have been moderate increases, as in *Luxembourg*, *Malta*, *Sweden* and the *United Kingdom*.

- **Unemployment and other indicators of social stress remain very high[16].** Unemployment soared in particular in countries concerned by current account reversals, and divergences among Member States are also very high. Youth and long-term unemployment are specific concerns, while skill mismatches also need to be addressed. However, since mid-2013, there have been some signs of stabilisation and timid

[14] See 'Drivers of Diverging Financing Conditions across Member States,' *Quarterly Report on the Euro Area*, 2013 (1), 19-25, and 'Assessing the Private Sector Deleveraging Dynamics,' *Quarterly Report on the Euro Area*, 2013 (1), 26-32.

[15] See 'Product Market Review: Financing the Real Economy,' *European Economy*, 2013 (8), 'Financial Dependence and Growth,' *Quarterly Report on the Euro Area*, 2013 (3), 7-18, and 'Firms' Investment Decisions in Vulnerable Member States,' *Quarterly Report on the Euro Area*, 2013 (4), 29-35.

[16] See also the Commission Communication 'Strengthening the Social Dimension of the Economic and Monetary Union,' COM(2013) 690, 2.10.2013 and 'Draft Joint Employment Report 2014,' COM(2013) 801 final, 13.11.2013.

reductions in the unemployment rate in some Member States, like *Bulgaria*, *Ireland*, *Hungary* and *United Kingdom*. To the extent that the current account reversals lead to a persistent fall in investment and productivity, the reduction in unemployment may require that wage developments are in line with productivity, supporting thus both competitiveness and aggregate demand.

The latest forecasts show that the pace of fiscal adjustment is set to decelerate in the EU and euro area. This is thanks to the major consolidation efforts of the past two years. However, in most Member States there is still a need to step-up fiscal consolidation.

- **Fiscal consolidation is slowing down while the public debt ratio is peaking in 2014.** In 2013, public finances have continued to improve both in the EU and the euro area thanks to continued consolidation efforts. In 2014 the pace of adjustment is expected to slow down. Nevertheless, ongoing consolidation efforts and the economic recovery should allow for a further reduction of headline deficits. As regards structural adjustments, the efforts of most Member States were satisfactory in 2013. Both in the EU and in the euro area, the debt-to-GDP ratio is forecast to increase further in 2013 and, at a somewhat lower pace, in 2014, when it is expected to peak.

- **There are doubts whether the consolidation is strong enough in some Member State to ensure that the correction of the excessive deficits remains on track.** This is in particular the case of *France* and *Slovenia*. For these countries, the Commission is adopting Recommendations inviting Governments to address the situation in a timely manner. In the case of *Italy*, which does not have an excessive deficit, the forecasts point to a need of further consolidation efforts to ensure the required debt reduction. As far as non-euro area countries are concerned, *Croatia* is at risk of missing targets for both headline deficits and structural adjustment on current trends and in the absence of additional measures. In *Hungary*, which does not have an excessive deficit, the structural balance is loosening which puts at risk the debt reduction.

4. FINDINGS BY MEMBER STATE

The imbalances that fourteen Member States are experiencing are of different natures. On the basis of the analysis documented in detail in the IDRs, the Commission considers that *Belgium, Bulgaria, Germany, Ireland, Spain, France, Croatia, Italy, Hungary,* the *Netherlands, Slovenia, Finland, Sweden,* and the *United Kingdom* experience imbalances. Among those Member States, *Croatia, Italy* and *Slovenia* are experiencing excessive imbalances. In the case of *Spain*, the Commission considers that a significant adjustment has taken place over the last year and that on current trends imbalances would continue to abate over time. While this is the basis to conclude that imbalances in *Spain* are no more excessive in the sense of the MIP, the Commission stresses that risks are still present. The differences in the nature of imbalances and excessive imbalances, including their fiscal space and stage in the surveillance process mean that the policy responses, to be prepared by the Member States in cooperation with the Commission should be customised to the specific needs of each country.

- **Belgium** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, developments with regard to the external competitiveness of goods continue to deserve attention as a persistent deterioration would threaten macroeconomic stability.

More specifically, a continuing worsening of competitiveness, including its non-cost dimension, may engender negative consequences for the economy. The ability of manufacturing to compete internationally has been hampered, which is reflected in eroding producers' margins and in job destruction. Squaring high labour costs with sustainable job creation and high standards of living requires a push towards products higher up in the global value chains. At the same time, a further decoupling between fast wage and slow productivity growth needs to be prevented. In this respect, Belgium has taken steps that are expected to produce effects in upcoming years. Yet, preserving the manufacturing basis requires more ambitious action, all the more so with reforms unfolding in competitor countries. This is related to labour taxes and making wage formation more responsive to economic and sectorial realities, and addressing persistent problems with regard to labour market functioning. Belgium's high public debt remains a concern for the sustainability of public finances. On the positive side, however, Belgium has managed to stabilize its public debt ratio, is estimated to have met the recommended deficit target in 2013, and is projected to keep the deficit below 3 per cent of GDP. Moreover, long average maturities, relatively reduced interlinkages with the domestic financial sector and a relatively healthy private sector temper risks for the wider economy.

- **Bulgaria** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, the protracted adjustment of the labour market warrants policy actions, while the correction of the external position and corporate deleveraging are progressing well.

  More specifically, Bulgaria experienced a period of very rapid accumulation of imbalances during the boom phase that coincided with accession to the EU. High foreign capital inflows contributed to the overheating of the economy and sustained increases of fixed asset prices. The current account reversed since 2009 but the stock of external liabilities, though a large share is FDI, remains high. The adjustment appears to be mostly non-cyclical, but a further reduction in external liabilities depends on sustaining external competitiveness and a strong export performance. The ongoing deleveraging of non-financial corporations could limit investments and growth in some sectors in the short and medium term. Also the weak non-inclusive labour market limits the adjustment capacity of the economy and is one of the reasons that holds back potential growth. Unemployment has increased sharply, as the contraction in employment during the crisis has been more pronounced than suggested by the contraction of output. The low-skilled and young workers have been most affected by labour shedding. Despite relatively low wage costs, after strong increases in recent years, wage floors may risk pricing the most vulnerable out of the labour market. At the same time, active labour market policies and the educational system have not been effective in facilitating the adjustment process so far and hamper a broad-based accumulation of human capital.

- **Germany** is experiencing *macroeconomic imbalances, which require monitoring and policy action*. In particular, the current account has persistently recorded a very high surplus, which reflects strong competitiveness while a large amount of savings were invested abroad. It is also a sign that domestic growth has remained subdued and economic resources may not have been allocated efficiently. Although the current account surpluses do not raise risks similar to large deficits, the size and persistence of the current account surplus in Germany deserve close attention. The need for action so as to reduce the risk of adverse effects on the functioning of the domestic economy and of the euro area is particularly important given the size of the German economy.

More specifically, relatively low private and public sector investment together with subdued private consumption over a longer period contributed to modest growth, falling trend growth, increased dependence of the economy on external demand and the build-up of the external surplus. The challenge is, therefore, to identify and implement measures that help strengthen domestic demand and the economy's growth potential. Higher investment in physical and human capital, and promoting efficiency gains in all sectors of the economy, including by unleashing the growth potential of the services sector, which would also contribute to further strengthening of labour supply, are central policy challenges.

- **Ireland**: The recently completed macroeconomic adjustment programme was instrumental to manage economic risks and reduce imbalances. However, the remaining macroeconomic *imbalances require specific monitoring and decisive policy action*. In particular, financial sector developments, private and public sector indebtedness, and, linked to that, the high gross and net external liabilities and the situation of the labour market mean that risks are still present. The Commission will put in motion a specific monitoring of the policy implementation, and will regularly report to the Council and the Euro Group. This monitoring will rely on post-programme surveillance.

  More specifically, starting in 2007, Ireland experienced a collapse of the property market, and measures to address losses in banks and a fall in government revenues gave rise to severe budgetary problems. On the back of a loss of market access, Ireland sought international financial assistance at the end of 2010. Ireland maintained a strong track record of implementation throughout the programme, which was completed in 2013. The fiscal consolidation targets under the programme have been met, and Ireland has improved domestic fiscal rules and institutions. Moreover, the headline deficit is projected to meet the targets in 2013 and 2014. Bank deleveraging targets have been met and capital adequacy ratios have improved. Financial supervision and regulation have been strengthened. Households have increased their saving rates to reduce their indebtedness. Labour market reforms contributed to a reduction in unemployment. House prices have also stabilized and shown signs of recovery. Nonetheless, more progress is needed as public debt remains very high, as does external debt, the financial sector is vulnerable with a high amount of non-performing loans and long-term and youth unemployment remains elevated.

- **Spain** is experiencing *macroeconomic imbalances which require specific monitoring and decisive policy action*. In several dimensions, the adjustment of the imbalances identified last year as excessive has clearly advanced and the return to positive growth has reduced risks. Yet, the magnitude and inter-related nature of the imbalances, in particular high domestic and external debt levels, mean that risks are still present. The Commission will continue a specific monitoring of the policies recommended by the Council to Spain in the context of the European Semester, and will regularly report to the Council and the Euro Group. This monitoring will rely on post-programme surveillance.

  More specifically, the adjustment has been supported by decisive policy actions at the EU level and by Spain. In particular, the recapitalisation and restructuring of weaker banks have dispelled systemic concerns about the financial sector and allowed a smooth ending of the financial assistance programme at the beginning of 2014. The current account has turned into surplus, as a result of a combination of import compression and strong exports, supported by competiveness gains. The housing market has approached stabilisation. Employment destruction appears to be coming to an end. On the policy front, the comprehensive agenda of structural reforms outlined in the 2013 NRP is mostly completed from legislative point of view, and attention is shifting to a challenging implementation phase. These positive developments have led to a strong return of confidence, manifest in the fall in market risk premia, the return of foreign capital inflows and the rise in business and consumer confidence.

Yet, the adjustment is far from complete and vulnerabilities persist. More specifically, the very high stock of private and public debt, both domestic and external, continues to pose risks for growth and financial stability. Despite its recent contraction, unemployment remains at alarming levels. The re-orientation of the productive system towards exporting sectors and the recovery in international competitiveness will have to be maintained to reduce the very large stock of external liabilities and the burden that it causes in terms of negative flow of incomes towards the rest of the world. The adjustment of private sector balance-sheets is advancing, but high unemployment and falling incomes have limited the pace of deleveraging of households. Non-financial corporations have reduced debt at a somewhat more sustained pace. Going forward, the challenge is ensuring that deleveraging will go hand in hand with positive credit flows to financially healthy borrowers. Removing hindrances in the functioning of the product and financial markets and efficient insolvency procedures could reduce the drag on growth from deleveraging. In the labour market, building on the positive effects of recent reforms on internal flexibility and wage settings, additional reforms could be envisaged. Finally, significant revenue shortfalls, higher social expenditure and costs of bank recapitalisation have led to a substantial pressure on government deficits and a steep rise in government debt to high levels. The 2013 fiscal deficit target might have been missed, although the improving macroeconomic prospects should allow Spain to meet the 2014 headline target. Ensuring a reduction in government debt in the medium-term will require sustained fiscal efforts.

- **France** continues to experience *macroeconomic imbalances, which require specific monitoring and decisive policy action*. In particular, the deterioration in the trade balance and in competitiveness as well as the implications of the high level of public sector indebtedness deserve continuous policy attention. The need for decisive action so as to reduce the risk of adverse effects on the functioning of the French economy and of the euro area is particularly important given the size of the French economy and potential spillovers onto the functioning of the euro area. Given the need for policy action already called in the 2013 IDR, the Commission will put in motion a specific monitoring of the policies recommended by the Council to France in the context of the European Semester, and will regularly report to the Council and the Euro Group.

  More specifically, the growing trade deficit reflects the long-term decline in export market shares which is linked to persistent losses in both cost and non-price competitiveness. Despite measures taken to foster competitiveness, so far there is limited evidence of rebalancing. While wages have developed in line with productivity, the labour cost remains high and weighs on firms' profit margins. The low and decreasing profitability of private companies, in particular in the manufacturing sector, may have hampered their ability to grow and improve their export performance. The unfavourable business environment, and in particular the low level of competition in services, further aggravate the competitiveness challenge. In addition, rigidities in the wage setting system result in difficulties for firms to adjust wages to productivity. Despite measures taken to reduce the government deficit since 2010, public debt has continued to increase, which calls for continued fiscal consolidation and, given the high level of public expenditure, for specific focus on spending cuts, notably through the search for efficiency gains. France is projected to miss both headline deficit and structural adjustment targets over the entire forecast period.

- **Croatia** is experiencing *excessive macroeconomic imbalances, which require specific monitoring and strong policy action.* In particular, policy action is required in view of the vulnerabilities arising from sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt, all within a context of low growth and poor adjustment capacity. The Commission will put in motion a specific monitoring of policy implementation, and will regularly report to the Council.

  More specifically, after an expansionary phase, in which imbalances accumulated, Croatia is now experiencing a prolonged bust, in which a range of external and internal risks have come to the fore. External rebalancing is beset by important risks pending the reduction of Croatia's foreign liabilities to safer levels and is conditioned on improved competitiveness and broadening exports beyond tourism to support growth. The deleveraging of non-financial corporates is still at an early stage and non-performing loan developments in this segment need monitoring. State-owned enterprises, which in some sectors still play a dominant role and which are often un-restructured, are overall highly indebted and weakly profitable. Croatia has the lowest activity and employment rates in the EU, which is partly related to underlying institutions and policy settings. Better labour market functioning will be crucial to support the growth and adjustment needed in view of external and internal vulnerabilities. On nearly a range of standard indicators, Croatia's business environment ranks significantly below the average for central and eastern European Member States. These factors combine to lower potential growth, which hinders private sector balance sheet repair and increases the required fiscal consolidation effort. There is a need for significant additional fiscal consolidation efforts to curtail the deficit and prevent debt from rising unsustainably. Croatia is in EDP and needs to take effective action to address the excessive deficit by 30 April 2014. On current trends, in the absence of additional measures, Croatia risks missing its targets by a large margin in 2014.

- **Italy** is experiencing *excessive macroeconomic imbalances, which require specific monitoring and strong policy action*. In particular, the implications of the very high level of public debt and weak external competitiveness, both ultimately rooted in the protracted sluggish productivity growth, deserve urgent policy attention. The need for decisive action so as to reduce the risk of adverse effects on the functioning of the Italian economy and of the euro area, is particularly important given the size of the Italian economy. The Commission intends to put in motion a specific monitoring of the policies recommended by the Council to Italy in the context of the European Semester, and will regularly report to the Council and the Euro Group.

  More specifically, high public debt puts a heavy burden on the economy, in particular in the context of chronically weak growth and subdued inflation. Reaching and sustaining very high primary surpluses – above historical averages – and robust GDP growth for an extended period, both necessary to put the debt-to-GDP ratio on a firmly declining path, will be a major challenge. In 2013, Italy has made progress toward its medium-term fiscal objective. However, there is a risk that the adjustment of the structural balance in 2014 is insufficient given the need to reduce the very large public debt ratio at an adequate pace. The crisis has eroded the initial resilience of the Italian banking sector and weakens its role to support the recovery of the economy The losses of competitiveness are rooted in a continued misalignment between wages and productivity, a high labour tax wedge, an unfavourable export product structure and a high share of small firms which find it difficult to compete internationally. Rigidities in wage setting hinder sufficient wage differentiation in line with productivity developments and local labour market conditions. Long-standing inefficiencies in the public administration and judicial system, weak corporate governance, and high levels of corruption and tax evasion reduce the allocative efficiency in the economy and hamper the materialisation of the benefits of the adopted reforms. Large human capital gaps – reflecting low returns to education for younger generations, the country's specialisation in low-to-medium technology sectors and structural weaknesses in the education system – adds to the productivity challenge.

- **Hungary** continues to experience *macroeconomic imbalances, which require monitoring and decisive policy action*. In particular, the ongoing adjustment of the highly negative net international position, the high level of public and private debt in the context of a fragile financial sector and deteriorating export performance continue to deserve very close attention so as to reduce the important risks of adverse effects on the functioning of the economy.

  More specifically, despite a lacklustre export performance, the NIIP has been improving, reflecting primarily private sector deleveraging. Although there have recently been some encouraging signs in manufacturing, it will not be enough to bring out by itself a marked turnaround in export performance. While the debt level has declined, the imbalance and risks related to private debt remain, as deleveraging has been hindered by a high share of distressed borrowers, a depressed housing market, a fragile financial sector, a substantial share of loans in foreign currency as well as prevailing business uncertainty. Restoring normal lending to the economy in a sustainable manner would require improving the operating environment for banks. A high government debt is another important source of concern. Despite substantial improvements in the structural fiscal balance, a weakened exchange rate, a poor growth potential and elevated financing costs have kept the debt from declining. Hungary is not expected to meet its medium-term objective and its structural balance is projected to deteriorate in 2014.

- **The Netherlands** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, macroeconomic developments regarding private sector debt and ongoing deleveraging, coupled with remaining inefficiencies in the housing market, deserve attention. Although the large current account surplus does not raise risks similar to large deficits, and is partly linked to the need for deleveraging, the Commission will follow the developments of the current account in the Netherlands in the context of the European Semester.

  More specifically, rigidities and distorted incentives have built up over decades to shape house financing and sectorial savings patterns. Balance sheets of financial institutions became heavily geared towards housing finance, as households leveraged up against housing wealth. In parallel, since the mid-1990s, non-financial corporates moved into a structural savings surplus. This has resulted in a substantial and persistent current account surplus going hand-in-hand with a high level of both gross household debt and household net assets. In recent years, subdued domestic demand in the wake of the global crisis has further pushed up the external surplus. Over the past years there have been improvements in this regard with policies implemented to curb mortgage-financing. Deleveraging will continue to weigh on economic activity but a stabilising housing market and a significantly positive net asset position of households limit the risks. As regards public finances, the Netherlands is forecast to miss its headline deficit target in 2014, the year in which the excessive deficit should be corrected, although it is expected to have adopted the structural measures of the recommended size in 2013-14.

- **Slovenia** continues to experience *excessive macroeconomic imbalances which require specific monitoring and continuing strong policy action.* Imbalances have been unwinding over the last year, thanks to macroeconomic adjustment and decisive policy action by Slovenia. Yet the magnitude of the necessary correction means that substantial risks are still present. The Commission will continue the specific monitoring of the policies recommended by the Council to Slovenia in the context of the European Semester, and will regularly report to the Council and the Euro Group.

  More specifically, the risk stemming from an economic structure characterized by weak corporate governance, high level of state involvement in the economy, losses in cost competitiveness, the corporate debt overhang, the increase in government debt warrant very close attention. While considerable progress has been made in repairing the banks' balance sheets, determined action with respect to the full implementation of a comprehensive banking sector strategy, including restructuring, privatisation and enhanced supervision is still required.

  Slovenia continues to struggle with the legacy of its previous boom, with corporates remaining unsustainably over-indebted. The transfer of non-performing loans (NPLs) to the Bank Asset Management Company (BAMC) has improved the banks' balance sheets but NPLs remain elevated relative to pre-crisis levels and still need to be durably restructured based on the recently amended insolvency framework. As domestic demand, and especially investment, contracted significantly, the current account has corrected sharply, turning into a large surplus, but cost competitiveness losses have not been recouped and reforms so far have not fully addressed the labour market flexibility and competitiveness challenge. Weak corporate governance, particularly but not only in state-owned enterprises, reduces the overall efficiency of the economy through possible inefficient allocation of resources. Significant withdrawal of the state from the corporate and financial sector, combined with a comprehensive strategy for the management of core assets and divestment of non-core assets, could improve the adjustment capacity of the economy. Finally, the substantial increase in government debt in recent years, albeit from a relatively low level, creates new challenges. While the headline fiscal deficit is expected to be above the targets due to the significant expenditures related to bank recapitalisation in 2013 and 2014, the deficit is also projected to exceed the target in 2015 under a no-policy-change scenario. The structural adjustment likewise falls slightly short of what would be needed. Taken together, these shortcomings and challenges weigh on the near term macroeconomic performance. The recent fall in sovereign bond yields relieves some pressure but the pace of implementation of the programme of structural reform needs to accelerate.

- **Finland** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, the weak export performance during the last years, driven by industrial restructuring, cost and non-cost competitiveness factors, deserve continued attention.

  More specifically, high import growth prior to the crisis and subdued exports afterwards explained the erosion in external balance. However, the current account has stabilised recently and external sustainability is not a concern. The country continued to lose export market shares at a fast pace, despite the recovery in world trade. Finland's integration into global value chains has played a role in the declining performance of exports, while the industrial restructuring has not yet been able to make up for the large downsizing of the electronics and forestry industries. In turn, the adjustment capacity of the economy is constrained by low productivity and weak competitive pressures in services as well as increasing costs due to dynamic wage growth and a high energy-intensity. Exporters have thus been able to sustain price competitiveness mainly by compressing profit margins, which have limited their capacity to translate the high innovation potential into new products. Non-cost factors appear to explain most of the deterioration in competitiveness: a limited number of large exporting firms selling a narrow product range, a lower propensity of small companies to export as well as less efficient R&D spending. In turn, weak investment, a declining working age population and a significant drop in productivity weigh on potential growth. As regards public finances, the structural deficit is expected to be slightly above its medium-term objective in 2014 while, partly due to the unfavourable growth dynamics, the public debt is projected to increase to above 60 per cent of GDP.

- **Sweden** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, developments regarding household indebtedness, coupled with inefficiencies in the housing market, continue to warrant attention. Although the large current account surplus does not raise risks similar to large deficits, and is partly linked to the need for deleveraging, the Commission will follow the developments of the current account in Sweden in the context of the European Semester.

  More specifically, household debt has increased again after a period of stabilisation, as the main contributing factors – low interest rates on mortgages, debt-bias in taxation, slow mortgage amortisation and limited housing supply – remain in place. Various indicators of credit supply and demand conditions do not indicate imminent deleveraging pressures. After stabilising in recent years, house prices increased again in 2013, driven by favourable demand conditions and supply inefficiencies. Moreover, rental market inefficiencies, cumbersome planning procedures and little competition in construction, have also contributed to the house price dynamics. More stable house prices are needed to limit private indebtedness and reduce macroeconomic risks, once debt service costs increase. The recent macroprudential measures are instrumental, but likely not enough, to reduce macroeconomic risks. In particular, strong tax incentives for debt financing are perceived as key drivers of house prices. Higher residential investment would also improve the savings-investment balance. As regards the non-financial corporate sector indebtedness the analysis finds that it does not give rise to macroeconomic risks. Moreover, recent reforms in company taxation are likely to further reduce the level of corporate debt by limiting tax minimisation by multinationals.

- The **United Kingdom** continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, developments in the areas of household debt, linked to the high levels of mortgage debt and structural characteristics of the housing market, as well as unfavourable developments in export market shares, continue to warrant attention.

  More specifically, while recent growth in economic activity is welcome, it is driven mostly by household consumption and is accompanied by a rising current account deficit. Business investment and net exports are yet to pick up from their current low levels. Containing high indebtedness, in particular of the household sector, while minimising the impact on investment and growth, would help limit medium-term risks and vulnerability to rises in the cost of borrowing. Credit growth for mortgage loans has been modest but rising from high pre-existing levels of household indebtedness. The risks in the housing sector relate to a continuing structural under-supply of housing; the relatively slow response of supply to increases in demand results in high house prices, particularly in London and the Southeast, and in household mortgage indebtedness. While the declining export market share is unlikely to pose short-term risks, together with the current account deficit, it still points to structural challenges. These are related to skills gaps and a low level of infrastructure endowment. As regards public finances, the UK seems to continue missing its headline deficit targets and its structural adjustment targets by wide margins.

For three countries under review, no macroeconomic imbalances have been identified. The IDRs shows that the macroeconomic risks in *Denmark* and *Malta* have abated and are better controlled. Also, there is no evidence of imbalances in the sense of the MIP in *Luxembourg*. However, careful surveillance and policy coordination is necessary at all times for all Member States to identify emerging risks and put forward the policies that contribute to growth and jobs. This surveillance will continue in the context of the European Semester.

- The macroeconomic challenges in **Denmark** *no longer constitute substantial macroeconomic risks and are no longer identified as imbalances in the sense of the MIP*. The adjustment on the housing market and the implications of a high private sector debt for the real economy and the stability of the financial sector seem contained. However, these developments, as well as drivers of external competitiveness deserve continued monitoring.

  More specifically, macro-financial risks stemming from elevated private debt appear limited, even in the face of tail risks such as combined adverse interest rate shocks and unfavourable labour market developments. The high level of household debt is matched by high household assets, mirroring large savings in pension funds and real estate. Households have so far been financially capable of handling the house price adjustment since 2007, as the number of arrears has stayed at a very low level. Moreover, various stress test and studies have concluded that the households would be resilient in the event of adverse shocks. The financial sector appears stable with the remaining challenges tackled through strengthened regulatory and supervisory measures. Regarding competitiveness, Denmark has been losing export market shares; this is linked to high wage growth and weak productivity growth. However, the mismatch between productivity and wages seems to be a cyclical phenomenon. In view of the high current account surpluses, the trend decline in exports market shares does not point to short-term risks. As regards public finances, Denmark is expected to have sustainably corrected its excessive deficit in 2013.

- The macroeconomic challenges of **Luxembourg** *have not been identified as imbalances in the sense of the MIP*. They stem from a growth model based on an efficient financial sector, which has weathered the crisis well. Still, losses in the manufacturing competitiveness, the evolution of the housing market and the high level of indebtedness of the private sector deserve continued monitoring.

  More specifically, the analysis of the current account surplus shows that it does not stem from an anaemic domestic demand, but is rather the result of the particular growth model of the country strongly based on financial services. Still, it masks a large and steadily increasing deficit in merchandise trade, which broadly comes from disappointing exports. Losses of export market shares are largely associated with unit labour costs rising much faster than in trading partner countries, driven to a certain extent by the wage setting mechanism. In such regard, finding a structural solution to the temporary modulation of the automatic wage indexation constitutes a challenge. Risks to the domestic financial stability stemming from the presence of a large financial sector exist, but they are relatively contained as the sector is diversified and specialised at the same time. Furthermore, domestic banks post sound capital and liquidity ratios. The high level of indebtedness of the private sector and in particular of the non-financial corporations mainly reflects the presence of a large number of multinational firms that use their branches or subsidiaries in Luxembourg for intra-group financing operations. The dynamism of house prices represents an increasing source of concern. Finally, the current favourable position of public finances is highly dependent on the sustainability of the growth model based on a buoyant financial sector and presents a high sustainability risk in the long term. In this vein, the recently implemented pension reform is insufficient to cope with the challenge. However the structural balance is above the medium-term objective.

- The macroeconomic challenges in **Malta** *no longer constitute substantial macroeconomic risks and are no longer identified as imbalances in the sense of the MIP*. Although indebtedness remains high, risks to the sustainability of private and public sector debt and the stability of the financial sector appear contained, even if they deserve continued monitoring.

  More specifically, the analysis in the IDR finds that financial stability indicators remain sound. Still, in light of the structural nature of the risks in the sector, a continuation of the current prudent supervisory and risk-taking practices is key. The housing market has stabilised and thus risks arising from over-exposure to property are limited. Private debt is on the decrease; the corporate deleveraging is taking place in an orderly manner and credit market pressures are limited. As regards public finances, Malta is expected to meet its nominal deficit targets in 2013 and 2014. As regards external sustainability, trade performance has been positive, thanks to product and geographical market orientation and non-cost competitiveness factors; the current account balance is in surplus. Still, external competitiveness could benefit from active policy response to cost-adjustments in competitor countries.