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COMMISSION STAFF WORKING DOCUMENT

Analysis of the euro area economy

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on the economic policy of the euro area

{COM(2021) 742 final}

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Table of Contents

Introduction 2

Macro Developments 2

Policy developments and progress in the implementation of the 2021 euro area recommendation 5

1. Fiscal and monetary policy mix 6
   1. Fiscal Policy Stance 6
   2. Composition and quality of public finances 9
   3. Revenue policy 10
   4. Monetary Policy Stance 11
2. Long-term macroeconomic impact of COVID-19 13
   1. Impact on capital accumulation and productivity 14
   2. Phasing out of support to the corporate sector 15
   3. Labour market challenges 16
3. Structural Policies 18
   1. Business environment, access to finance and Capital Market Union 18
   2. Insolvency frameworks 19
   3. Labour market policies and skills strategies 20
   4. Institutional quality and measures to increase fund absorption 21
4. Macro-Financial Stability 23
   1. Current state of play 23
   2. Risks to financial stability and potential reforms 26
5. The euro area in the World 28
   1. The euro area and global economic developments 28
   2. Global value chains and trade linkages 30
   3. Global Imbalances 30
   4. The International Role of the Euro 32

Annexes 33

Annex 1: 2021 Euro Area Recommendation 33

Annex 2: Correspondence between reforms implemented in the Recovery and Resilience Programmes and priorities in the Euro area Recommendation 2021 35

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Introduction

This Staff Working Document (SWD) underpins the Recommendation for a Council recommendation on the economic policy of the euro area (Euro Area Recommendation, EAR). The recommendation provides policy guidance on the reforms and investments that euro area Member States should put forward, including by implementing their Recovery and Resilience Plans (RRP), and highlights areas where Member States could work collectively to improve the economic and social resilience of EMU.

The SWD offers first an overview of the main macroeconomic and policy developments since the 2021 Euro Area Recommendation (EAR)[1]*. It then provides an assessment of the developments in five areas of particular relevance: (i) the overall policy stance underpinning the recovery; (ii) the medium-term impact of the crisis; (iii) the role of structural reforms to ensure a sustainable recovery; (iv) macro-financial stability and (v) the interconnectedness between the euro area and the global economy. These are areas where spillovers and euro area common goods are particularly important; that are crucial for the correct functioning of the euro area; and that are of high relevance in the current recovery context.*

Macro Developments

A strong economic recovery has taken hold in 2021 and the EU is now moving into expansion. The euro area economy is rebounding faster and more forcefully than previously expected from the COVID-19 crisis. Economic growth came in at 2.1% in 2021Q3, surpassing expectations. Growth continued unabated at 2.2% in the third quarter, allowing the euro area to virtually close its gap with pre-pandemic output levels (2019Q4) – one quarter earlier than previously expected. The rebound was driven by consumption of investment, the two demand components most hit by the pandemic crisis during the first half of 2020[2] (**Graph 2**). According to the European Commission Autumn 2021 Economic Forecast[3], growth in the euro area economy is expected to slow down to 0.8% in the fourth quarter and achieve a yearly rate of 5.0% in 2021. The economy would then continue expanding by a still robust 4.3% in 2022, before moderating to 2.4% in 2023. Importantly, by 2023, real GDP in the euro area is expected to converge to the level that was expected before the pandemic hit, based on an extrapolation of trend growth in the Forecast (**Graph 1**).

The COVID-19 shock had different impacts across sectors and regions. By its nature, the crisis had a much stronger impact on services that require physical interaction. At the trough of the crisis, gross value added in contact-intensive services fell by around 25%[4], against a decrease of 19.5% in manufacturing and 6.5% in other services. By 2020Q2, value added in contact-intensive activities still remained 8% below the pre-pandemic level. The impact of the crisis has also been asymmetric across regions, with areas with large tourist sectors being

[1] After the presentation of the proposal by the Commission on 18 November, and the Eurogroup agreement on 16 December 2020 (following negotiations at technical level), the Council approved the draft 2021 Council recommendation on the economic policy of the euro area in January 2021. The Council formally adopted the Council Recommendation on the economic policy of the euro area, on 13 July 2021, after the endorsement by the European Council.

[2] See Croitorov, O., Filippeschi, G., Licchetta, M., Pfeiffer, P., Reut, A., Simons, W., Thum-Thysen, A., Vandeplas, A. and Vogel, L. (2021), '[The macroeconomic impact of the Covid-19 pandemic in the euro area](#)', Quarterly Report on the Euro Area (QREA), Vol. 20, No. 2, European Commission.

[3] Based on European Commission, (2021), 'European Economic Forecast: Autumn 2021', Directorate General for Economic and Financial Affairs, Institutional Paper 160, November 2021, Publications Office of the EU 2021, Luxembourg.

[4] Contact-intensive sectors include: arts, entertainment and recreation as well as wholesale and retail trade, transport, accommodation and food service activities.

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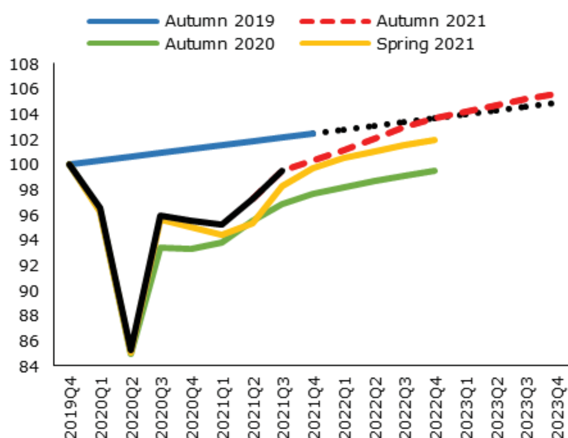
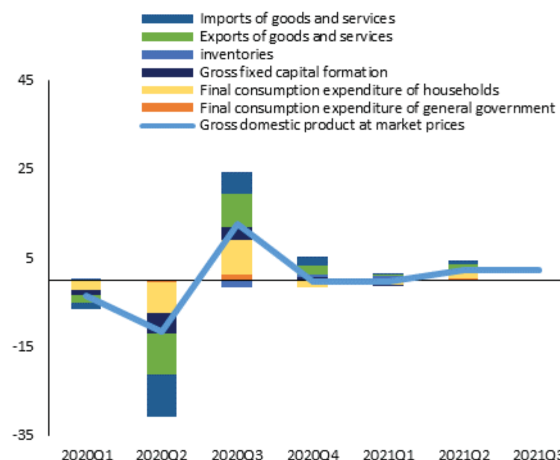
more severely affected[5]. Weekly hours worked also dropped significantly in moderately and less developed regions.

Graph 1: GDP level since 2019Q4 versus pre-crisis trend line (various forecasts)



Note: The series are indexed at 2019Q4 = 100.
Source: AMECO.

Graph 2: Decomposition of quarterly real GDP growth in the euro area



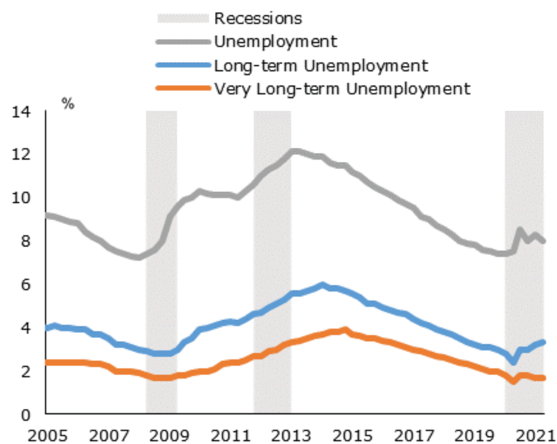
Note: At the date of 15/11/2021, the decomposition of quarterly GDP in 2020Q3 is still not available.
Source: Eurostat.

Labour markets continue to recover, though pockets of labour market shortages are emerging. The monthly unemployment rate in the euro area was 7.4% in September 2021 **(Graph 3)**, down from a peak of 8.6% in September 2020 and slightly below the pre-crisis level recorded in January 2020 (7.5%). Meanwhile, the job vacancy rate has steadily increased since 2020Q1 and reports of pockets of labour shortages are starting to emerge, particularly in sectors where activity is surging most. The broad use of short-time work schemes, including via the Support to Mitigate Unemployment Risks in Emergency (SURE), has cushioned the impact of the pandemic on the labour market (see also Section 3). Given the widespread use of these schemes, the contraction in employment was most visible in the sharp reduction in hours worked. The fall in headline employment **(Graph 4)** was rather mild compared with the recorded loss in output. Total hours worked decreased particularly strongly in contact-intensive services. In the second quarter of 2021, total employment and average hours worked per person remained below their pre-crisis levels, also reflecting remaining labour market slack. As the economy has started recovering, also labour market conditions improved markedly, as both headcount employment and hours worked increased. At the same time, the number of workers benefiting from job retention schemes fell and the unemployment rate decreased further. However, the recovery progressed unevenly across sectors and Member States. According to the European Commission Autumn 2021 Economic Forecast, employment in the euro area will surpass its pre-crisis level by 2022 and further expand to a record high level in 2023.

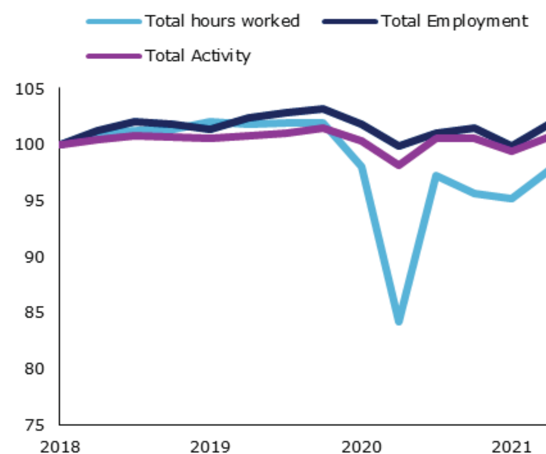
Graph 3: Euro area unemployment rate, long-term unemployment rate and very long-term unemployment rate

Graph 4: Euro area hours worked, total employment and activity (20-64)

[5] Batista e Silva, F., Marin-Herrera, M.A., Rosina, K., Barranco, R., Freire, S., Schiavina, M. (2018), 'Analysing spatiotemporal patterns of tourism in Europe at high resolution with conventional and bit data sources'. Tourism Management, volume 68, p. 101-115.



Source: Eurostat.



Note: The series are indexed at 2008Q1 = 100.
Source: Eurostat (Labour Force Survey).

The strong resumption of activity has been accompanied by a stronger than expected pick-up in inflation, but inflationary pressures are expected to abate in 2022. Following several years of very low inflation, the recovery has been accompanied by a surge in inflation rate. Annual HICP inflation in the euro area hit a ten-year high of 4.1% in October. This swift increase reflects to a large extent strong base effects, as factors that dragged down prices during the pandemic in 2020 are ceasing to play a role this year. In recent months, increases in energy prices well above the pre-pandemic levels have ignited new inflationary pressures and price increases have become broad-based, also under the impact of disruptions to production and logistics in many parts of the world (see also Box 1). Inflation in the euro area is set to peak at 3.7% in the last quarter of the year and continue recording high prints in the first half of 2022. Being to a large extent linked to the re-opening of the economies and ensuing economic adjustment, the current elevated price pressures are still expected to be largely transitory. Inflation is thus expected to moderate sharply thereafter and fall down to 1.4% by 2023.

The COVID-19 crisis has temporarily increased divergences across the euro area. The depth of the economic contraction caused by the pandemic in 2020 varied significantly across Member States. The length and stringency of the containment measures, the sectoral specialisation, and degree of resilience have been important factors in explaining the differences in the impact of the pandemic crisis across Member States. In spite of a successful coordination, the extent and type of policy support also mattered. As the economies re-opened and the recovery took hold, new patterns of heterogeneity have come to the fore. Notably, supply-side disruptions matter most for the countries that have either a high degree of trade exposure or a relatively large manufacturing sector. Going forward, the NGEU/Recovery and Resilience Facility is set to play an important role in reducing divergences and improving convergence processes within the euro area[6].

[6] Estimates from the European Commission seem to confirm that countries that experienced the highest GDP fall in 2020 will be also the ones benefiting the most from the facility. See Pfeiffer, P., et al. (2021), 'Quantifying spillovers of the the Next Generation EU investments', Directorate-General for Economic and Financial Affairs, Discussion Paper 144, European Commission.

Policy developments and progress in the implementation of the 2021 euro area recommendation

In response to the pandemic, the euro area, the EU and the Member States took very bold policy measures. At the EU level, the policy response included, first, measures granting flexibility to Member States to support their economies (activation of the general escape clause of the Stability and Growth Pact, temporary framework to use the flexibility under EU state aid rules and redirection of cohesion policy funds) and, second, a series of safety nets. Throughout 2020, support measures were established for workers (the temporary Support to mitigate Unemployment Risks in an Emergency - SURE); for businesses (Pan-European Guarantee Fund by the European Investment Bank); and for Member States (European Stability Mechanism (ESM)'s Pandemic Crisis Support). Together with sizeable measures put in place, individually and in a coordinated manner by Member States, to contain the pandemic and provide support to individual and business, as well as the resolute monetary policy interventions by the ECB (see Section 1), the policy response effectively mitigated the impact of the crisis on EU economies: it effectively mitigated the risk of further divergence, supported the recovery, and participated to the enhancing of social and economic resilience in the euro area by tacking structural challenges.

The European recovery strategy is centred on the Recovery and Resilience Facility (RRF). The RRF, as the main component of the NGEU, makes available, through grants and loans, up to EUR 723.8 billion (in current prices) in financial support for reforms and investment based on Recovery and Resilience Plans (RRPs) proposed by Member States. As of Mid-November 2021, 26 EU Member States had submitted their plans to the Commission, out of which all but one euro area country[7]. The Council had adopted the recovery and resilience plans of 22 Member States, including of eighteen euro area countries, after positive assessments by the Commission. The Commission has already paid close to EUR 50.5 billion in pre-financing to euro area Member States since August 2021. With the roll-out of the Recovery and Resilience Facility and first funds disbursed to Member States, the focus now turns to the implementation phase. The timely and full implementation of reforms and investments by Member States, in line with the agreed milestones and targets, can spur the recovery, strengthen resilience and ensure a lasting impact on the EU's society and economy.

The RRPs will also be central to implementing the recommendation on the economic policy of the euro area. The RRPs of euro area Member States need to be consistent both with the relevant country-specific recommendations and with the challenges and priorities "identified in the most recent Council recommendation on the economic policy of the euro area". The 2021 Council recommendation on the economic policy of the euro area focused on five areas, with the aim to (i) ensure a policy stance that supports the recovery from the COVID-19 crisis; (ii) further improve convergence, resilience and sustainable and inclusive growth; (iii) strengthen national institutional frameworks; (iv) ensure macro-financial stability; and (v) complete the EMU and strengthen the international role of the euro (see Annex 1). RRPs contribute to progress in the implementation of the euro area recommendations related to public finances, to structural reforms and to the strengthening of the national institutional framework (see Annex 2). Measures aimed at ensuring macro-financial stability are comparatively less present in RRPs: only four euro area Member States appear to have taken measures to that effect. However, the very creation of NGEU has clearly boosted confidence in the euro area, thus contributing to macro-financial stability. Actions to

[7] As at 15/11/2021, the Netherlands had not yet submitted a Recovery and Resilience Plan.

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make further progress on deepening the Economic and Monetary Union, with specific focus on the Banking Union and the Capital Markets Union, are essentially collective tasks and therefore are not addressed as such by the national RRPs.

Beyond the RRF, the Union has put forward an ambitious policy agenda to steer a sustainable, fair and inclusive recovery and to make the EU's economy more resilient to future shocks, while transforming our economies and societies in line with the ambition of the twin transition. Since the last EAR Staff Working Document, the Commission has taken concrete steps to deliver on our green, digital and social ambitions[8]. The 2022 Annual Sustainable Growth Survey presents the four dimension of the EU economic agenda, as guiding principle for EU's competitive sustainability: (i) environmental sustainability; (ii) productivity; (iii) fairness; and (iv) macroeconomic stability. These dimensions are closely interrelated and should be mutually reinforcing; they have guided Member States' reform and investment agenda over the past years and feature prominently among the objectives of the Recovery and Resilience Facility. Moreover, after a temporary adaptation in 2021 due to the launch of the Recovery and Resilience Facility, in 2022 the annual cycle of economic and employment policy coordination, of which the EAR are a key part, is expected to restart, supporting Member States to deliver on their sustainable growth agenda. Finally, the Commission has relaunched the public debate on the review of the EU economic governance framework to build broad-based consensus on how to enhance the effectiveness and transparency of the framework, tackle macroeconomic imbalances and address long-term fiscal challenges in a growth-friendly manner, taking into account the lessons learnt from the COVID-19 crisis.

1. Fiscal and monetary policy mix

The policy mix, which results from the interaction of monetary and fiscal policies, is a key pillar of the euro area economic policy. The supportive policy mix during the COVID-19 crisis has ensured effective macroeconomic stabilisation, mitigating risks of scarring and supporting rapid economic recovery. Monetary policy has avoided fragmentation in euro-area debt markets and has facilitated the transmission of fiscal impulses to the entire euro area economy, while also increasing the available fiscal space. At the same time, the fiscal response has helped cushion the impact of the COVID-19 crisis, by ensuring favourable financing conditions and continued access to external funding, as well as by providing direct support to firms and households in the euro area. Going forward, a supportive, consistent and coordinated policy mix[9] will continue to play an important role in strengthening the recovery, including by stabilising financial markets, and boosting potential growth by supporting the economic transition. Fiscal and macroeconomic policies are set to move away from temporary emergency measures towards recovery measures over the short-term and towards more sustainable growth-friendly measures over the longer-term.

1. Fiscal Policy Stance

Fiscal policy stance and main components

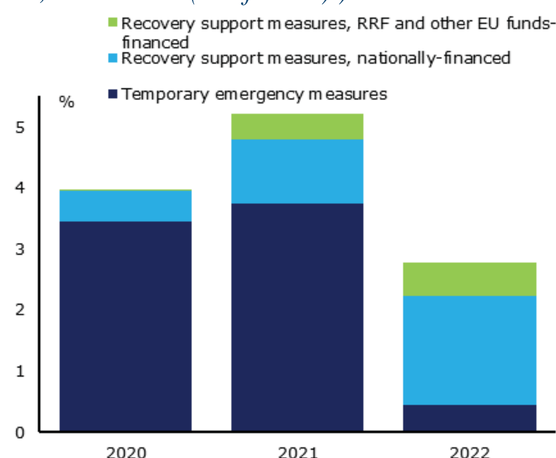
Euro area Member States have provided significant and timely fiscal support to their economies. In 2020, Member States provided an unprecedented amount of fiscal support

[8] For more information, see Annual Sustainable Growth Survey 2022.
[9] In full compliance with the Treaty safeguards concerning the respective institutions.

totalling around 6½% of GDP[10]. Discretionary fiscal measures adopted since March 2020 are expected to amount to 5.2% of GDP in 2021 and 2.8% of GDP in 2022, while automatic stabilisers have also made a significant contribution. Temporary emergency measures supported health systems and compensated workers and firms for pandemic induced income losses. Other crisis-related measures have included public investment and other spending focused on ensuring a sustainable recovery.

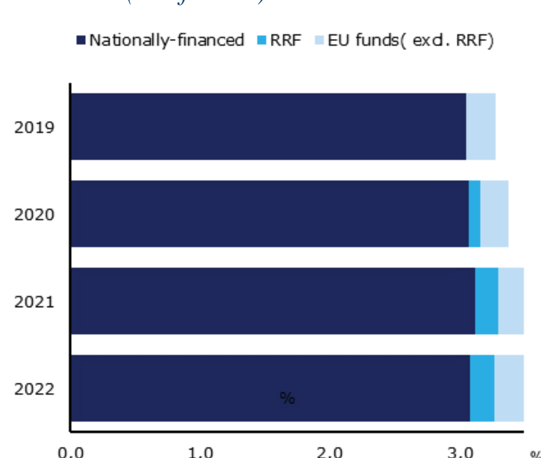
With the economic recovery taking hold, fiscal policy is expected to pivot from temporary emergency measures to recovery support measures in 2022[11]. Temporary emergency measures are estimated to represent over half of total discretionary fiscal support in 2021 but, contingent on the evolution of the pandemic, they are projected to be mostly phased out in 2022 **(Graph 5)** and to expire in 2023. In contrast to the gradual winding down of temporary emergency measures, the cost of recovery support measures (in part funded by RRF grants) is expected to increase from around 1.5% of GDP in 2021 to 2.3% of GDP in 2022. Some of these recovery support measures are expected to last beyond 2022[12]. The euro area aggregate general government deficit is expected to reach 7.1% of GDP in 2021 but to fall to 3.9% of GDP in 2022, as measures are withdrawn and economic activity returns to trend. The deficit projections from the Commission 2021 Autumn Economic Forecast are slightly lower than aggregates calculated on the basis of Member States' 2022 Draft Budgetary Plans. All euro-area Member States plan markedly lower deficits in 2022 compared to 2021.

Graph 5: Discretionary fiscal measures in the EU, 2020-2022 (% of GDP))



Source: European Commission Autumn 2021 Economic Forecast.

Graph 6: Public investment in the euro area, 2019-2022 (% of GDP)



Source: European Commission Autumn 2021 Economic Forecast.

Public investment, which had suffered after the global financial crisis, is set to support the recovery in the coming years. Public investment decreased substantially in the aftermath of the global financial crisis (GFC), averaging 2.8% of GDP between 2012 and 2016, compared to 3.4% of GDP between 2007 and 2011. In net terms[13], public investment has remained stagnant for a good part of the last decade, oscillating between -0.1% and 0.1% of

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[10] Measured as the year-on-year change in the aggregate primary general government balance.

[11] *Temporary emergency measures* are aimed at supporting health systems and compensating workers and firms for pandemic-induced income losses. They are by nature temporary, with an expiry date in 2023 or earlier. *Recovery support measures* include public investment and other measures focusing on ensuring a sustainable recovery. They can be either temporary or permanent, and some may be funded by RRF grants. Measures with a budgetary impact in 2023 that is below 10% of the initial budgetary impact are considered temporary.

[12] These measures mainly consist of increase in public sector wages, in pensions and social benefits, and reductions in personal income taxes and social security contributions. Some non-temporary measures will finance public investment, thus supporting potential growth and fiscal sustainability.

GDP, a level barely sufficient to maintain the public capital stock. In contrast, public investment in euro area Member States is forecast to reach 3.5% of GDP in both 2021 and 2022, compared to 3.3%- of GDP in 2019 **(Graph 6)**. In 2022, almost all Member States are expected to spend more on public investment than in the pre-pandemic period. EU funding, mostly through RRF grants, is expected to contribute to this increase in public investment in the euro area by 0.2% of GDP in both 2021 and 2022.

Table 1: General Government budgetary position

	2017	2018	2019	2020	2021	2022	2023
Total revenue (1)	46,2	46,4	46,3	46,6	46,1	45,5	45,5
Total expenditure (2)	47,1	46,9	46,9	53,8	53,2	49,4	47,9
Actual balance (3) = (1) - (2)	-0,9	-0,4	-0,6	-7,2	-7,1	-3,9	-2,4
Interest expenditure (4)	1,9	1,8	1,6	1,5	1,4	1,2	1,2
Primary balance (5) = (3) + (4)	1,0	1,4	1,0	-5,7	-5,7	-2,7	-1,2
One-offs (6)	-0,1	-0,1	-0,2	-0,1	0,0	0,0	0,0
Cyclically-adjusted balance (7)	-1,1	-0,9	-1,4	-3,7	-5,6	-3,8	-2,7
Cyclically-adjusted primary balance (8) = (7) + (4)	0,8	0,9	0,3	-2,2	-4,2	-2,6	-1,6
Structural budget balance (9) = (7) - (6)	-1,0	-0,9	-1,2	-3,6	-5,7	-3,8	-2,7
Structural primary balance (10) = (7) - (6) + (4)	0,9	1,0	0,4	-2,1	-4,3	-2,6	-1,6
Change in actual balance:	0,5	0,5	-0,2	-6,6	0,1	3,3	1,5
of which change in:							
- Cycle	0,8	0,3	0,2	-4,2	2,0	1,5	0,4
- Interest (reverse sign)	0,2	0,1	0,2	0,1	0,1	0,2	0,1
- One-offs	-0,2	0,0	-0,1	0,0	0,2	0,0	0,0
- Structural primary balance	-0,3	0,0	-0,5	-2,5	-2,2	1,7	1,1
Change in cyclically-adjusted primary balance	-0,4	0,1	-0,6	-2,5	-2,0	1,6	1,1
Change in structural budget balance	-0,1	0,2	-0,3	-2,4	-2,1	1,8	1,1
Public debt (% GDP)	**89,6**	**87,5**	**85,5**	**99,3**	**100,0**	**97,9**	**97,0**

Note: Contribution to change in actual balance may not add up to total due to rounding.
Source: European Commission Autumn 2021 Economic Forecast, Ameco.

Overall, the euro area fiscal stance – including support from the EU budget but excluding temporary emergency measures – is projected to remain supportive both in 2021 and 2022. In 2020, the euro area fiscal stance is estimated to have been only slightly expansionary (¼% of GDP), as the lockdowns affected the ability of governments to spend on permanent activities. In 2021, the fiscal expansion is expected to be sizeable at 1¾% of GDP, in line with the Council recommendations of spring **(Graph 7)**. Nationally-financed current expenditure is expected to provide an expansionary contribution of just over 1% of GDP in 2021, with positive contributions also coming from public investment and other capital spending financed by the national and EU budgets. The expansionary contribution from the EU budget (close to ½% of GDP) mainly reflects the implementation of Member States' RRPs. A further fiscal expansion of about 1% of GDP is forecast in the euro area for 2022, with almost all Member States expected to maintain a supportive fiscal stance. While the aggregate euro area fiscal stance appears appropriate in 2022, a better composition and calibration could better contribute to medium-term fiscal sustainability.

Debt dynamics

After a peak in 2021, the euro area general government debt-to-GDP ratio is set to start declining in 2022. The large government deficits recorded in 2020 and 2021, resulting from the severe economic recession and the necessary policy response to the COVID-19 pandemic, have increased debt levels for all Member States. According to the Autumn 2021 Economic Forecast, the euro area aggregate debt-to-GDP ratio rose by around 14 points to just below 100% of GDP in 2020, and is expected to remain at around the same level in 2021. A

[13] Net public investment is defined as gross fixed capital formation net of the consumption of fixed capital.

reduction in the ratio is forecast for 2022 (to close to 98% of GDP) on the back of lower deficits and the pick-up in nominal GDP growth. Member States' 2022 Draft Budgetary Plans project similar dynamics in the euro area debt-to-GDP ratio.

The general government debt-to-GDP ratio is expected to remain elevated over the next decade. In the euro area, the debt ratio is expected to remain broadly stable, reaching 99% of GDP by 2032[14], although this stabilisation could be hampered in the case of adverse economic shocks. Stochastic projections, featuring the uncertainty surrounding baseline projections, suggest that debt-to-GDP ratio could stand between more than 79% and 112% of GDP by 2026 with an 80% probability. While it results from appropriate fiscal support throughout the crisis, the increase in debt ratios in Member States observed in 2020 could turn into a source of vulnerability for macroeconomic stability. A progressive reduction in debt ratios is thus set to be a policy objective over the next years across the whole euro area.

Several factors affect debt projections. On the one hand, longer debt maturities and relatively stable financing sources, with a diversified and large investor base, reduce pressure on public finances. Moreover, historically low borrowing costs and the continued favourable interest rate-growth differentials expected in the coming years should help governments to stabilise or reduce their debt ratios. The successful implementation of fiscal and growth-enhancing reforms and investment under the RRF is further expected to support potential growth, improving debt sustainability and maintaining favourable financing conditions. On the other hand, government debt levels may increase if a large number of state guarantees materialise. A sudden and large reversal in the currently observed low-interest environment over the medium term could also aggravate vulnerabilities. Finally, taking a longer-term perspective, government spending related to climate change may add to pressures on public finances.

2. Composition and quality of public finances

The crisis has significantly impacted public expenditures across the euro area, placing considerable strains on Member States' public finances. Total expenditure to GDP ratio is projected to remain broadly stable (53.8% and 53.2% in 2020 and 2021, respectively) before decreasing by 3.8 percentage points in 2022. Most of the increase in expenditures has been directed to support economies and citizens, as public support has been extended to keep businesses and households afloat (see Section 2.1).

In a moment of unprecedented fiscal efforts to support the recovery, measures to improve the composition and quality of public expenditure appear particularly relevant. High-quality public investment enhances growth potential, ensures a sustainable and inclusive recovery, and supports the green and digital transitions and well-functioning public investment management schemes have the potential to enhance its effectiveness. These schemes rely on financially realistic long-term strategic planning, transparent and consistent project selection, capital budgeting integrated in a medium-term perspective, effective procurement, and implementation and monitoring throughout the lifetime of the asset[15]. Most countries are using the opportunity presented by the RRF to reform their public investment management systems, for example through reform of public procurement and/or increased

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[14] The Commission's debt sustainability analysis (DSA), which combines sensitivity tests and stochastic projections around the baseline, is the central tool to assess medium-term debt developments. The Commission baseline scenario assumes that structural primary balances will remain constant (before ageing costs) over the projection period.

[15] See for example Kim, J. H., Fallov, J. A., and Groom, S. (2020), 'Public investment management reference guide', *International Development in Practice*, World Bank; IMF, (2018), 'Public Investment Management Assessment – Review and Update', International Monetary Fund. .

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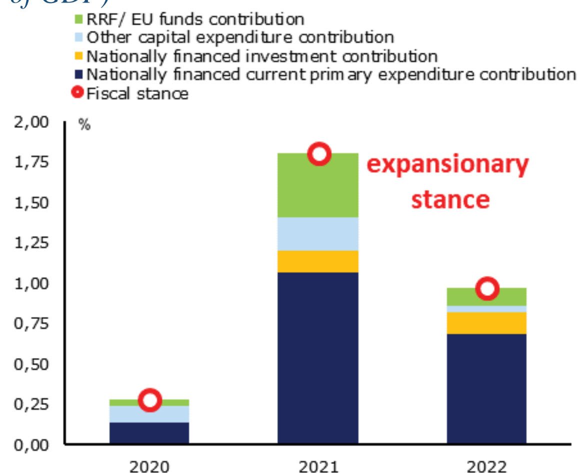
administrative capacity. Moreover, Recovery and Resilience Plans are required to provide detailed information on implementation and monitoring, audit and control mechanisms, as well as protection against corruption and fraud. In addition, expenditure reviews may help in creating fiscal space for public investments, rationalise public spending and direct it to areas in greater need. By offering a better understanding on how to spend public resources, spending reviews can improve the composition of public expenditure, including by targeting growth-friendly and sustainable expenditures. In that respect, 'green budgeting' tools can also support this process, while helping address the challenges of climate mitigation and environmental protection[16]. For example, while fossil fuel subsidies in Europe amounted to EUR 52 billion in 2020[17], green budgeting efforts suggest that wider environmentally harmful subsidies are much larger. Finally, effective public procurement systems can improve the efficiency of spending, ensuring that public authorities get the best value for money.

3. Revenue policy

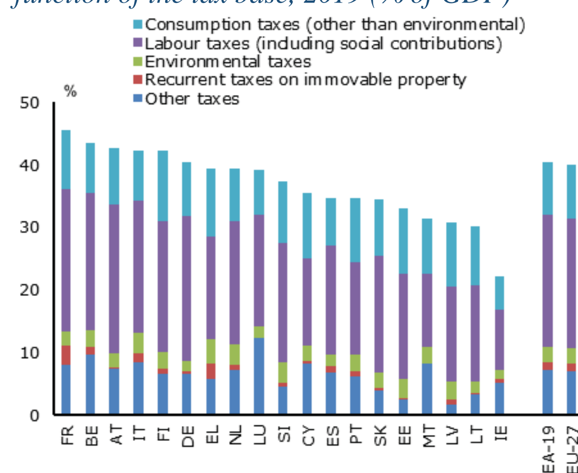
Revenue policy has become even more fundamental in the aftermath of the COVID-19 crisis. The contraction in consumption and incomes, the negative effect of the crisis on many firms and, to a lesser extent, the temporary measures to cut or defer taxes during the crisis contributed to a considerable decline in tax revenue in 2020[18]. Nevertheless, total revenues increased slightly as a share of GDP in 2020 (to 46.6%, up from 46.3% in 2019), as receipts of some taxes did not immediately respond in full to the unprecedented drop in economic activity. In both 2021 and 2022, total revenue is forecast to decline as a share of GDP, as growth in tax receipts slightly lags the strong rebound in GDP, to 46.1% and 45.5% respectively.

Graph 7: Euro area fiscal stance, 2020-2022 (% of GDP)



Source: European Commission Autumn 2021 Economic Forecast.

Graph 8: Structure of taxation by economic function of the tax base, 2019 (% of GDP)



Note: 2019 is the last year for which data on structure of taxation by economic function is available
Source: European Commission, Taxation trends in the European Union, 2021.

There is scope to make tax systems more growth-and environment-friendly. The tax burden in the euro area remains high, and above that in other advanced economies. In 2019, the last year for which data is available, the tax burden in the euro area (40.5% of GDP) was

[16] See for example Bova, E. (2021) 'Green Budgeting Practices in the EU: A First Review', Economic and Financial Affairs, Discussion Paper 14, European Commission.
[17] See 'State of the Energy Union 2021 – Contributing to the European Green Deal and the Union's recovery', European Commission, COM(2021) 950 final.
[18] See European Commission, (2021), 'Taxation Trends in the European Union 2021.

6.7 percentage points above the OECD average. The overall tax burden is skewed towards labour and production factors, with more growth-friendly environmental taxes representing a small share of tax revenues. Labour tax provides just over half of revenues in the euro area, followed by consumption and capital taxes. By comparison, corporate income taxes (circa 7% of total receipts), environmental taxes (circa 6%) and property taxes (circa 5%) contribute relatively little. Moreover, the tax wedge on labour[19] in the majority of euro area Member States remains above the OECD average, despite recently decreasing. A greater use of environmental taxes, while being careful to mitigate possible negative distributional effects[20], could support revenues and boost GDP, contribute to behavioural changes and make the polluters pay[21,22]. There are a number of national examples that are proven, and could be more widely adopted in Europe. Environmental taxes are considered relatively less distortive for market outcomes, in part due to Pigouvian effects, and are generally characterised by low administrative cost and relative ease of management. Government revenues from the auctioning of emissions permits, including the EU Emission Trading System, are also treated as tax receipts and are an important source of revenue.

A robust, efficient and fair corporate tax framework is important for the recovery and to ensure a level playing field. A sizeable tax gap in the euro area, highlights risks linked to tax evasion and tax avoidance practices. The increasing digitalisation of the economy and the internationalisation of businesses has eroded the relevance of the concept of tax residence. Companies are able to carry out their activities across the world and book the profits derived from these activities in low tax jurisdictions. In that context, differences between Member States' tax systems can create compliance cost for businesses and carry risks of double taxation. It also leads to loopholes and complexities that can leave open opportunities for aggressive tax planning, hampering the level playing field. At the international level, efforts have been made to reform the global corporate tax framework. In October, 137 member jurisdictions of the OECD/G20 Inclusive Framework reached an agreement on a solution to ensure a fair allocation of taxing rights and a minimum effective taxation of large multinationals' profits, subsequently endorsed by G20 Finance Ministers and G20 leaders. All EU Member States support the agreement. A number of Member States have also put forward measures in the Recovery and Resilience Plans to address aggressive tax planning. In this context, efforts to fight tax evasion and tax fraud, through digitalisation and exchange of information, also remain a priority.

4. Monetary Policy Stance

Since the outset of the crisis, the ECB has put in place forceful monetary policy measures. These were aimed at supporting credit supply and ensuring the smooth functioning of different financial market segments (i.e. sovereign, commercial paper, corporate bond), in order to offset the downward impact of the pandemic on price stability over the medium term. These measures mostly consisted of (i) additional asset purchases; (ii) easing of collateral

[19] Defined as the sum of personal income taxes and employee and employer social security contributions net of family allowances, expressed as a percentage of total labour costs.

[20] At the same time, the political viability of some measures could be limited, in particular at a time of high energy prices. See Murauskaite-Bull, I. and Caramizaru, E. (2021), 'Energy taxation and its societal effects', Publications Office of the European Union, Luxembourg, EUR 30552 EN.

[21] In line with the recommendations in the European Court of Auditors' Special Report No 12/2021, 'The Polluter Pays Principle: Inconsistent application across EU environmental policies and actions'.

[22] The 2021 study 'Green taxation and other economic instruments' examines the potential for internalisation of environmental externalities. It finds that the costs of air pollution, GHGs and water pollution alone amount to at least EUR 750 billion per year across the EU. However, polluters are charged only 44% of the cost of air pollution and GHGs, whilst water polluters pay almost nothing. See European Commission (2021), 'Green taxation and other economic instruments. Internalising environmental costs to make the polluter pay', Publications Office of the European Union, Luxembourg.

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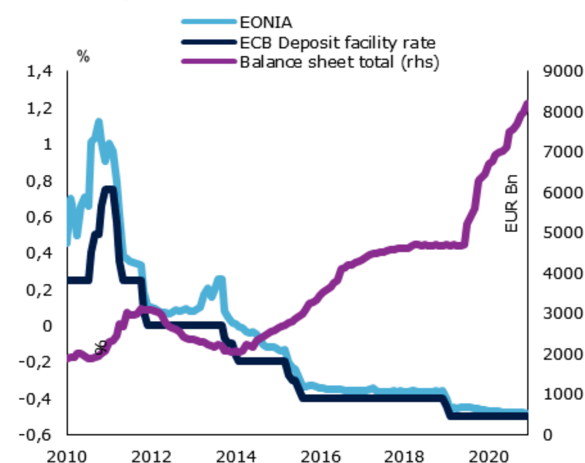
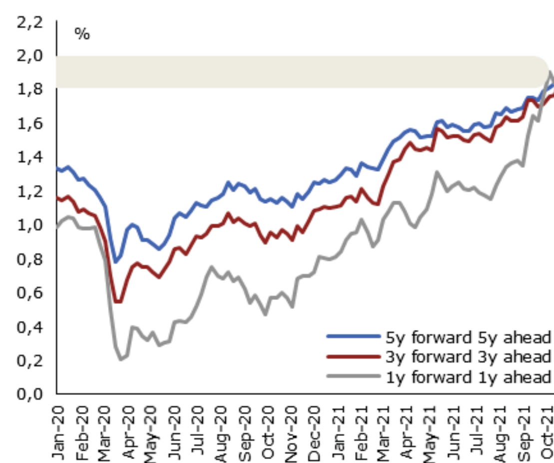
requirements; and (iii) new and more favourable liquidity provision operations. By providing over EUR 2.2 trillion of funding through its different liquidity-provision operations, notably the third series of targeted longer-term refinancing operations (TLTROs III), the Eurosystem has ensured that banks could continue to grant loans at favourable terms to firms and households.

Graph 9: ECB deposit rates and balance sheet of the Eurosystem



Source: European Central Bank.

Graph 10: Inflation Expectations



Source: Bloomberg.

The ECB monetary policy stance is expected to remain accommodative. It will support the ongoing recovery and, ultimately, bring inflation durably to its 2% target. Following the adoption of a new monetary policy strategy in July 2021, which has in particular introduced a 2% symmetric inflation target over the medium term, the ECB has revised its forward guidance on policy rates. According to the new forward guidance, the ECB expects to keep its key interest rates at their current levels or lower, until it sees inflation reaching 2% well ahead of the end of its projection horizon (currently 2023) and durably for the rest of the projection horizon, supported by sufficient progress in underlying inflation.

Box 2: Inflation dynamics

Inflation has picked up in the euro area since the beginning of the year, following years of inflation well below the definition of price stability. Headline inflation rose to a ten-year high of 3.4% in September 2021, while core inflation in the euro area remained at 1.9%. Eurostat's flash estimate for October stood even higher, at 4.1%. This swift increase reflects to a large extent strong base effects. Moreover, a number of factors put upward pressure on consumer prices, including rising energy and commodity prices, supply chain bottlenecks, resulting in a shortage of inputs and capacity constraints in a context of strong demand both at home and abroad. The observed inflation dynamics differ across euro area Member States; however, while certain measures of inflation dispersion have picked up, they remain of an order of magnitude observed over the past decade[23]. An increase in inflation was expected with the economic recovery. Still, and although the hike in price is contained in comparison to other large economies such as the US, UK and Canada, the speed and magnitude of the pick-up have come as a surprise. Going forward, the Commission Autumn 2021 Economic

[23] The slight increase in inflation dispersion measures can be attributed to the uneven and sometimes unsynchronised severity of the pandemic and of restrictions, as well as pandemic-related policy measures that have directly affected national prices and inflation, notably shifts in seasonal sales or generalised or sectoral indirect tax reductions. Moreover, the uneven reaction to the recent hikes in oil and gas prices further pushed up dispersion.

Forecast expects the direct impact of the current increases in higher energy and commodity prices to further raise inflation before progressively fading out. Inflation in the euro area is set to peak at 3.7% in the last quarter of the year and continue recording high prints in the first half of 2022, before starting to decrease by the end of 2022. Annual inflation is thus projected to reach 2.4% and 2.2% in 2021 and 2022, respectively.

While driven by temporary factors, the current inflation increase, if sustained, could have consequences for wage formation and price setting. Being to a large extent linked to the post-pandemic re-opening and ensuing economic adjustment, the current elevated price pressures are expected to be largely transitory. Inflation expectations have picked up, but remain anchored below 2%. Moreover, despite signs of tightening in some labour market segments, there are, for the time being, no indications of strong wage pressures. However, the risk of mutually reinforcing wage/price dynamics increases with the length of the supply disruptions and labour shortages. Rising inflation would affect in particular low-wage earners with potential increases in in-work poverty. In addition, the pandemic is also causing structural changes that may impact inflation in the medium term. The COVID-19 pandemic is likely to remain as a potential localised threat and disruptor of economic activity, which may influence strategic business decisions, notably those related to cross-border fragmentation of production. Supply constraints seem to be driving up producer prices, however more markedly in industry than in services. In addition, in the event that the energy price increases are more permanent than expected, this could have implications for the overall inflation dynamics and economic activity, as higher energy prices could affect supply chains, profit margins and the likelihood for pass through to consumer prices and to the wage bargaining process.

Inflation developments have important implications for monetary policy, fiscal policy and convergence capacity of the euro area. As elevated inflation has been unusual over the past decade, the recent inflationary dynamics force policy-makers to account for a different policy environment. High inflation pressures, if persistent, could be followed by monetary tightening and also lead to higher inflation risk premia on government bond yields, weighing on public finances. At the same time, an increase in inflation could, in the short term, reduce the real value of debt with an impact on the debt holders' balance sheets.

2. Long-term macroeconomic impact of COVID-19

A strong economic recovery has taken hold in the euro area in 2021, pointing to lower than initially feared scarring effects. While activity and labour market seem to have rebounded, there remains uncertainty around the long-term impact of COVID-19 on potential output. Historical evidence suggests that economic scarring following recessions is common, although the magnitude of the losses varies greatly among types of crises[24]. In particular, there remains uncertainty –linked in part to data limitations- over the economic impact of the COVID-19 crises on capital accumulation and productivity, the impact of unwinding policy support on corporates and over developments in the labour market[25].

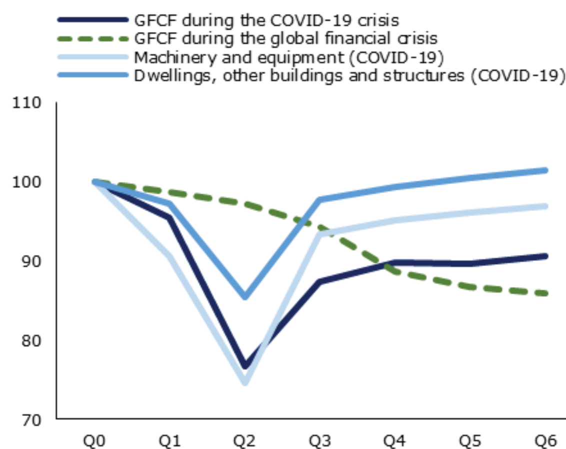
[24] The latest IMF Staff Country Report (2021), 'Austria – Selected Issues' shows that permanent output losses after a crisis ranges from less than 5% (currency crisis and health crisis), to over 10% (civil wars). See also Dieppe, A. (2021), 'Global Productivity: Trends, Drivers, and Policies', Advance Edition. World Bank Group.

[25] See European Commission, 'Adjustment to large shocks in the euro area - insights from the COVID-19 pandemic', technical note for the Eurogroup, 2021.

1. Impact on capital accumulation and productivity

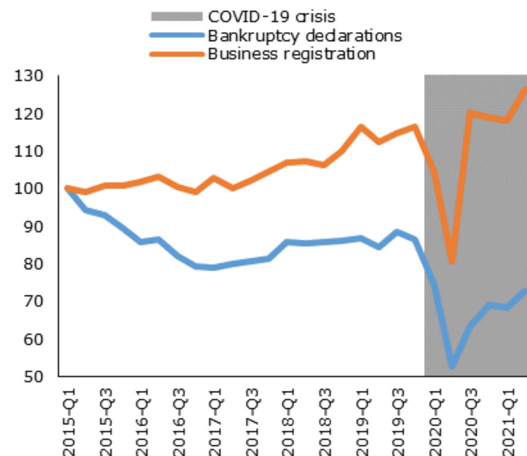
The contraction in gross fixed capital formation (GFCF) in 2020 turned out to be short-lived but the recovery remains incomplete. After a strong contraction in GFCF in the first half of 2020 (-23% versus 2019Q4) GFCF rebounded strongly in 2020Q3 and continued to grow since, albeit at a much slower pace (**Graph 11**). Nevertheless, the recovery remains incomplete and, by mid-2021, GFCF was about 9 % below its pre COVID-19 levels[26]. Going forward, the pre-crisis level of GFCF is expected be reached in the course of 2022. The lower accumulation of capital and slower adoption of capital-embodied new technologies could weigh on lower labour productivity[27], while the mobility restriction and the reduced possibility of face-to-face contact could also hinder knowledge acquisition and transfer. As observed in the aftermath of the global financial crisis, weak capital accumulation in some Member States can translate into uneven recoveries and widening growth divergences within the euro area.

Graph 11: Gross Fixed Capital Formation in the euro area (real terms) during COVID-19 and GFC



Note: Q0 = 2019Q4 in COVID-19 and 2008Q1 in global financial crisis.
Source: Eurostat.

Graph 12: Number of bankruptcies and business registrations in the euro area



Note: The series are indexed at 2015Q1 = 100.
Source: Eurostat.

Corporate debt increased further during the COVID-19 crisis, risking to drag on investment. Revenue losses might have constrained firms' ability to finance investment projects. By mid-2021, around one-third of all euro-area businesses were estimated to have accumulated losses beyond their cash buffers[28], indicating the protracted and deep nature of the shock. These losses pushed non-financial corporations' consolidated debt-to-GDP ratio from 76.2% in 2020Q1 to 83.1% in 2021Q1, before decreasing again to 80.5 in 2021Q2. In particular, the increase in indebtedness seems to be concentrated in a subset of already highly leveraged companies[29]. The resulting deleveraging needs may stifle corporate investment going forward, with negative implications for the recovery. Recent analysis[30] found that, on

[26] However, it is broadly unchanged from 2019Q4 if the volatile Irish data are excluded from the comparison.
[27] See Adler, G., Duval, R., Furceri, D., Kılıç Çelik, S., Koloskova, K., Poplawski Ribeiro, M. (2017), 'Gone with the Headwinds; Global Productivity', IMF Staff Discussion Notes 2017/004, IMF.
[28] Croitorov, O. et al. (2021), 'The macroeconomic impact of the Covid-19 pandemic in the euro area', Quarterly Report on the Euro Area (QREA), Vol. 20, No. 2 (2021), European Commission.
[29] See ECB Financial Stability Review, 2021, May.
[30] Demmou, L., Calligaris, S., Franco, G., Dlugosch, D., Adalet McGowan M. and Sakha, S. (2021), 'Insolvency and debt overhang following the COVID-19 outbreak: Assessment of risks and policy responses', OECD WP 1651.

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average, a percentage point increase in the equity leverage ratio between 2019 and 2020 was associated with a 2% drop in capital expenditures.

On the upside, the twin transition could have a positive impact on investment and productivity. The accelerated adoption of digital technologies during the pandemic could have lasting impact on companies[31]. In addition, during the pandemic and similar to the trends observed during the global financial crisis, investment in intellectual property (e.g. investment in software and research and development) has held up better than investment in machinery and equipment. Most RRPs aim to promote digitalisation across public and private sectors (especially SMEs), and will provide further impetus to that trend. In addition, the need for companies to adapt to the green transition will translate into significant investment needs, in particular to tackle the impacts of weather events and reduce carbon emissions[32].

2. Phasing out of support to the corporate sector

In 2020 and 2021, the policy response focused on easing firms' liquidity pressures to prevent bankruptcy of viable firms. Liquidity measures taken at national level included loan moratoria; state guarantees in support of credit flow. They added to the support provided, in particular by job retention programmes, to mitigate the impact of the crisis on employment and firm's viability. Besides financial and liquidity support, temporary adjustments to insolvency frameworks (e.g. suspension of the obligation to file for bankruptcy) have also contributed to reduce number of bankruptcies. As a result, and despite the large contraction in GDP, the number of bankruptcy filings fell in 2020 as compared with the situation before the COVID-19 outbreak **(Graph 12)**. As support schemes are being phased out, quarterly data suggest that bankruptcies have started growing in the euro area as a whole in 2021. Bankruptcies are also above pre-crisis levels in some of the sectors most affected by the COVID-19 pandemic, notably accommodation and food. There is a risks of significant job shedding in these sectors, depending on the extent to which the demand for the related goods and services will recover.

Calibrating the phasing out of policy support measures can mitigate an increase in business failures and capital retirement, and allow for a job-richer recovery. As the emergency policy support measures for firms are lifted too abruptly, this might contribute to an increase in corporate distress, in turn raising financing constraints. Available estimates suggest remaining pockets of underlying financial vulnerabilities among firms mainly because of depletion of equity following protracted periods of losses, and because of high debt burden, notably in the sectors most affected by COVID-19[33]. Measures to avoid excessive corporate deleveraging have included providing equity and quasi-equity, or incentives to mobilise private capital. Still, recent surveys suggest that businesses expect insolvencies to increase in the next two years, particularly in high-contact services sectors[34].

Meanwhile, excessive prolongation of support measures would risk keeping unproductive and unviable businesses afloat, with negative impact on productivity. By pushing unproductive firms into bankruptcy, crisis have a "cleansing effect" on the corporate sector conducive of faster productivity growth in the ensuing recovery. On the contrary,

[31] McKinsey (2020), 'How COVID-19 has pushed companies over the technology tipping point—and transformed business forever', 5 October.
[32] ECB (2021), 'The euro area capital stock since the beginning of the COVID-19 pandemic', ECB Economic Bulletin Issue 2/2021.
[33] See Archanskaia L., Canton E., Hobza A., Nikolov P., Simons W. (2021). 'The sectoral impact of the COVID-19 shock: a novel approach to quantifying its economic impact', Forthcoming.
[34] OECD (2021) Economic Policy Survey, Euro Area.

extended financial support to companies can give rise to so-called “zombie firms”, which have very low productivity but survive thanks to poorly targeted support schemes. While Member States generally set up broad and unconditional support scheme, preliminary evidence suggest that financial support did not benefit predominantly companies with lower productivity, indicating that long-term negative impact on business dynamics and productivity may be contained[35]. In addition, data for 2021Q2 suggests that business registrations are already above pre-COVID levels (**Graph 12**).

3. Labour market challenges

The policy response has helped keeping the unemployment rate broadly stable through the crisis. During the first wave of the pandemic, the number of jobs benefiting from national and EU public support through short-time work schemes and similar measures reached unprecedented levels, peaking at 23.5% of total employment in the euro area in April 2020. As a result, the initial impact of the crisis on the unemployment rate remained well below what would be implied by the historical relationship between unemployment and GDP growth[36]. Reflecting the easing of restrictions, the number of workers in job retention schemes declined significantly in 2021, decreasing to 2.7% of the labour force in July 2021 (or 4.1 million people)[37]. While the phasing out of job retention schemes is set to lead to further reduction in those numbers, the number of beneficiaries remains testimony of the still incomplete adjustment of labour market. In particular, a number of sectors, such as tourism and hospitality, have not recovered their pre-crisis level and may not recover fully in the near future. While short-time work schemes and other job retention measures have effectively mitigated the negative impact of the pandemic on the European labour market, their prolongation may, under some conditions, hamper transitions between jobs and sectors.

The impact of the crisis, and the ensuing recovery, has been uneven across Member States and sectors. The recovery will sustain job creation, but getting back to pre-crisis employment levels is not expected before 2022 in the euro area, and will occur at different pace across Member States, regions and sectors. By its nature, the COVID-19 shock has had a much stronger impact on services activities that require physical interaction and has thus been more detrimental to euro area countries where those activities predominate. Consistently, employment decreased especially in sectors most hit by the pandemic (**Graph 13**). The speed and extent of the return of workers to employment will depend largely on the resilience of the different sectors, as well as the speed and completeness of their recovery. At the same time, supply-chain bottlenecks may slow down the rebound of employment in manufacturing, as observed in some Member States.

Though the recovery will take some time to fully materialise, labour shortages are already manifesting in some sectors. In 2020, labour shortages, which had reached an historical peak in 2019, declined in almost all Member States. Containment measures linked to the pandemic and the resulting economic disruptions drove the decline in labour shortages as many firms withdrew their job openings during the lockdown. Vacancy rates reached 1.6% in 2020Q2, compared to 2.3% a year earlier. Since then, labour shortages are on the rise again in most Member States. The situation nonetheless varies across countries and sectors. In industry, labour shortages are rising rapidly and exceed their pre-pandemic levels on average

[35] On the risk of lending to non-viable firms (‘zombification), see Laeven L., Schepens, G. and Schnabel, I. (2020), ‘Zombification in Europe in times of pandemic’. Also see Bighelli, T., Lalinsky, T. and di Mauro, F. (2021), ‘Covid-19 government support may have not been as unproductively distributed as feared’, VOX, CEPR Policy Portal (voxeu.org).

[36] See European Commission (2020), ‘Labour Market and Wage Development in Europe’, Publications Office of the European Union, Luxembourg.

[37] ECB (2021), Economic Bulletin, Issue 6/2021.

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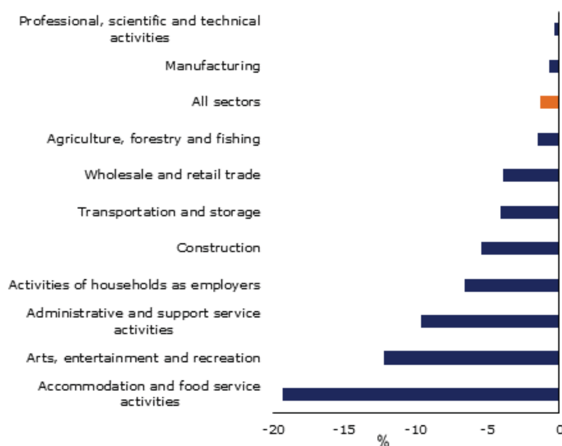
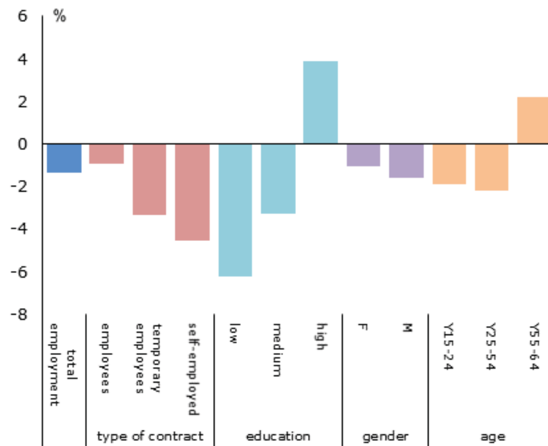
in the EU, while overall they remain below their pre-pandemic levels in services. In construction, they have by now returned to their pre-pandemic levels. In some sectors, such as construction and information and communication, shortages constituted a structural feature already before the COVID-19 pandemic while in other sectors, the current shortage can be more directly linked to the on-going post-COVID recovery. These are partly driven by remaining health concerns of workers to come back to high-contact occupations, uncertainties about business closures and re-openings (hospitality), or lower labour intra-EU labour mobility and migration flows (agriculture and health sector). Furthermore, the pandemic accelerated the shift towards higher-skilled jobs. As such, the increasing labour shortages may not only reflect the quick recovery from the deep recession and a decrease in the number of migrant workers, but also signal rising skills mismatches linked to the twin transition.

Graph 13: Change in employment in various sectors between 2019Q4 and 2021Q2 (% change)



Note: The graph only takes into consideration those sectors that experienced a fall in employment level.
Source: Eurostat (Labour Force Survey).

Graph 14: Change between 2019Q4 and 2021Q2 in employment by type of contract, skill level, gender and age (% change)



Source: Eurostat (Labour Force Survey).

The COVID-19 crisis and the structural transformation it has accelerated have persistent distributional implications[38] **(Graph 14)**. In contrast with initial expectations, available figures suggest that women and men were affected to a similar extent by the pandemic, though at the peak of the pandemic total hours worked dropped more substantially among women than men[39]. The COVID-19 crisis impacted strongly young people, due to their over-representation in hardest-hit industries (e.g. art and entertainment, travel and transport, tourism and hospitality) and in non-standard jobs. As a consequence, the share of those (aged 15-29) neither in employment, nor in education and training (NEETs) has risen in the euro area, after 6 years of constant decline. The highly asymmetric impact of the COVID-19 crisis on the labour market may also increase income differences, in particular between high-skilled workers that could telework and low-skilled workers in sectors badly hit by the crisis (e.g. tourism). Differences in skills levels may in turn risk exacerbating income inequalities. Low-skilled individuals have experienced among the largest negative falls in employment. This risk is further compounded by the fact that the pandemic has disrupted the provision of training and education at all levels. Learning losses were significant even in

[38] See Furceri, D., Loungani, P., Ostry, J.D., and Pizzuto, P. (2020), 'Will COVID-19 affect inequality? Evidence from past pandemics', Covid Economics, Issue 12, pp. 138-157. See also Schnabel, I. (2020), 'Unequal scars – distributional consequences of the pandemic', speech at the Deutscher Juristentag (18 September).
[39] In addition, women were often more exposed to a double burden of work and increasing care responsibilities. In this regard, women with children experienced larger employment losses than those without children

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countries with a well-developed IT infrastructure and were more severe for students from more deprived socio-economic backgrounds[40]. Finally, the transformation of the economy linked to the twin transition will introduce new opportunities but also new challenges to the labour market, including a possible negative impact on some low-skilled jobs.

3. Structural Policies

Structural policy efforts are needed to ensure a solid long-term economic recovery. In that respect, the implementation of the RRF, which also seeks to boost investment, lays the ground for enhancing reforms uptake. This section builds on the previous one to draw structural policy implications in the areas of labour and product markets, as well as related to the corporate sector. Insolvency frameworks and institutional quality are singled out as two transversal issues that can support the well-functioning of markets in a context of recovery and structural transformation. In the financial markets area, a more advanced Capital Markets Union can be instrumental in supporting private investment besides direct public support for investment (see Section 1). In parallel, the need for resource reallocation linked to the recovery, and to some extent to the green and digital transition, means that the efficiency of insolvency systems will be of particular importance. Labour market-wise, measures in favour of job transitions, upskilling and re-skilling can minimize risks of skill mismatches and facilitate structural transformation. Finally, and given the very large investment and reform packages put forward by Member States, the quality of the institutional framework is essential to ensure the fund absorption capacity and the adequate implementation of the recovery strategy.

1. Business environment, access to finance and Capital Market Union

A number of measures can make the business environment more conducive to private investment. Reforms improving the business environment and the quality of public administration are shown to be positively correlated with investments in the euro area. A number of Member States have included measures in this direction in their RRPs, such as policies for simplifying procedures for business and private investments and cutting red tape, reforming judicial and corporate governance, facilitating business activity through updating the regulatory framework. RRPs also include more direct measures to support access to finance, for example through the set-up of independently managed investment funds, or using promotional banks, to support businesses through measures leveraged via the financial sector. At the EU level, the EIB Group is also employing sizable financial instruments, such as dedicated guarantees to contain the COVID-19 impact by unlocking borrowing from the commercial banks, to support European SMEs and small mid-caps. Such measures can strengthen the equity of SMEs and bring in additional private investment in innovation, in start-ups and innovative companies.

Progress in the Capital Markets Union (CMU) will help diversify funding sources in the economy. Beyond banking lending (see Section 4), capital market funding can play a key role in complementing bank-lending to sustain the economic rebound and improve its resilience. Accordingly, as part of its response to the COVID-19 crisis, the Commission proposed a capital market recovery package in summer 2020 that aims to simplify access to capital market funding. A few euro area countries also include in their RRPs measures to improve the functioning of their national capital markets. Despite the prompt recovery of capital market

[40] See for example Engzell, P., Frey, A., and Verhagen, M.D. (2021) ‘Learning loss due to school closures during the COVID-19 pandemic’, procedings of the National Academy of Sciences of the United States of America.

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funding, investment and growth in the euro area continue to be held back by the level of development and integration of capital markets. The euro area's capital markets are still small when compared to other advanced economies. This potentially deprives companies of an important source of finance and constrains investment levels. Euro area capital markets continue also to be strongly fragmented along national borders, with companies' access to finance and funding costs varying greatly across Member States.

CMU can be key to mobilise long-term investments in new technologies and infrastructure. It is instrumental in fostering structural adjustment to tackle climate change and to deliver on the commitments made under the Europe's New Green Deal and Digital Agenda. The Commission's CMU action plan of September 2020 contains key measures to help achieve these objectives. In 2021 and 2022, the Commission will put forward a number of legislative proposals that will seek to make it easier for companies to access financing and fight capital market fragmentation. For example, the Commission plans to adopt a legislative proposal that cuts the red tape for companies wanting to raise funds on EU public markets, while preserving market integrity and investor protection. The new rules will make it more attractive for companies, in particular SMEs, to list and to remain listed and for investors and financial intermediaries to invest in listed companies. Further initiatives are underway to explore ways how to best support the Member States' work in encouraging citizens to supplement public pensions with life-long savings and investments, and how to alleviate the tax-associated burden in cross-border investment. Finally, the CMU plays an important role in the euro area as it can address remaining imbalances. A more advanced CMU would facilitate the channelling the historically high levels of savings towards equity, which would help reduce leverage in the corporate sector.

2. Insolvency frameworks

The economic turmoil calls for well-functioning insolvency frameworks. The COVID-19 crisis has led to substantial revenue losses for many firms and continues to pose risks to corporate solvency across the euro area, including through increased levels of corporate indebtedness (see Section 2). Effective insolvency frameworks play a crucial role in supporting viable firms undergoing temporary problems and in providing for the orderly exit of non-viable firms. Moreover, well-performing insolvency frameworks matter for economic performance. The benefits of proper regimes range from reducing the loss of value, improving access to finance, enhancing the deepness and size of capital markets and contributing to an effective management of non-performing loans (NPLs)[41]. Moreover, well-functioning insolvency frameworks are needed to ensure re-allocation of productive resources in the corporate sector and to facilitate the smooth exit of less efficient firms while granting a second chance for firms with a viable business model but impaired balance sheet.

Despite actions at EU and Member States' level, insolvency regimes across the euro area still differ substantially. Divergences exist across Member States on a number of issues, including the criteria to open an insolvency proceeding, the ranking of creditors, the valuation procedures and the role of participation of creditors in an insolvency proceeding[42]. A number of actions have been put forward. For preventive restructuring and debt discharge, the 2019 Directive on preventive restructuring frameworks[43] achieved minimum harmonisation in

[41] AFME and Frontier Economics (2016), 'Potential economic gains from reforming insolvency law in Europe'.
[42] McGhee P., Suarez J., and Simmons, G. (2016), 'The importance of better EU insolvency regimes', VOX, CEPR Policy Portal (voxeu.org).
[43] The Restructuring and Second Chance Directive (2019/1023) was adopted to introduce minimum standards across Member States in order to ensure that preventive restructuring frameworks are available to debtors in financial difficulty, to provide procedures leading to a

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certain areas. In the meantime, several Member States have updated their insolvency legislation to reflect the circumstances originated by the pandemic. In addition, several RRPs include commitments to pursue reforms in this area and the judiciary system at large. However, there is currently still little evidence of Member States significantly boosting their insolvency regime capacity (e.g. creation of special insolvency courts, designation and accelerated training of insolvency judges, support staff increases on a significant scale) in anticipation of an increase in insolvencies.

Going forward, actions will be needed to avoid putting some administrations under strain. In the long-term, the convergence of non-financial insolvency rules remains one of key structural reforms necessary for a genuine integration of national capital markets. This would bring significant value added to the euro area economy, as it would improve the business environment, strengthen the resilience of the monetary union and attract additional international investors. As regards core insolvency regimes dealing with non-viable companies, the Commission seeks to harmonise targeted aspects of the corporate insolvency framework and procedures. The Commission is currently working on a proposal for a Directive. The exact form of a future initiative will, however, still be subject to exchanges with Member States and a positive impact assessment. In the absence of an effective system that distinguishes viable from non-viable businesses, prolongation of insolvency moratoria and forbearance of NPLs entails difficult decisions as it might lead to misallocation of resources and increase the losses under an eventual bankruptcy.

3. Labour market policies and skills strategies

The new jobs being created may be different in terms of skills requirements. The COVID-19 crisis has had a strong sectoral dimension, with job losses mostly concentrated in the sectors particularly hit by containment measures, and teleworkable sectors having largely recovered to pre-pandemic levels (see Section 2). As the COVID-19 crisis has accelerated structural changes in the world of work, labour markets are expected to experience structural adjustments, some of which may be long-lasting.

Measures that support job transitions will be key to ease adjustment and prevent unemployment from becoming entrenched. Effective active labour markets policies (ALMPs) in the context of coherent policy packages of hiring incentives, upskilling and reskilling and enhanced support by employment services, can foster a swift labour market (re-)integration and prevent scarring effects on certain groups. Accordingly, the Commission has put forward a Recommendation on an Effective Active Support to Employment (EASE) following the COVID-19 crisis. More broadly, the European Pillar of Social Rights provides the framework for policy action to address current labour market, skills and social challenges and promote upward economic and social convergence in the Union[44].

Skills development is conducive of smoother reallocation of labour, also in light of the green and digital transitions. Low-skilled workers and workers with less transferrable skills risk being less employable, in the event of dismissal due to structural transformations. Up-skilling and reskilling effectively contribute to ease job transitions, and mitigate the risk of

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discharge of debts incurred by over-indebted entrepreneurs, and to increase the efficiency of restructuring, insolvency, and debt discharge procedures. This Directive will have to be transposed into national law by 17 July 2022.

[44] In this context, the Commission's Action Plan on the implementation of the Pillar proposed new EU targets on employment, skills and poverty reduction by 2030, which were welcomed by EU leaders in the Porto declaration of 8 May and the European Council conclusions of 25 June. By 2030 (i) at least 78% of people aged 20-64 should be in employment; (ii) at least 60% of all adults (25-64) should participate in learning activities every year; and (iii) the number of people at risk of poverty or social exclusion should be reduced by at least 15 million compared to 2019.

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raising inequality following a crisis. The digital transition is expected to create new employment opportunities, however it may also entail risks to existing jobs, in particular for routine-intensive and low-skilled activities. Technological change will require future workers to be equipped with a broad set of skills beyond digital, including transversal skills, such as social, communication and leadership skills[45]. In addition, the transformation linked to the green transition, while increasing the demand for medium-skilled jobs, may also bring job losses in some sectors (notably in resource extractive and energy intensive sectors). Managing the effects of these transitions requires a close cooperation among education and training institutions, public employment services, social partners and other stakeholders[46].

Social protection systems can smoothen transitions within and across jobs and make economies and societies more resilient. A substantial reinforcement of social protection in the short term has prevented a surge in income poverty and inequality[47], but there is a risk that the latter may increase when measures are phased out. This would have adverse effects particularly on the most vulnerable groups. Promoting adequacy and sustainability of social protection systems as well as strengthening access remains highly relevant, given the complexity of the challenges at stake and the structural changes that euro area economies are undergoing. At the same time, they can play a role in smoothening transitions within and across jobs, and to make economies and societies more resilient. Moreover, as the effects of the pandemic may have persistent distributional effects, adversely affecting low income earners, promoting adequate minimum wages, while preserving competitiveness and job creation, will help mitigating in-work poverty and income inequality[48].

The RRF provides an opportunity to build more resilient and inclusive labour markets. All the Recovery and Resilience Plans submitted by euro area Member States so far address social and employment challenges. For instance, they include measures for improving labour market participation, promoting upskilling and reskilling, the modernisation of labour market institutions and services, as well as of social protection and healthcare systems, thus complementing more traditional cohesion policy funding in these domains (like European Social Fund + and European Regional Development Fund). In order to support the recovery, it will be crucial to deliver on the agreed ambitions, while respecting financial and time commitments.

4. Institutional quality and measures to increase fund absorption

The implementation of the RRF provides a clear rationale, and a strong incentive, to increase the quality of institutions, and in particular the effectiveness of public administration. For a number of euro area Member States, notably Greece, Slovakia, Latvia, Lithuania, Estonia and Portugal, the sum of grants received through cohesion policy funds and NextGenerationEU may well represent more than 2% of GDP in annualised terms for the next 5 years. Administratively, this will require careful planning and implementation to ensure that EU outlays are efficiently and timely spent on the ground. An effective public administration is needed to (i) plan, develop and coordinate policies; (ii) recruit and provide career development to civil servants that is based on merit; (iii) have strong oversight institutions to which the government is held accountable for; (iv) define a citizen-oriented policy that

[45] See for example Morandini, M.C., Thum-Tysen, A., and Vandeplas, A. (2020) 'Facing the Digital Transformation: are Digital Skills Enough?', European Commission, Economic Brief, 054, July 2020, Brussels.
[46] In this context, the Just Transition Mechanism will also help address the social and economic effects of the transition, focusing on the regions, industries and workers who will face the greatest challenges, inter alia through a Just Transition Fund.
[47] Analysis in the 'Employment and Social Developments in Europe, Annual Review 2021', based on EUROMOD simulations, suggests that low-income households have faced relatively large losses in market income, but that tax-benefit systems have protected their disposable income, though to a different extent across Member States.
[48] The proposal for a Directive on adequate minimum wages in the EU aims at supporting these efforts.

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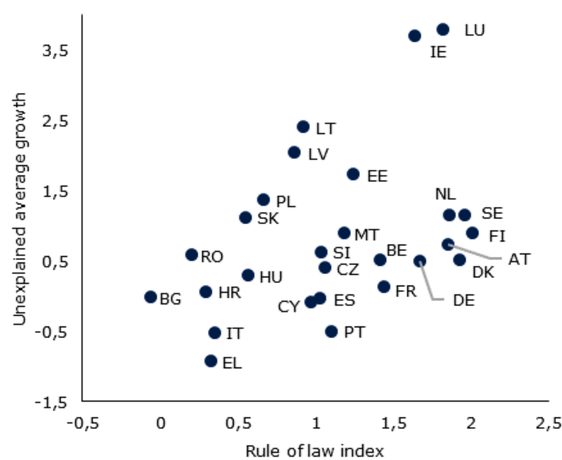
delivers quality and accessible public services; and (v) count with sound public financial management[49]. All euro area Member States have committed measures to modernise their administration in the context of the RRF. National RRPs also include measures specifically linked to removing barriers to investments, including improving the functioning of the single market and the business environment. Previous studies have suggested a focus on governance effectiveness, administrative capacity-building and fighting corruption across lagging regions can indeed improve absorption rates of European cohesion policy funds[50].

Strengthening the single market can also improve the framework conditions for investment. A well-functioning Single Market has the potential to strengthen the euro area's recovery and resilience, in particular through the reallocation of production factors. In that respect, the persisting barriers in the areas of market surveillance for products, procurement and in services markets[51] are an impediment to the good functioning of the euro area. In terms of investments, unnecessarily stringent product market regulations are associated with lower investment levels[52].

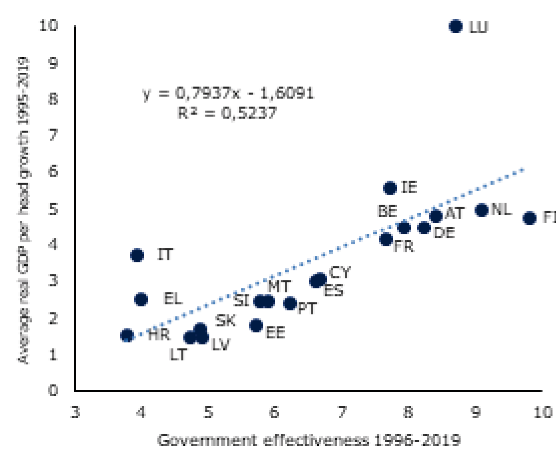
In the longer term, institutional quality contributes to a more resilient EMU. Large cross-country institutional quality divergences may jeopardise the functioning of the currency union in the short-term, as countries with lower-quality institutions may become more sensitive to shocks. Thus, enhancing the quality of institutional settings has the potential to increase resilience of the whole euro area and improve the functioning of monetary policy[53]. In addition, institutions have long been recognized as a key growth driver. The average growth of real GDP per head is positively correlated with the average rule of law index of the World Bank **(Graph 15)**. Countries with better performing public administrations tend to be countries with higher GDP per head **(Graph 16)**, while countries with better governance tend to show higher growth in GDP per head and in total factor productivity.

Graph 15: Relationship between real GDP per head and the rule of law



Note: Y-axis: Unexplained average growth after controlling for the initial

Graph 16: Relationship between real GDP per head and government effectiveness



Note: The chart shows the positive correlation between growth of real GDP

[49] OECD-SIGMA (2019), 'Methodological Framework for the Principles of Public Administration', OECD Publishing, Paris. The Commission services rely on the OECD–SIGMA principles of public administration for its own analyses of public administration.

[50] Incaltarau C., Pascariu, G., and Surubaru N. (2019), 'Evaluating the Determinants of EU Funds Absorption across Old and New Member States – the Role of Administrative Capacity and Political Governance', Journal of Common Market Studies, Volume 58, Issue 4, p. 941-961.

[51] European Commission(2021), 'Annual Single Market Report', SWD(2021) 351 final.

[52] Egert, B. (2017), 'Regulation, Institutions and Aggregate Investment: new Evidence from OECD countries', OECD Economics Department Working Papers No. 1392.

[53] See Pérez-Moreno S., Bárcena-Martín E. and Ritzen, J. (2020), 'Institutional quality in the Euro area countries: any evidence of convergence?', Journal of Contemporary European Studies, Volume 28, 2020 - Issue 3; and Christodoulakis, N., Dimelis, S., and Kollintzas, T. (1995), 'Comparisons of Business Cycles in the EC: Idiosyncracies and Regularities', Economica, Vol. 62, No. 245.

level of income. The chart shows the positive correlation between growth of real GDP per head and the average rule of law index.
Source: World Bank Governance indicators, AMECO.

per head and government effectiveness.
Source: World Bank governance indicators, Ameco, European Commission.

4. Macro-Financial Stability

Given a high degree of interdependence between its member economies, macro-financial stability is key for the functioning of the euro area as a whole. As different actors of the financial system are interlinked (banks and other intermediaries, borrowers and lenders), shocks may lead to spillover effects and can easily threaten the overall stability of the system. Given the high degree of financial integration, Member States' financial stability also depends on national authorities in other euro area Member States as well as supranational action.

The policy support and the upswing that started in 2021Q2 attenuated concerns about weak corporate fundamentals (see Section 2), and the impact on bank balance sheets. Nevertheless, euro-area banks are likely to experience some deterioration of asset quality over the short to medium term. This will compound the long-standing challenge of low profitability and potentially reduce banks' ability to lend. While corporate and bank vulnerabilities declined so far, adjustment in the price of financial assets or adverse developments in the housing market could have an impact on macro-financial stability. Progress in completing the Banking Union, including the early introduction of the common backstop to the Single Resolution Fund, would help mitigating some of the downside risks and enhance macro-financial stability going forward. The full implementation of Basel III – as proposed by the Commission on 27 October – would further contribute to the stabilisation of the banking sector, with positive macroeconomic impacts[54].

1. Current state of play

The banking sector has weathered the crisis well so far. Euro area banks entered the crisis much better capitalised and with a higher liquidity buffer than before the global financial crisis. Thanks also to the policy response to the crisis, banks have been able to maintain their robust capital and liquidity positions, and to keep the credit channel open. Nevertheless, loan growth to the private sector has slowed significantly in recent months, in particular as regards loans for non-financial corporates. After an initial worsening, the overall credit risk outlook for banks improved, with inflow of loans with a significant increase in credit risk ("stage 2" loans) moderating since mid-2020. Thanks to government support measures and moratoria, the quality of banks' assets has not deteriorated as much as initially feared. Moreover, banks in Member States with highest non-performing loan (NPL) ratios managed to actively dispose large holdings of NPLs, partly due to a high volume of NPL securitisations. As a consequence, the ratio of NPLs remained stable or even decreased **(Graph 17)**. However, an increase in NPLs may still materialise to the degree that the number of insolvencies picks up with some delay (see Section 2).

The euro area's largest banks appear resilient even when faced with severe economic stress. The European Banking Authority's (EBA) 2021 stress test assessed the resilience of EU banks. With an average CET1 capital of 15.0% of risk-weighted assets, EU banks entered the 2021 stress test with higher capital ratios than last time (14.0% at the end of 2017). Under the baseline scenario, all tested banks' CET1 capital ratios remain above their overall capital requirement. In the adverse scenario, assuming a prolonged recession in a lower-for-longer

[54] See also ECB (2021), Macroeconomic impact of Basel III finalisation on the euro area, 26 July 2021, https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202107_1~3292170452.en.html

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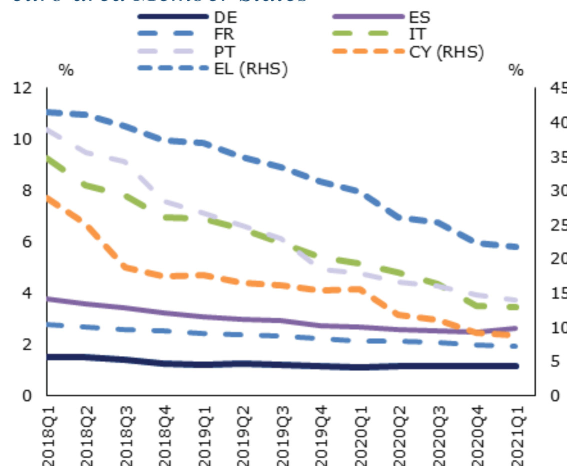
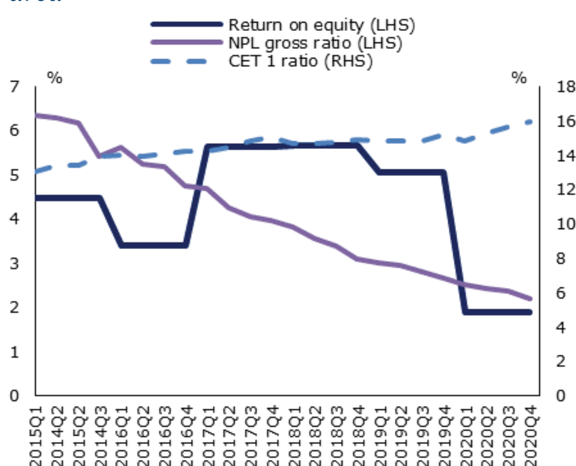
interest rate environment, EU banks' capital ratios would take a hit, but 36 of the 38 euro area banks in the sample would manage to maintain capital cushions above minimum requirements. The breakdown of the aggregate results by clusters of banks shows that capital depletion is lower for banks with high net interest income and for banks less concentrated on domestic markets; moreover, the analysis based on a dimensional factor shows no relevant difference between capital depletion of largest banks and other banks[55].

Graph 17: Non-performing loans in selected euro area Member States



Note: Gross non-performing debt instruments as a percentage of total gross debt instruments.
Source: European Central Bank.

Graph 18: Bank stability indicators for the euro area



Source: European Central Bank.

The COVID-19 crisis has added to the long-standing challenge of banks' low profitability. In the wake of the pandemic, profitability of the banking sector took a hit, mainly due to increased provisioning needs. This was reflected in a sharp decline in return-on-equity (**Graph 18**). Although it recovered in the first quarters of 2021 for large listed euro area banks, low profitability may have an adverse impact on the stability of institutions and supply of credit in the future. Moreover, the very accommodative monetary policy stance has had adverse effects on lending margins. Indeed, in an environment of negative policy rates, bank deposit rates – especially for households – have been floored around zero in most euro area Member States, putting additional pressure on bank profits[56]. The ECB has introduced some offsetting measures (e.g. the tiered excess reserve remuneration, favourable pricing of the targeted longer-term refinancing operations), and banks have also benefitted from quantitative easing purchases, but the drag of low interest rates on bank lending margins might be raising over time[57].

There has been an additional supply of sovereign bonds amid strong policy interventions at EU level[58]. The volume of the AAA- and AA-rated euro area government bond issuance increased during the crisis, but the proportion of highest rated government securities as percentage of euro-area GDP is still lower than in the first decade of this century, mainly due to sovereign downgrades at the beginning of the previous decade (**Graph 19**). Issuance by the

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[55] EBA (2021), '2021 EU-wide stress test - results', 30 July 2021. At https://www.eba.europa.eu/eba-publishes-results-its-2021-eu-wide-stress-test

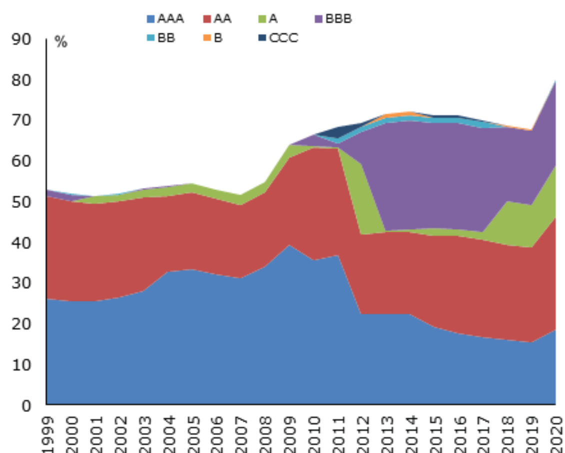
[56] Feng S., and Stehn, J. (2021), 'European Daily: ECB—Checking in on Negative Rates', Goldman Sachs, 18 June 2021. https://publishing.gs.com/content/research/en/reports/2021/06/18/b254c1da-634b-473c-be5e-803b7382e6ae.html

[57] Altavilla C., Boucinha, M., and Peydró, J.-L. (2019), 'Monetary policy and bank profitability in a low interest rate environment', Economic Policy, Volume 33, Issue 96, October 2018, p. 531–586.

[58] Cœuré B. (2016), 'Sovereign Debt in the Euro Area: Too Safe or Too Risky?', European Central Bank, Keynote address, 3 November 2016. At https://www.ecb.europa.eu/press/key/date/2016/html/sp161103.en.html

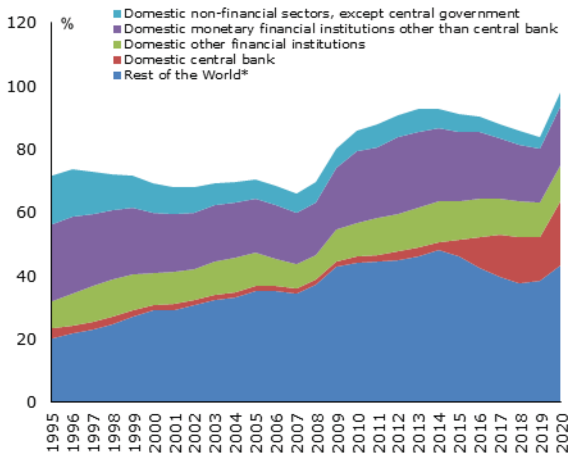
Commission on behalf of the EU under NGEU provides additional high-quality euro-denominated debt securities of up to EUR 672.5 bn (in 2018 prices). In 2021, the annual borrowing decision allows the Commission to issue up to a maximum amount of EUR 125 billion in long-term funding and up to a maximum outstanding amount of EUR 60 billion in short-term funding. The ECB intervention **(Graph 20)** through the PEPP stabilized yields and liquidity conditions in sovereign bond markets.

Graph 19: Euro area-19 government debt securities by rating (% of euro area GDP)



Note: Government debt securities by rating, as applied by Moody's, S&P and Fitch. Constant euro area-19 composition applied from 1999. Common issuance is not included.
Source: European Central Bank.

Graph 20: Euro area gross government debt by holder(% of euro area GDP)



Note: *Rest of the world includes holdings in other euro area Member States.
Source: European Central Bank.

Banks have increasingly diversified their sovereign holdings, reducing the concerns of growing interconnectedness between banks and sovereigns[59]. Following the decline in sovereign-bank interlinkages observed between 2014 and 2019, exposures between banks and their sovereigns were again on the rise in the first half of 2020[60]. In contrast to the situation ahead of the sovereign debt crisis of 2013, bank sovereign holdings are diversified, since the second half of 2020, the share of domestic bonds in banks' total sovereign bond holdings is decreasing. However, the situation differs across countries and, in some Member States, the concentration in bond holdings observed was the highest in years, even without including COVID-19-related guarantee exposures, which represent contingent liabilities potentially linking closer sovereigns and their banks. Also, some Member States see at the same time a higher concentration of NPLs and domestic sovereign exposure (**Graphs 21** and **22**).

Finally, house prices have been growing at their fastest rate since the global financial crisis[61]. Compared to other G7 economies, euro area households hold a significant part of their wealth in real estate. During the Covid-19 crisis, excess savings and the low-interest rate environment allowing for cheap financing have boosted residential property demand amid significantly constrained housing supply. As a result, unlike in other recessions, house prices growth has remained buoyant. The house price recovery in recent years has been driven to a

[59] Dell'Ariccia G. et al. (2018), 'Managing the sovereign-bank nexus', ECB Working Paper Series, No 2177, September 2018. At https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2177.en.pdf
[60] Lozano Guerrero S., Metzler J., and Scopelliti A. (2020), 'Developments in the sovereign-bank nexus in the euro area: the role of direct sovereign exposures', ECB Financial Stability Review, November 2020. At https://www.ecb.europa.eu/pub/financial-stability/fsr/focus/2020/html/ecb.fsrbox202011_04~f83a448770.en.html
[61] See 2022 Alert Mechanism Report.

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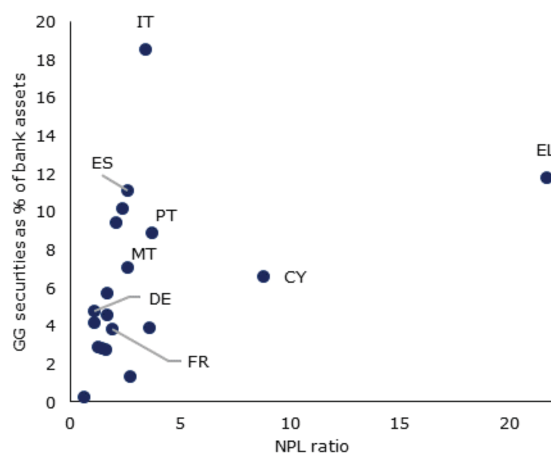
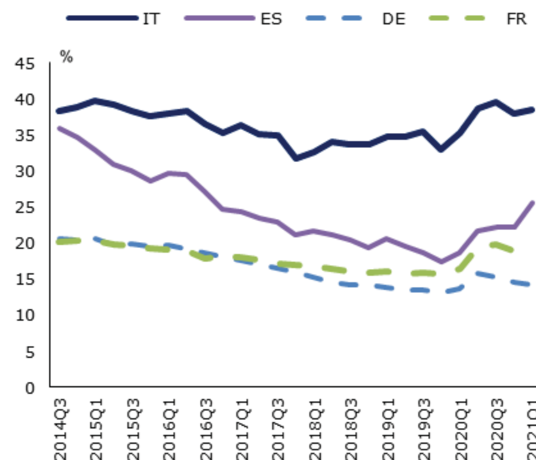
lesser extent by household loans, which limited the probability of a bubble. The current context is also different compared with the period before the global financial crisis, in particular since macro-prudential frameworks have been strengthened and macro-prudential tools are increasingly used across the euro area. By contrast, commercial real estate markets have already been facing a substantial market correction. It remains to be seen how far increases in office vacancy rates would reverse, given the possible structural shift towards teleworking. The retail real estate sector might also be affected by a shift towards online shopping. Overall, further declines in commercial real estate prices, due to a persistent downshift in demand in key market segments, might also lead to a deterioration of banks' asset quality, given the commercial property sector's reliance on debt.

Graph 21: Domestic sovereign exposure and non-performing loan ratio of euro area banks



Note: Share of credit to domestic general government in total assets (as of July 2021). Gross non-performing debt instruments as % of total gross debt instruments (as of 2021Q1), not yet reflecting a possible increase in NPLs due to the pandemic.
Source: European Central Bank.

Graph 22: Domestic monetary financial institutions - excl. central bank - holdings of total sovereign (% of GDP)



Source: European Central Bank, Eurostat and government finance statistics.

2. Risks to financial stability and potential reforms

Financial markets are vulnerable to disruptive repricing, affecting the broader financial system. Equity markets have broadly recovered to above pre-COVID-19 levels, even if the pace of recovery has been uneven across euro area Member States and sectors. Spreads on euro area non-financial corporate bonds, in particular for the high-yield segment, have fallen below pre-pandemic levels despite growing vulnerabilities. The biggest risk facing euro area financial markets is now a sudden reassessment of valuations amid a general decoupling of securities prices from economic fundamentals[62]. Also, liquidity buffers of investment funds have declined below pre-pandemic levels, potentially leaving some funds (particularly those with relatively illiquid assets) vulnerable to fire sales spirals if a market correction triggers unanticipated investor redemptions. The low yield environment is adding to the challenges for pension funds and insurance companies. A number of possible developments could lead to a sudden reassessment of risk premia, including negative surprises regarding the macroeconomic or public health situation, political and policy uncertainty, geopolitical issues, a reassessment of commodity prices or the long-run growth outlook in light of e.g. climate

[62] European Securities and Markets Authority (2021), ESMA Risk Dashboard, 3 June 2021. At https://www.esma.europa.eu/sites/default/files/esma50-165-1761_risk_dashboard_no_1_2021.pdf

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change. Moreover, a sustained increase in real interest rates could also reduce the fiscal policy's room for manoeuvre (Box 2).

There are risks resulting from a potential deterioration of the quality of assets. The increased share of stage-2 loans – for which credit risks are considered to have increased considerably - observed already in 2020 suggests that the euro-area banks are recognising the risk of a potentially deteriorating asset quality, adding to the long-standing challenge of low profitability, and potentially constraining their lending. This could be exacerbated by withdrawal of corporate sector policy support, and the deterioration in asset quality would be concentrated in some sectors and in some Member States; however, it could put a drag generally on banks' profitability going forward. In this context, efficient insolvency frameworks can have a positive effect on bank balance sheets[63].

The climate and digital transitions can have significant financial stability implications. Up to 30% of euro area bank corporate exposures could be impacted by physical climate hazards (e.g. floods, wildfires, heat and water stress); these exposures are concentrated in certain regions. Exposures to emission-intensive firms, which will be affected by the green transition (mainly in the manufacturing, electricity, transportation and construction sectors), represent 14% of collective euro area banking sector balance sheets[64]. In the medium to longer term, also thanks to the transition planning and the supervisory powers proposed by the Commission in the Banking package, reducing the exposure to fossil fuel activities would support the green transition and limit market risk connected with these industries. On the digital side, a high level of interconnectedness across financial entities, financial markets and financial market infrastructures exposes the financial system to cyber risks. The widespread use of a limited number of closely connected ICT third party providers by a large number of financial institutions can lead to macro-prudential risks, such as concentration and systemic risks.

The common backstop to the Single Resolution Fund (SRF) will reinforce risk-sharing. The SRF was established by the EU for resolving failing banks in the Banking Union, thus protecting against financial instability. It is financed by contributions from the banking sector and will be built up progressively. However, in case of a larger-scale bank failure or the failure of multiple banks, there is a risk that the means in the SRF could be depleted. The Eurogroup strengthened the resolution pillar of the Banking Union through the establishment of a common backstop to the SRF in the form of a credit line from the ESM. This backstop, which will become operational in early 2022, will strengthen the resilience of the Banking Union while reinforcing risk sharing.

Completing Banking Union remains a priority and the current crisis has made the benefits of the Banking Union and its safety nets even more evident. The Banking Union is still missing its third pillar: the European Deposit Insurance Scheme, which would increase depositor confidence and financial stability, as well as weaken the bank-sovereign nexus. A complete Banking Union could help unlock further market integration, in particular cross-border consolidation and foster European banks' competitiveness internationally. This could pave the way for a more robust Economic and Monetary Union and for Europe's strategic autonomy. In addition, cross border market integration would need to be accompanied by

[63] Countries with better insolvency proceedings, higher recovery rates, and shorter resolution time, see more bankruptcies and restructurings happening, which in turn leads to earlier removal of troubled assets from banks balance sheets and more lending to firms with better investment opportunities. See Becker B., and Ivashina, V. (2021), 'Corporate insolvency rules and zombie lending', ECB. At https://www.ecb.europa.eu/pub/conferences/ecbforum/shared/pdf/2021/Ivashina_paper.en.pdf

[64] ECB/ESRB Project Team on climate risk monitoring (2021) 'Climate-related risk and financial stability', July 2021.

appropriate common safety nets protecting financial stability at national level in times of crises[65].

In particular, as part of the work on completing the Banking Union, the efficiency and coherence of the bank crisis management and deposit insurance framework could be increased in order to cater for banks of all sizes and business models. The EU bank crisis management and deposit insurance framework lays out the rules for handling bank failures. It was built with the objectives of maintaining financial stability, protecting depositors, mitigating financial contagion, minimising taxpayer losses, limiting moral hazard and improving the internal market for financial services. However, so far, the resolution framework has been used in a limited number of cases.

5. The euro area in the World

The trade and financial inter-dependencies between the euro area and its global partners are a key driver of economic performance. Economic and financial developments in advanced and emerging market economies have direct repercussions on the euro area through a number of channels, including global value chains, trade and monetary policy. Moreover, the level of interconnectedness of economies has increased steadily. The extensive trade and financial linkages present for the euro area are important channels for the transmission of economic and financial shocks both from and towards the euro area. The economic size and integration of the euro area gives it a prominent role in the build-up and unwinding of global imbalances. The disruption in global supply chains that arose in the wake of the recovery further testifies to the growing interconnectedness of the euro area economy. Finally, strengthening the international role of the euro remains an important strategic objective of the euro area.

1. The euro area and global economic developments

The COVID-19 health and economic crisis has had large socio-economic impact across advanced and emerging economies. According to the Autumn 2021 Economic Forecast, the global economy is projected to grow by 5.7% in 2021, and 4.5% in 2022. In this context, Advanced Economies (AEs) are expected to grow by 5.3% and 4.1% in 2021 and 2022 respectively, on the back of the effective policy response and swift reopening of the economies, linked to successful vaccination campaigns. The euro area, which has been a stabilising factor throughout the crisis, would thus grow at a slightly slower pace than some other advanced economies in 2021. Meanwhile, emerging and developing economies are forecast to grow by 6.0% and 4.8% in 2021 and 2022, but with large divergences across countries, reflecting the pace of reopening, structure of exports and size of policy response.

The evolution of the health crisis, the vaccination rollout as well as the extent of the policy support are key factors in explaining divergent economic developments. Contrary to the global financial crisis, the emerging market economies are expected to recover slower than advanced economies, also due to their limited fiscal capacity, and suffer from long-term scarring effects. The spread of the Delta variant, in particular in emerging market economies, weighed on the rebound of services and softened the recovery in manufacturing and global goods trade. In addition, vaccine production and access has also become a clear dividing line

[65] The 2021 Recommendation on the economic policy of the euro area stressed the importance of completing the Banking Union, including the bank crisis management and depositor insurance framework.

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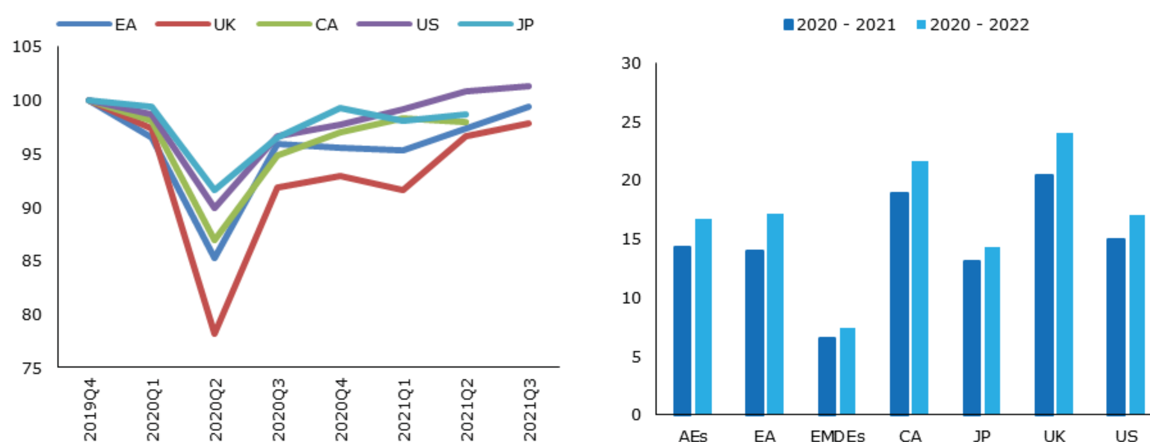
between advanced and emerging economies. The different size and type of policy support lies behind divergent impact across regions **(Graph 24)**.

Risks to the recovery in emerging economies have implications for the euro area. As vaccination rates outside the largest advanced economies remain low, disruptions in economic activity in emerging markets could result in negative effects on the euro area, including through global supply chains channels. According to IMF estimates, failure to close the massive gap in vaccination rates could hold back a global recovery, driving cumulative global GDP losses to USD 5.3 trillion over the next five years. Moreover, if the current global inflationary pressures were to prompt monetary tightening, financing costs would increase, in particular for emerging economies. Investors' portfolio reallocation would then bring, possibly disorderly, adjustments in global financial markets. Such tensions may in turn have an impact on credit risks for the euro area, with impacts on banks and financial institutions.

Graph 23: GDP developments EA, US, JP, CA, UK

Graph 24: Policy response across countries



Source: Eurostat and Office for National Statistics for the UK.

Note: Policy support is measured as cumulative change in net primary balance versus 2019. AEs stands for Advanced Economies; EMDEs stands for Emerging Market and Developing Economies.
Source: IMF 2021 October WEO.

The US policy mix generates spillovers, which affect the euro area. The US recovered rapidly in late 2020 and early 2021, reaching pre-pandemic GDP levels in 2021Q2. Headline CPI inflation dropped to 1.2% in 2020 as the pandemic took hold, but rose sharply in 2021, influenced by strong base effects, high energy prices, and supply constraints. In this context, the Fed's new monetary policy framework allows for some temporary overshoot of the 2% PCE inflation target, and the target Fed funds rate remains at 0.25%, though in September it was indicated that tapering of asset purchases could begin soon. The US Federal Open Market Committee's decision to reduce the purchase of US Treasuries at a faster rate than expected might lead to an increase in the US bond yields, which could in a negative scenario, potentially provoke tensions in global equity and financial markets and a disorderly asset price correction[66]. Tightening by the Fed could also affect financing conditions of the euro area corporate bonds sector as well as industrial production[67]. A fast correction of the valuation of financial assets and real estate prices – possibly generating outside of the euro area - could also have effects. In addition, the US fiscal support packages are expected to have

[66] See Grothe M. et al. (2021), 'Risk of spillovers from US equity market corrections to euro area markets and financial conditions', ECB Financial Stability Review, May 2021.
[67] Ca'Zorzi M. et al. (2021), 'Making waves – Fed spillovers are stronger and more encompassing than the ECB's', ECB's Research Bulletin No 83, 15 April 2021.

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a non-negligible impact on EU real GDP, which would derive primarily from international trade linkages[68].

2. Global value chains and trade linkages

Global merchandise trade has rebounded since the second half of 2020 but recent data suggest a slowdown. Global trade in goods increased by almost 14% in the first 6 months of 2021 compared to the same period last year, and is now well above pre-pandemic levels. On the other hand, services trade is still below pre-pandemic levels. Overall, global imports of goods and services (excluding EU) is forecast to grow by 9.3% in 2021, 6.1% in 2022 and 4.5% in 2023. The recent slowdown has been mostly due to a slowdown in demand for goods, as well as supply-chain disruptions and transport hiccups.

Global supply chains and trade linkages help mitigate the impact of internal shocks but are also channels for shock transmission globally. The euro area economy is both a major importer and exporter on the international stage, and the pandemic has highlighted the dependency of the EU and the euro on imports from third countries for the supply of critical goods, including medical equipment. The strong trade linkages increase economic efficiency, they help absorb shocks and speed up recovery support economy activity. They also transmit shocks to and within the economy[69]. The effect on the euro area economy of the recent transport and supply side disruptions, highlight the importance of this channel. Within the euro area, recent analytical evidence suggests that the shock amplification force of the trade channels is substantial, as the transmission to the rest of the euro area of a shock originating in one of the five largest Member States ranges from 15% to 28% of the original shock's size[70].

Bottlenecks in global supply chains may hamper the functioning of the single market. Supply chain bottlenecks, including the lack of supply of critical raw material[71], bear a negative impact on firm's productivity levels, employment, turnover and entry-exit rates. Safeguarding the Single Market and the free movement of workers, goods, services and capital can mitigate the effects of temporary or persistent global disruptions and address shortages of essential inputs. The Commission has conducted work to improve crisis preparedness and identify strategic dependencies[72]. Understanding current and possible future strategic dependencies and taking steps to address them could contribute to building up resilience and strengthen EU's open strategic autonomy.

3. Global Imbalances

The impact of COVID-19 on current account developments has been uneven. The impact of the pandemic shock on countries' external positions has been uneven depending on countries' economic structure and institutional features. In particular, stronger fiscal support in advanced countries has affected their fiscal stance relative to trade partners. According to the IMF, global current account imbalances declined between 2015 and 2019, but widened again during the pandemic from 2.8 percent of world GDP in 2019 to 3.2 percent of GDP in

[68] See European Commission Spring 2021 Economic Forecast.
[69] See ECB (2021), 'The implications of globalisation for the ECB monetary policy strategy', ECB Occasional Paper Series related to the ECB's Strategy review 2020-21, No 263.
[70] Di Nino, V., and Veltri, B. (2020), 'The viral effects of foreign trade and supply networks in the euro area', ECB Economic Bulletin, Issue 6/2020.
[71] OECD (2018), Global Material Resources Outlook to 2060.
[72] See 'An Open, Sustainable And Assertive Trade Policy, Open Strategic Autonomy', 2021, European Commission.

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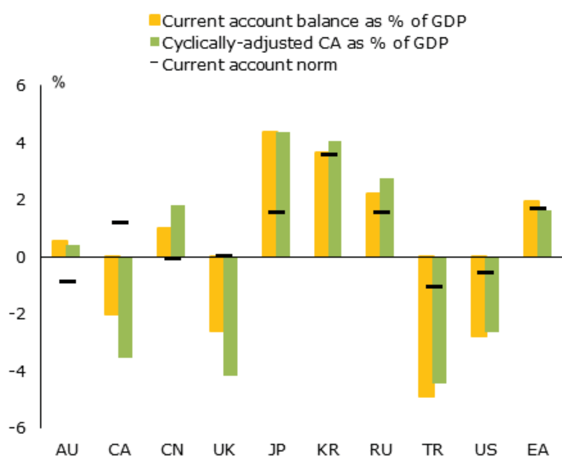
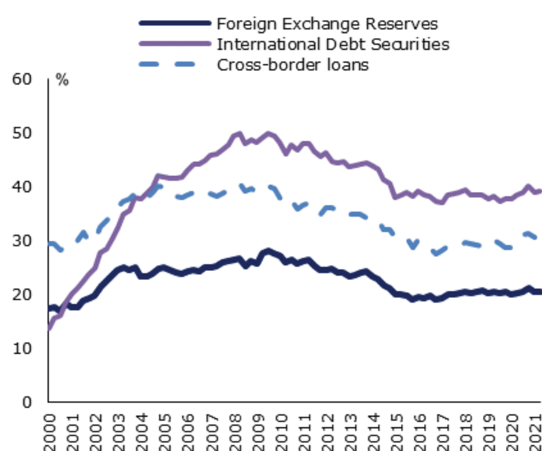
2020[73] (however, imbalances are projected to start declining again following the pandemic). The increase in imbalances contrasts with the patterns observed in the aftermath of the global financial crisis. Looking at stock positions, the international investment positions are historically high and beyond their benchmark rates in a number of countries; differently from current account balances, NIIP have widened in the aftermath of the global financial crisis.

Graph 25: Global current account balance and current account norms (percent of GDP, 2020)



Note: indicators for EA are built using Balance of Payment concepts; for other countries, National Account concepts are used instead.
Source: European Commission External Balance Indicators.

Graph 26: Euro denominated share of foreign exchange reserves, international debt securities and cross-border loans



Source: IMF Database, BIS Database. Own computations.

Global imbalances can have a number of negative consequences, including risks stemming from asset price adjustments, financial market tensions, as well as trade tensions across countries. While no such factors are currently observed or expected, large financial imbalances have the potential to negatively affect global economic developments and create instability in financial markets. A faster than expected potential tightening of financing conditions in advanced economies could affect negatively emerging market economies, in particular through capital outflows, financial market volatility and financing difficulties. In addition, the presence of large and persistent current account imbalances could fuel trade tensions across countries.

In this context, the euro area current account surplus continued to narrow in 2020, as domestic demand held up better than in most trade partners[74]. In 2020, the euro area current account recorded a surplus of 2% of GDP, which came close to the current account norm that reflects the euro area's economic fundamentals, estimated at 1.7% of GDP[75]. Data for the first half of 2021 show an increase in the euro area current account surplus to 2.9% of GDP by 2021Q2, driven mainly by a higher balance of trade in services. The euro area current account is currently forecast to return close to 2019 levels in 2021, and to mildly increase going forward. This reflects a return of the difference between GDP and aggregate demand to its pre-pandemic level, and thus the continuation of the persistent demand shortfall that characterised the 2010s. In terms of stock positions, the NIIPs of euro area Member States

[73] Global imbalances are measured as the absolute sum of current account deficits and surplus worldwide. See 2021 IMF External Sector Report.
[74] For more information, see 2022 Alert Mechanism Report
[75] According to the IMF External Sector Report, the euro area current account norm comes at 1% of GDP in 2020, which would imply a gap to cyclically-adjusted current account equal to 0.8% of GDP. After making adjustments for the transitory impact of the COVID-19 crisis the estimated gap is reduced to 0.6%.

differ substantially, but broadly offset each other; in 2020, the euro-area NIIP was 9.6% of GDP, closer to balance than in most other G20 Members.

4. The International Role of the Euro

Strengthening the international role of the euro is a strategic objective for the euro area[76]. The latest 2020 ECB assessment shows that the pandemic has not led to any significant shift in the euro's share across global currencies[77]. The euro remained thus the second most important currency in the international monetary system; however, the share of the euro across various indicators of international currency use was close to historical lows, averaging around 19%. Inter alia, the share of the euro in global foreign exchange reserves remained broadly stable, albeit decreasing by 0.7 percentage points, when measured at constant exchange rate (while it increased at current exchange rate, owing to the appreciation of the euro). The share in foreign currency-denominated debt issuance decreased more noticeably, by around 2 percentage points. All in all, the international role of the euro remained broadly stable in 2020, when observing a composite index of the international role of the euro.

Increasing the international role of the euro would strengthen the economic and financial autonomy of the euro area. The bond issuances under the SURE and NGEU programmes will increase the amount of highly-rated euro-denominated assets. Moreover, ambitious structural reforms in euro-area Member States as outlined in their Recovery and Resilience Programmes will improve the euro-area's economic resilience and hence boost investor confidence in euro-denominated assets. An increased role for the euro could increase the resilience of the international monetary system, reduce dependence on other currencies, especially the US dollar, and open up more choices for market operators across the globe. As a result it would support diversifying the global currency regime and alleviate the effects of asymmetric shocks, in particular linked to monetary policy measures by third countries[78].

Finally, the digital euro could unlock a number of benefits but it needs to be carefully designed to find a balance between different objectives. As a new form of a central bank money made available in digital form for use in retail payments, a digital euro would be complementary to cash. Its introduction could contribute to supporting the economy's digitalisation (and development of the digital single market), further spur innovation in retail payments and contribute to Europe's open strategic autonomy at a time when foreign central bank digital currencies and private foreign digital means of payment are emerging. At the same time, the digital euro would have effects on the euro area financial sector. Its design therefore will require finding a balance between different objectives, e.g. between privacy and countering money laundering, and will need to limit potential adverse repercussions including on financial intermediation and financial stability.

[76] Enhancing the international role of the euro is part of the Commission agenda for strengthening the economic and financial autonomy of the EU. See 'The European economic and financial system: fostering openness, strength and resilience', 2021, European Commission.
[77] See ECB (2021) 'The international role of the euro', June 2021.
[78] See 'The European economic and financial system: fostering openness, strength and resilience'

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Annexes

Annex 1: 2021 Euro Area Recommendation

The Council recommended that euro area Member States take action, individually, including through their Recovery and Resilience Plans, and collectively within the Eurogroup, in the period 2021–2022 to:

(1) Ensure a policy stance that supports the recovery from the COVID-19 crisis. As the health emergency persists, adopt fiscal policies that remain supportive in all euro area Member States throughout 2021. Adopt policy measures that are tailored to country-specific circumstances and timely, temporary and targeted. Continue coordinating actions to effectively address the COVID-19 pandemic, sustain the economy and support a sustainable recovery. When the epidemiological and economic conditions allow, phase out emergency measures while combatting the social and labour-market impact of the crisis. Pursue fiscal policies that aim to achieve prudent medium-term fiscal positions and to ensure debt sustainability, while enhancing investment. Pursue reforms that strengthen the coverage, adequacy and sustainability of health and social protection systems for all. Pay particular attention to the quality of budgetary measures. Improve public procurement frameworks and public financial management, including in particular investment frameworks and the use of green budgeting tools. Make use of spending reviews to better focus public expenditure on recovery and resilience needs.

(2) Further improve convergence, resilience and sustainable and inclusive growth. Mitigate the risk of further divergence, and enhance economic and social resilience in the euro area by continuing to tackle structural challenges, by implementing reforms that strengthen productivity and employment, ensure a smooth re-allocation of resources and improve the functioning of markets and public administration, by increasing the level of public investment, and by fostering private investment to support a fair and inclusive recovery consistent with green and digital transitions. Further integrate the single market for goods and services, including the digital single market, by removing unnecessary restrictions, enhancing market surveillance and guaranteeing sufficient administrative capacity. Ensure effective active labour market policies and support for job transitions, in particular towards the green and digital economy. Foster fair working conditions, address labour market segmentation and strengthen inclusion. Ensure the effective involvement of social partners in policy making, and strengthen social dialogue and collective bargaining. Strengthen inclusive education and training systems and investment in skills, addressing skills shortages. Continue working within the framework of the Council on a global consensus-based solution to address the tax challenges arising from the digitalisation of the economy within the OECD Inclusive framework on Base Erosion and Profit Shifting, with the expectation that agreement will be reached by mid-2021 in that forum. Engage in the relevant preparatory work on the way forward in order to address those tax challenges arising from the digital economy, including in the absence of an international consensus by mid-2021. Make further progress to combat aggressive tax planning, lower the tax wedge and support a shift towards carbon pricing and environmental taxation.

(3) Strengthen national institutional frameworks. Pursue and frontload reforms to address bottlenecks to investment and to ensure the efficient and timely use of Union funds, including through the Recovery and Resilience Facility. Strengthen the effectiveness and digitalisation of public administration, including justice and health systems, as well as public employment services. Reduce the administrative burden for firms and improve the business environment.

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Continue to improve the frameworks for countering fraud and corruption and for preventing money laundering and terrorism financing. Promote concrete actions to increase the efficiency, effectiveness and proportionality of insolvency frameworks, to work out non-performing exposures and ensure an efficient allocation of capital.

(4) Ensure macro-financial stability. Maintain the credit channels to the economy and measures to support viable companies as long as necessary during the emergency of the unprecedented COVID-19 crisis. Keep sound bank sector balance sheets, including by continuing to address non-performing loans through, amongst others, the development of secondary markets for non-performing loans.

(5) Complete the EMU and strengthen the international role of the euro. Make progress on deepening the EMU to increase the resilience of the euro area by completing the Banking Union, by continuing to work, without delay, and with the same level of ambition, on all elements, including those discussed in the High Level Working Group on a European Deposit Insurance Scheme, and by deepening the Capital Markets Union, as well as through support for initiatives implementing digital finance, retail finance and sustainable finance policies. Work further on solutions for overcoming limitations in the current set-up for liquidity provision in resolution and on strengthening the Union's regulatory and supervisory framework, including by ensuring consistent and effective supervision and enforcement of anti-money laundering rules.

Further steps in deepening the EMU should take into account the lessons learnt from the Union's comprehensive economic policy response to the COVID-19 crisis. Progress in deepening the EMU, in full respect of the Union's internal market and pursued in an open and transparent manner towards non-euro area Member States, will contribute to enhancing the international role of the euro and promote the Union's economic interests globally.'-

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Annex 2: Correspondence between reforms implemented in the Recovery and Resilience Programmes and priorities in the Euro area Recommendation 2021

The Regulation establishing the Recovery and Resilience Facility (RRF) (Regulation (EU) 2021/241) foresees that the Recovery and Resilience Plans (RRP) submitted by Member States "shall be consistent with the relevant country-specific challenges and priorities identified in the context of the European Semester, as well as those identified in the most recent Council recommendation on the economic policy of the euro area for Member States whose currency is the euro" (Article 17.3). Accordingly, the table below identifies the reforms and investments planned by the various euro area Member States that respond to the challenges identified in the Euro area recommendation of 2021[79]. EAR 5 was focusing on "completing the EMU and strengthening the international role of the euro" and individual action by Member State can only indirectly respond to this common challenge. Accordingly, this challenge is not included in the table below.

The information included in the table has been collected by the staff of the European Commission based on the RRPs and, for Member States for which the assessment of the plan has already been adopted by the Commission, on the analysis provided in the staff working document accompanying the Commission's proposals for Council implementing decisions.

	EAR 1: Ensuring a policy stance which supports the recovery	**EAR 2: Further improving convergence, resilience and sustainable and inclusive growth**	**EAR 3: Strengthening national institutional frameworks**	**EAR 4: Ensuring macro-financial stability**
BE	The BE plan pursues reforms to strengthen the coverage, adequacy and sustainability of social protection systems, most notably in the area of pensions. The pension reform included in the plan aims to reinforce the insurance principle of the pension system by increasing minimum pensions and strengthening the link between contributions and benefits. The plan integrates spending reviews in the budget planning cycles of all	Reforms and investments in the BE plan are expected to support overall productivity and an improved efficiency of the public administrations' action. This should foster private investment to address the recovery and the twin green and digital transition. In parallel, efforts will be made to match the skills of human capital with labour market needs through the modernisation of education and training systems, and to promote effective active labour market policies.	The BE plan includes measures to modernise and digitise public administrations. In the area of business environment, certain measures aim to remove unnecessary or disproportionate administrative barriers to business creation and growth.	

[79] The 2021 Council recommendation on the economic policy of the euro area, which were approved by the ECOFIN Council on 25 January 2021, were the first to take into account the challenges linked to the COVID-19 pandemic. As such, although they were formally adopted by the Council only on 13 July 2021, they are the most relevant document to assess the extent to which recovery and resilience plans reflect economic priorities set for the euro area.

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	government levels to improve spending efficiency. Further, the plan aims to foster the resilience of the Belgian health system, notably through targeted investments in e-health solutions that aim to increase the quality, speed and agility of healthcare through the digitalisation of health processes.			
DE	The DE plan includes investments that aim to increase the resilience of the health care sector, e.g. by providing better digital infrastructure for hospitals.	The DE plan contains investments that focus on supporting digital education, increasing social inclusion and supporting a fair recovery through the post-pandemic catch-up education programme for children and young people. To support parents and increase equality of opportunity, childcare is bolstered. Companies receive financial incentives to hire and retain apprentices, supporting the apprenticeship system.	The DE plan puts forward reforms that strive to modernise and digitalise public administration, increase its efficiency and to tackle investment bottlenecks. These reforms are expected to reduce the administrative burden for businesses and citizens and improve the business environment.	
EE	The EE plan includes reforms and investments aimed at supporting the provision of integrated and human-centred health care, raising the capacity of health institutions to adapt to crisis situations and addressing the shortages of health workforce.	The EE plan includes reforms and investments to improve the capacities of businesses to achieve the green and digital transition, promote climate change adaptation and mitigation and support employment and labour market participation of young people.	The EE plan includes measures aimed at contributing to the digital transformation of public services and public administration. The EE plan equally includes a measure to strengthen the fight against money laundering.	
IE	The IE plan contains several measures that are expected to support the recovery. In this respect, the work placement experience programme is expected to help combat the labour market impact of the crisis, while the eHealth and health reform measures have the potential to support the accessibility and cost-effectiveness of the healthcare system.	The IE plan includes measures that are expected to increase public investment and foster private investment to support a recovery consistent with the green and digital transitions, while also aiming to support a shift towards carbon pricing and environmental taxation. Other measures have the potential to strengthen inclusion and support job transitions, as well as to make further progress in combatting aggressive tax planning.	The IE plan is expected to strengthen national institutional frameworks, by among others digitalising public administration and aiming to lower barriers to entrepreneurship with an SME test. The plan also has the potential to strengthen the European regulatory and supervisory framework by reinforcing the supervision and enforcement capacities of Ireland’s anti-money laundering framework.	

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EL	The EL plan contains reforms and investments to improve the quality and sustainability of public finances and the accessibility and resilience of the health system. Among others, the plan contains investments, primarily in the green and digital areas, and measures to further improve the business environment and the efficiency of the public procurement framework, including through the digital transformation of public procurement processes and the set-up of an effective governance system.	The EL contains a wide range of measures that support productivity and employment. It has a strong focus on active labour market and social welfare policies, including in the area of education, and contains measures to support public and private investments, including for the green and digital transition. Targeted interventions aim to stimulate research, development and innovation performance and address skill mismatches.	The plan contains measures to improve public administration and governance systems, including by modernising staff hiring procedures and strengthening the national public procurement framework. Reforms of the justice system (revision of the judicial map, digitalisation and upskilling of judges and judicial clerks) aim at modernising the system and increasing its quality and efficiency. Reforms regarding the anti-money laundering framework, fight against corruption and improving tax collection capacity are addressed through various components, which will enhance the AML/CFT framework, as well as modernize and digitalise the relevant infrastructures and databases.	The EL plan aims at addressing the lack of affordable financing for companies, with loans passed on to the private sector through international financial institutions and commercial banks. This could help overcome the significant constraints in providing credit through the Greek banking sector, which suffers from the still high volume of non-performing loans and low profitability. Moreover, the plan contains financial-sector reforms aimed to a) enhance credit decision-making and empower the non-performing loan market through tackling information asymmetries and b) to strengthen capital markets, thus increasing Greece's economic resilience to future shocks.
ES	Measures in the ES plan are expected to mitigate the impact of the crisis and support the recovery. In the medium term, the reform of the pension system is set to increase related expenditures. Still, measures included in the plan to strengthen the fiscal system and enhance the efficiency of public spending will support investment and improve the sustainability of public finances. The modernisation of public procurement can also play a role in this respect. Measures improving the resilience and quality of the health system are also included in the plan.	Reforms and investments in the ES plan are expected to support productivity and better functioning markets and public administrations. This should foster private investment to address the recovery and the twin green and digital transition. The plan also shows commitment to deepen the Internal Market, including the digital one. In parallel, efforts will be made to correct labour market segmentation, to match the skills of human capital through the modernisation of education and training, and to promote effective active labour market policies across the national territory. This is to be done within the framework of social dialogue and with the broadest possible consensus, with a view to ensuring that reforms are effective in the medium and long term. Further reforms	Measures have been taken to simplify administrative procedures for the efficient absorption of European funds, in particular those of the RRF. The Plan also provides for measures to modernise and digitalise public administrations, particularly in the areas of health, justice and public employment services. In the area of business climate, reforms envisaged can help remove unnecessary or disproportionate administrative barriers to business creation and growth. They can also facilitate business restructuring processes through amendments to the insolvency framework.	

		of the tax system are planned to move towards greener taxation.		
FR	Measures included in the FR plans will support the economy while contributing to a sustainable recovery. In particular, the reform of the governance of public finances and efforts to increase the efficiency of public spending will contribute to prudent fiscal positions in the medium term. The FR plan also aims to implement measures contributing to the resilience of the health and social security system, in particular by strengthening the healthcare and socio-medical sectors, as well as social measures supporting employment. The quality of the country's public financial management should, among others, be strengthened by the digitalisation of the public administration and fiscal structural reforms.	The FR plan includes measures to promote the climate transition and includes investments to promote the digital transformation. There are measures aimed at supporting educational and pedagogical innovation through digitalisation and modernization, as well as strengthening vocational education and training and upskilling and reskilling. These are all expected to enhance productivity, employment and labour market integration.	The FR plans includes measures to boost the digital transition of the public service and of the national health system. Several reforms included in the FR plain aims at simplifying the regulatory environment for companies and reduce administrative burdens.	The FR plan includes measures aimed at strengthening the equity of SMEs and the quality of public finances.
IT	The IT plan includes measures that will support the economy while contributing to long-term sustainability. In particular, it foresees an improvement of the public spending reviews to also support green budgeting. The plan also aims to strengthen the coverage, adequacy and sustainability of the health system. A number of measures are envisaged to reinforce local health care facilities, fostering the digital transition throughout the health system and use health data to assess the quality of care and support health care decisions and planning for improving the governance of the healthcare system.	The IT plan includes measures that aim at enhancing the green transformations of the economy, by improving energy efficiency and building renovation, promoting renewables and hydrogen production as well as fostering circular economy and better agricultural practices. Furthermore, a number of measures is also envisaged to contribute to improving labour market participation, particularly for women and young people, and to enhancing the quality of the education and training services.	The IT plan includes measures aiming at increasing the effectiveness of the public administration, the efficiency of the justice system and the resilience of the healthcare system. Moreover, to improve the business environment, the Plan includes measures to remove barriers to competition, improve regulation in certain sectors and streamline the public procurement code. The IT plan also includes reforms of the justice system, including in measures to reinforce the insolvency framework.	
CY	The CY plan contains several measures	The CY plan contains a variety of	The CY plan includes reforms linked to	The CY plan aims to address financial

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	that are expected to support the recovery. More specifically, it contains reforms and investments to strengthen the effectiveness, accessibility and overall resilience of the healthcare sector, supporting the recently introduced National Health System through various interventions. These include the (i) modernisation and digitalisation of health care infrastructure and equipment, (ii) stepping-up of e-Health services, (iii) accreditation of provided health care services and introduction of evidence-based clinical protocols and quality monitoring systems, as well as (iv) upskilling opportunities for health workers.	measures that support productivity and employment in a sustainable way. There is a dedicated component promoting a new growth model and diversification of the economy, aiming to reduce overreliance on certain economic sectors, such as tourism, by addressing challenges in the primary and secondary sectors. In addition, the plan contains measures to improve access to finance for SMEs. It also contains measures aiming to support public and private investments with strong focus on green and digital transition. There is also a strong focus on active labour market policies and social protection as well as improving the education system and upskilling the workforce. Furthermore, the CY Plan includes measures aimed at safeguarding fiscal and financial stability such as securing tax collection capacity and improving tax administration.	improving the business environment, to the efficiency of public administration and the effectiveness of the justice system, including anti-corruption. It also includes investments for the digitalisation of the public administration and the justice system. In addition, it foresees a more decentralised local government framework, which is expected to improve the services provided to the citizens and improve the efficiency of the central and local governments.	stability inter alia by: (i) reducing legacy risks in the banking sector, to a large extent related to remaining stocks of non-performing loans, (ii) putting in place measures against high private indebtedness, such as improving monitoring, enhancing insolvency frameworks and improving financial literacy, and (iii) improving supervision in the non-bank sector (insurance, pension funds, and securities markets).
LV	LV plans reforms and investments to support provision of integrated and human-centred health care, raise the capacity of health institutions to adapt to crisis situations and to address the shortages of health workforce. LV also aims to improve the adequacy of the minimum income support system.	LV plans reforms and investments to promote the climate change adaptation and mitigation and digital transition. It aims to reduce inequalities and includes measures to improve labour market participation. The plan includes measures to foster regional development, research and innovation as well as support schemes for business investment. The plan also promotes investment in skills, including digital skills.	LV plans to improve the functioning of public administration by increasing the efficiency of tax administration, strengthening the competencies of the justice system, modernising public administration and improving the quality and efficiency of public procurement. The plan includes measures for the digital transformation of public administration, public services and businesses. The plan is expected to continue work on the implementation of the anti-money laundering strategy.	
LT	LT aims to reform the minimum income	The plan includes measures increasing	The digitalisation of the public sector	

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	scheme, increase the coverage of the unemployment social insurance and improve pension indexation mechanism. The plan also provides for introduction of an additional benefit to single elderly and disabled people as well as setting-up an accreditation scheme for social care. A set of reforms and investments is directed towards improving the quality and accessibility of health services and promoting innovation, improving long-term care services and strengthening the resilience of the healthcare system to deal with emergencies. Lithuania has envisaged measures to improve its medium-term budget framework and introduce spending reviews.	the scope and diversity of employment support measures with a focus on high value added jobs supporting the objectives of digital and green transformation. The plan also aims at improving the operational processes of public employment service through digitalisation and increasing customer orientation. The Plan also encompasses measures to improve HR management in the public service and extensive training of the civil service. In addition, Lithuania intends to expand environmental taxation.	includes measures to (i) fully consolidate state information resources, IT infrastructure and services, (ii) ensure the availability of reliable public sector data and the possibility to share it across sectors; and (iii) fully digitalise government processes and expand digital public services, while ensuring that all digital public services are accessible for citizens with disabilities. Lithuania also plans to develop digital tools facilitating insolvency procedures of businesses.	
LU	The LU plan contains several measures that will support the recovery. It promotes investment in skills, including digital skills, which will increase the qualification and employability of the workforce, including older workers. Investment in renewable energy and in green mobility will also contribute to the economic growth of the country. The plan also includes measures to strengthen the resilience and efficiency of the healthcare system. The LU plan includes a component with reforms and investments to modernize the health system, with a view to increasing its preparedness, efficiency and resilience ahead of the challenges that ageing populations will pose to the sustainability of public finances in the medium term.	The LU plan addresses social vulnerabilities by including measures to foster training for jobseekers and short-time workers. It promotes social cohesion by reforms incentivising the supply of affordable and sustainable housing. Among the largest projects of the plan features the development and deployment of a secure communication system among several MSs, which will facilitate a secure exchange of data and digital integration, contributing to the digital transition.	The plan includes reforms intended to ensure effective supervision and enforcement of the anti-money laundering framework as regards professionals providing trust and company services, and investment services. The LU plan is also set to strengthen the effectiveness and digitalisation of public administration. The integrated set of digital tools being deployed will improve the public service accessibility and interaction with the population and economic actors. The service aims to become a platform, on which stakeholders and the institutions can jointly build digital capacity and trust towards a more inclusive and engaged society.	

MT	The MT plan promotes key investments to strengthen growth potential and creating jobs. The plan contains measures that contribute to the resilience of the health system. In the area of social policy, the plan includes reforms and investments to assess and review unemployment benefits and the pension system to ensure their adequacy and sustainability.	The MT plan contains investments and reforms that aim to contribute to the green transition, circular economy and the digital transformation of the country. It also expands opportunities for upskilling and reskilling, especially low skilled adults, strengthens vocational training, and reinforces access to quality education, especially for pupils with special needs.	MT plans to improve the governance of the justice system, including by changing the appointment and dismissal procedures of the judiciary and ensuring the independence of specialised tribunals, as well as reinforcing the institutional framework to tackle corruption. On AML, Malta commits to complete the implementation of the national action plan on the AML/CTF and actions requested by the special task force. The plan includes investments to fast-track the digitalisation of the public administration, the health care and justice systems.	
AT	The AT plan includes a proposal for spending reviews related to the green and digital transition. The plan includes several measures that help address the challenges of the fiscal sustainability of the pension system. In addition, the pension splitting contributes to narrowing the gender pension gap, a long-recognised challenge in Austria. Further, the plan aims to foster the resilience of the Austrian health system, notably through a reform to strengthen primary care.	The AT plan includes reform and investment measures related to the green and digital transition to improve Austria's growth potential. The proposal of an eco-social tax reform included in the AT plan has the potential to become a key enabling reform for the green transition and a sustainable economic recovery. The plan also includes several measures to enhance the skills of the labour force, improve education outcomes and mitigate adverse social effects of the crisis.	The AT plan is expected to support structural changes in the country's public administration. This is particularly the case for the digitalisation of the country's public administration and digitalisation in the primary health care sector. Several measures aim to reduce administrative burden and to improve the business environment.	
PT	The PT plan aims at strengthening the social response network and the response capacity of the National Health Service, strengthening qualification of the labour force to help to mitigate the social and labour impact of the crisis. PT seeks to improve the quality of the country's public financial management by the digitalisation of the public administration and fiscal-structural	The PT plan includes investments to promote the climate transition and digital transformation. It supports educational and pedagogical innovation through digitalisation and modernization. PT aims to enhance productivity, employment and labour market integration by strengthening vocational education and training, and reskilling and upskilling.	The PT plan contributes to the modernisation and digitalisation of the justice system and includes the development of an information system to monitor Portugal's national anti-corruption strategy. Digitalisation measures are equally expected to strengthen the National Health Service. It foresees modernisation of public administration and digital transition, and	The PT plan aims to support viable companies and facilitate access to finance complementing the reforms to develop the Portuguese capital market.

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	reforms. PT is set to address several bottlenecks impacting on the quality of public finances.		seeks to reduce the administrative burden and improve the business environment.	
SI	The SI plan is expected to provide a short-term boost to the economy, through considerable investments, while it also envisages a series of reforms that are set to boost economic resilience and raise growth potential, including long-term care, healthcare and pension reforms. These reforms are equally expected to contribute to long-term fiscal sustainability.	The SI plan includes measures to improve business environment and boost investment and R&D and to ensure the digital and green transitions. These include reforms and investments in RDI and education and trainings.	The SI plan includes reforms to modernise public administration; it seeks to increase the efficiency, and greening, of public procurement to strengthen the national institutional framework. The plan aims to improve capital markets framework to attract equity investments.	
SK	The SK plan includes reforms and investments to support the recovery. It represents a detailed response to Slovakia's healthcare challenges, including the modernisation of its hospital network, and a reform of social and long-term care. The plan also envisages improving the sustainability of the pension system. It foresees a new public investment methodology aims at improving the prioritisation of mature projects. A public procurement reform aims at accelerating and simplifying procedures.	The SK has strong focus on inclusive education, public governance and productivity-enhancing investment into the green and digital transition. The plan places a particular emphasis on improving human capital and raising the skill level of population.	The SK plan includes several measures to strengthen national institutional frameworks. The plan seeks to improve the effectiveness and integrity of the justice system and to fight corruption and money laundering. The plan also envisages a large-scale shift to digital public services. Quicker and simplified insolvency processes targeted by the plan could also help to address a long-running complication for entrepreneurs operating in Slovakia.	
FI	FI's plan includes measures to strengthen the coverage, adequacy, and sustainability of health and social protection systems.	FI plans to strengthen productivity and employment and provide support to private investment to foster the green and digital transitions, support job transitions, address labour market segmentation and address skills shortages.	FI plans to strengthen the effectiveness and digitalization of public administration, the health system and public employment services. The measures related to the data economy and information sharing are set to reduce the administrative burden for firms and improve the business environment. The plan contains a reform of the AML/CTF framework.	

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