Brussels, 2.6.2021
COM(2021) 500 final

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

{SWD(2021) 401 final} - {SWD(2021) 402 final} - {SWD(2021) 403 final} - {SWD(2021) 404 final} - {SWD(2021) 405 final} - {SWD(2021) 406 final} - {SWD(2021) 407 final} - {SWD(2021) 408 final} - {SWD(2021) 409 final} - {SWD(2021) 410 final} - {SWD(2021) 411 final} - {SWD(2021) 412 final}

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1. INTRODUCTION

The European Union has taken unprecedented actions to fight the COVID-19 pandemic, cushion the impact of the crisis, and put our economy on a path of robust, sustainable and inclusive growth. Over the last year, the EU and the Member States have shown decisiveness and solidarity in adopting a series of policy measures to fight the pandemic, limit its economic and social impact, preserve favourable financing conditions, safeguarding the integrity of the single market and prepare a swift sustainable and inclusive recovery. According to the Commission spring 2021 economic forecast[1], the drop in the economic activity has been less than expected earlier, thanks to the emergency support measures to provide liquidity to businesses and protect incomes and jobs of EU citizens.

The breakthrough development of vaccines and the deployment of mass vaccination in Europe have brightened the outlook since the autumn. The vaccination in the EU is well on track to achieve the objective of 70% of all adults being vaccinated by July of this year.[2] According to the Commission 2021 spring economic forecast, the EU economy would reach its pre-crisis level of quarterly output in the course of 2021, with economic activity rebounding in all Member States.[3] After a declining trend over the last years, the COVID-19 crisis may lead to higher risks to macroeconomic stability. Strong coordination and effective deployment of all EU policy instruments will be crucial to address these risks and to avert further divergences.

NextGenerationEU, worth EUR 750 billion, is a key tool for the EU to foster investment and recovery in order to emerge stronger and more resilient from the current crisis. The roll-out of the Recovery and Resilience Facility ('the Facility') will help make our economies and societies more sustainable, inclusive, resilient and better prepared for the green and digital transitions. The Facility, which is the centrepiece of NextGenerationEU, will provide large-scale financial support to Member States of up to EUR 672.5 billion in grants and loans to finance reforms and investments.

The European Pillar of Social Rights Action Plan sets out concrete actions to strengthen the social dimension across all policies of the Union and will help ensure an inclusive recovery[4]. At the Social Summit in Porto on 7-8 May 2021, EU leaders recognised the European Pillar of Social Rights as a fundamental element of the recovery and underlined in the Porto declaration[5] their determination to continue deepening its implementation at EU and national level. This will strengthen the Union's drive towards a digital, green and fair transition and contribute to achieving upward social and economic convergence, addressing

[1] European Economic Forecast Spring 2021. *European Economy – Institutional Papers, 149*, May 2021.

[2] Communication from the Commission to the European Parliament, the European Council and the Council: 'A united front to beat COVID-19'. COM(2021) 35 final.

[3] The forecast incorporated the measures set out in the national recovery and resilience plans for all Member States. Conventional assumptions were used in cases where the details of the plans were not yet sufficiently known at the cut-off date for the forecast.

[4] COM/2021/102 final, available at: https://op.europa.eu/webpub/empl/european-pillar-of-social-rights/en/

[5] Available at: https://www.consilium.europa.eu/en/press/press-releases/2021/05/08/the-porto-declaration/

the demographic challenge and ensuring equal opportunities for all[6]. The three new EU headline targets, and complementary sub-targets, to be achieved by 2030 in the areas of employment, skills and social inclusion will support progress towards a strong Social Europe[7]. In addition, the revised Social Scoreboard will help to monitor progress towards the implementation of the Social Pillar principles as part of the policy coordination framework in the context of the European Semester. Furthermore, the EU leaders welcomed the European Social Partners joint proposal for an alternative set of indicators to measure economic, social and environmental progress, supplementing GDP as welfare measure for inclusive and sustainable growth.[8]

The environmental sustainability, productivity, fairness and macroeconomic stability, remain the guiding principles of the EU's economic agenda. The concept of competitive sustainability and its four axes, identified at the start of this College's mandate[9], continue being the overarching priorities of the EU's long-term growth strategy in line with the European Green Deal, and thus underpinning Member States' recovery and resilience plans. Furthermore, the digital transformation of our societies, businesses and economies is crucial to increase Europe's productivity and competitiveness for a robust recovery, in line with the Digital Decade[10].

Ensuring an effective policy coordination under the European Semester remains crucial to set the EU economy on a stronger growth path after the crisis. While this year's cycle was temporarily adapted to allow for the launch of the Facility, the European Semester continues to support the policy discussions among Member States, exchange of best practices and agreements on a common way forward. In their recovery and resilience plans, Member States are required to effectively address all or a significant subset of challenges identified in the relevant country-specific recommendations, including fiscal aspects thereof. Beyond the scope of the Facility, those recommendations that are not addressed remain valid and will continue to be monitored under the European Semester framework.

2. ECONOMIC AND EMPLOYMENT SITUATION AND OUTLOOK

The EU economy is set to rebound strongly. Since last autumn, the tight COVID-19 containment measures have caused the EU economy to fall back into recession. As containment measures are gradually relaxed and vaccination is progressing, activity in the EU is expected to pick up in all Member States, with acceleration as of the second half of 2021, also reflecting the growth impulse stemming from the implementation of the national recovery and resilience plans. The speed of the recovery will vary across Member States and regions. All EU Member States are projected to reach their pre-crisis level of quarterly output by the end of 2022.

[6] In line with the various initiatives aiming at building the Union of Equality.

[7] By 2030, at least 78% of the population aged 20 to 64 should be in employment; at least 60% of all adults (aged 25-64) should participate in training every year; the number of people at risk of poverty or social exclusion should be reduced by at least 15 million (compared to 2019), including 5 million children.

[8] In line with the Commission's ambition, stressed in the 2020 Strategic Foresight Report, COM(2020)493final.

[9] https://ec.europa.eu/info/publications/2020-european-semester-annual-sustainable-growth-strategy_en

[10] Commission Communication of 3 March 2021 "Digital Compass: the European way for the Digital Decade", COM(2021) 118 final.

Very large fiscal and a broad set of monetary measures have limited the economic damage and are propelling the recovery. Thanks to the swift activation of the general escape clause of the Stability and Growth Pact[11] and of the temporary framework on State aid,[12] large-scale fiscal support has been possible in all Member States. In 2020, Member States have provided total fiscal support estimated at above 6 ½% of GDP.[13] As a result, the euro area and EU aggregate government deficit increased from historically low levels of around 0.5% of GDP in 2019 to around 7% in 2020. In addition, the ECB took a broad set of monetary policy measures to preserve favourable financing conditions for all sectors of the economy in order to support economic activity and safeguard medium-term price stability. The mutually reinforcing effects of fiscal and monetary policies, in combination with regulatory and prudential measures for the financial sector were crucial for cushioning the impact of the crisis.

Thanks to the measures taken at EU and national level, the impact of the pandemic on European labour markets has been contained. When the pandemic struck, the European labour market had ended its sixth year of expansion, with more than 209 million people in employment and an unemployment rate of 6.5% in the fourth quarter of 2019. One year later, employment had dropped by 3 million, and the unemployment rate had increased to 7.2%. Given the size of the shock, the number of job losses has been limited. To cushion the impact, Member States implemented a wide range of job-retention measures, such as short-time work schemes and temporary furloughs, which supported up to 32 million European jobs. EU funding, including through the temporary support to mitigate unemployment risks in an emergency (the SURE instrument) and the Corona Virus Response Investment Initiative (CRII)[14] was instrumental in achieving this outcome. Up to now, over EUR 90 billion of SURE loans have been provided to 19 Member States, in support of between 25 and 30 million people and between 1.5 and 2.5 million firms.

The impact of the crisis has been uneven across social groups, sectors and regions; the most vulnerable have been hit hardest. Young people, women, low-skilled workers, migrants, persons with disabilities, those with temporary contracts or in other non-standard forms of employment, but also the self-employed, have been disproportionately affected. This has been aggravated by the fact that business providing services have been severely affected, in particular in industrial ecosystems such as tourism, cultural and creative activities. While income support and social safety nets have prevented a large fall in household incomes, the COVID-19 crisis has exposed gaps in access to social protection, highlighting the importance of fostering greater resilience. In this regard, most Member States have scaled up existing schemes, expanding coverage and relaxing their eligibility conditions on a temporary basis, while there is still scope to reinforce social protection for all in a sustainable manner.

[11] Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, COM(2020) 123 final.

[12] Commission Communication: Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, C(2020) 1863 final.

[13] Measured by the year-on-year development in their primary balances, based on data validated in April 2021 by Eurostat.

[14] More than EUR 23 billion of EU funds have been mobilised through CRII to tackle the pandemic and its economic and social impact.

Risks to the growth projections are broadly balanced overall. Nonetheless, uncertainty will remain elevated as long as the pandemic hangs over the EU and world economy. Despite the progress with vaccination campaigns, substantial risks to the forecast remain from the epidemiological and economic perspective. The evolution of the pandemic and the efficiency and effectiveness of vaccination programmes could turn out better or worse than assumed, requiring a different level of restrictions to activity. Economic growth could also be weaker than expected if the policy support is withdrawn too early. At the same time, a belated withdrawal could increase unwarranted side effects, postponing the transition to a more sustainable and future-proof economy. On the upside, the projections might underestimate households' propensity to consume, after a few quarters of repressed consumption and an increase in their savings rate. The recovery outside the EU could also be stronger than currently expected.

Economic policy needs to remain supportive throughout 2021 and 2022. Looking ahead, when economic conditions will allow, policies should be refocused towards minimising the medium-term consequences of this crisis. The implementation of the Recovery and Resilience Facility will contribute to lift potential growth and employment and thereby reduce imbalances. In the early stages of the crisis and during the lockdowns, policy support measures were heavily geared towards preventing job losses and bankruptcies. This has helped prevent deep and lasting scars to European economies. Going forward, targeted support measures should help viable but still-vulnerable firms to adjust their business models. The emphasis of the support should gradually be shifted to building up capabilities, including by increasing the focus on training, skills development, research and innovation and supporting quality job creation, and job-to-job transitions. The Facility will therefore support investments and reforms that strengthen the potential growth and employment of the Member States. As a result, the public investment-to-GDP ratio in 2021 and 2022 in the Union will be the highest for more than a decade. The updated New European Industrial Strategy sets out the framework to speed up Europe's recovery and transition towards a cleaner, more digital, and more resilient economic and industrial model as well as to build a stronger and more resilient Single Market[15].

Member States' continued reforms and investments along the path indicated by the Employment Guidelines will be crucial to foster the recovery, supporting quality job creation and smooth labour market transitions, with the active involvement of social partners. More broadly, the Employment Guidelines[16] provide steering on how to modernise labour market institutions, education and training as well as social protection and health systems, with a view to making them more inclusive and fair. They integrate specific guidance aimed at mitigating the employment and social impact of the crisis, and achieving socially just green and digital transitions. Given their continued relevance, the Commission proposes to carry over the current Employment Guidelines[17] to 2021, while underlining the role of the new EU headline targets and the policy guidance emerging from the Porto Social Summit.

[15] Commission Communication of 5 May 2021 "*Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery*", COM(2021) 350 final.

[16] Mandated by Article 148 of the TFEU.

[17] The Employment Guidelines are annexed to the Council Decision (EU 2020/1512),), adopted on 13 October 2020.

In addition, **the Commission Recommendation on an effective active support to employment following the COVID-19 crisis (EASE)**[18] provides concrete guidance for a gradual transition from emergency job-retention measures to active labour market policies needed for a job-rich recovery.

3. ROLL OUT OF THE RECOVERY AND RESILIENCE FACILITY

Swiftly implementing national recovery and resilience plans under the Recovery and Resilience Facility is key to support the recovery, while making our economies and societies more sustainable, inclusive, resilient and fit for the green and digital transitions. Through the Facility, which entered into force on 19 February 2021, EUR 312.5 billion in grants and up to EUR 360 billion in loans will be available over the next 6 years to support reforms and investments in all Member States. The Facility will therefore be an unprecedented opportunity for all Member States to address key structural challenges and investment needs, while embracing the green and digital transitions.

The Commission has engaged with all Member States in intense cooperation to support them designing ambitious recovery and resilience plans. The plans should propose investments and reforms that reflect the country-specific challenges and circumstances in each Member State, building on the thorough analysis and challenges identified over the last years in the European Semester. These plans will shape the reform and investment agenda in Member States for years to come. National ownership and the involvement of all relevant stakeholders are crucial to ensure effective implementation and a lasting impact. That is why throughout the entire process, Member States have been strongly encouraged to consult local and regional authorities, social partners, civil society organisations, businesses, youth organisations and other relevant stakeholders in accordance with their national legal framework. A summary of this consultation must be part of each national plan together with indications on how the input of these stakeholders is reflected in the plan.

So far, 23 Member States have submitted their plans and more plans are expected in the coming days[19]**.** Once the Commission has completed its assessment of those plans, the Council will have one month to approve the plans, paving the way for the first disbursements as pre-financing under the Recovery and Resilience Facility.

The recovery and resilience plans submitted or under preparation are expected to substantially contribute to the six pillars foreseen in the Regulation. As required by the Regulation, each plan will have to contribute in a comprehensive and adequately balanced manner to the policy areas of European relevance structured in the six pillars: green transition; digital transformation; smart, sustainable and inclusive growth, productivity and competitiveness; social and territorial cohesion; health, economic, social and institutional resilience; and policies for the next generation, children and the youth. Overall, the Commission expects a significant share of climate-related[20] and digital expenditure in the

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[18] Commission Recommendation for Effective Active Support to Employment (EASE) | European Commission (europa.eu)

[19] BE, CZ, DK, DE, IE, EL ,ES, FR, HR, IT, CY, LV, LT, LU, HU, AT, PL, PT, RO, SI, SK, FI, SE

[20] This will also include measures that benefit biodiversity, the circular economy and other environmental objectives.

plans, as well as measures contributing to social and territorial cohesion and resilience. The Commission also expects important reforms and investments that cut across those policy areas and will help ensure that all six pillars are comprehensively addressed, such as measures to increase digital skills and close connectivity gaps to foster the digital transformation, support cohesion and benefit SMEs.

Combining the funds from the NextGenerationEU recovery instrument and the new multiannual financial framework, the EU financing will provide EUR 1.8 trillion in 2021-2027. NextGenerationEU will provide EUR 750 billion to kick-start the recovery through specific programmes (Recovery and Resilience Facility, REACT-EU, Just Transition Fund, Rural Development, InvestEU, rescEU and Horizon Europe). InvestEU, for instance, brings together various financial instruments to support investment in the EU through an EU budget guarantee of EUR 26.2 billion. InvestEU is expected to mobilise more than EUR 370 billion of additional investment over the next seven years. The funds from NextGenerationEU come in addition to the EUR 1.074 trillion stemming from the EU's budget for 2021-2027. Within it, cohesion policy with its EUR 338.6 billion firepower is aimed at supporting through investment the longer-term development strategies of the Member States.

4. FISCAL POLICY COORDINATION

Coordination of national fiscal policies remains crucial to underpin the recovery. The overall fiscal stance, taking into account national budgets and the Recovery and Resilience Facility, should remain supportive in 2021 and 2022. Fiscal policy should remain agile and adjust to the evolving situation as warranted, and a premature withdrawal of fiscal support should be avoided. Once health risks diminish, fiscal measures should gradually pivot to more targeted measures that promote a resilient and sustainable recovery. Finally, given the expectation of economic activity gradually normalising in the second half of 2021, Member States' fiscal policies should become more differentiated in 2022, taking into account the state of the recovery, fiscal sustainability and the need to reduce economic, social and territorial divergences. As the recovery takes hold, fiscal policy should prioritise higher public and private investment, supporting the transition towards a green and digital economy.

The general escape clause of the Stability and Growth Pact will continue to be applied in 2022 and is expected to be deactivated as of 2023. The general escape clause has allowed Member States to adopt very sizeable expenditure and revenue measures to minimise the economic and social impact of the pandemic. It has also allowed them to coordinate their fiscal policies in a more flexible manner. As announced in the Communication of 3 March 2021[21], the decision to deactivate the general escape clause should be taken as an overall assessment of the state of the economy based on quantitative criteria, with the level of economic activity in the EU compared to pre-crisis levels as the key quantitative criterion. Based on the Commission 2021 spring forecast, pre-crisis economic activity (end-2019) is projected to be reached around the fourth quarter of 2021 in the EU as a whole and the first quarter of 2022 in the euro area. On the basis of this forecast, the conditions for the continued application of the general escape clause in 2022 and its deactivation as of 2023 are met.

[21] Cf. Commission Communication 'One year since the outbreak of COVID-19: fiscal policy response,' COM(2021) 105 final, 3.3.2021.

Country-specific situations will continue to be taken into account after the deactivation of the general escape clause.

In 2022, the fiscal stance, stemming from national budgets and the Recovery and Resilience Facility, needs to remain supportive. Expenditure financed by the Recovery and Resilience Facility will provide a substantial fiscal impulse in 2022 and the coming years. The expenditure financed with non-repayable support will make it possible to fund high-quality investment projects and cover costs of productivity-enhancing reforms without giving rise to higher deficits and debt. Member States should make use of Recovery and Resilience Facility financing, which will thus contribute to supporting the economic recovery, fostering higher potential growth and gradually improving their underlying fiscal positions. In particular, Member States with low debt should pursue a supportive fiscal stance, including the impulse provided by the Recovery and Resilience Facility. Member States with high debt should use the Recovery and Resilience Facility to finance additional investment in support of the recovery while pursuing a prudent fiscal policy. Member States should preserve nationally financed investment. At the same time, the growth of nationally financed current expenditure should be kept under control, and be limited for Member States with high debt. This will allow fiscal measures to maximise support to the recovery without pre-empting future fiscal trajectories and creating a permanent burden on public finances.[22]

For the period beyond 2022, fiscal policies should continue to take into account the strength of the recovery, the degree of economic uncertainty and fiscal sustainability considerations. When economic conditions allow, Member States should pursue a fiscal policy aimed at achieving prudent medium-term fiscal positions and ensuring fiscal sustainability in the medium term. At the same time, Member States should enhance investment to boost growth potential. In view of the currently still exceptionally high degree of uncertainty, including regarding the impact on growth potential of the crisis and the reforms and investments implemented with the support of the Recovery and Resilience Facility, this year’s guidance remains predominantly qualitative. More precise quantified guidance for the later years should be provided in 2022, once the degree of uncertainty has sufficiently declined.

The Commission has assessed compliance with the deficit and debt criteria in 2020. As the activation of the general escape clause does not suspend the procedures under the Stability and Growth Pact, the European Commission continues to operate the annual cycle of fiscal surveillance. The Commission has issued a report[23] (in accordance with Article 126(3) of the Treaty on the Functioning of the European Union (TFEU)) which assesses compliance with the deficit and debt criteria by all Member States, except Romania.[24] In this context, the Commission has taken into account the high uncertainty, the agreed fiscal policy response to the COVID-19 crisis and the Council recommendations for 2021. The analysis, which takes into account all relevant factors as appropriate, suggests that the *deficit criterion* as defined in the Treaty and in Regulation (EC) No 1467/1997 is fulfilled by three Member States and not

[22] Cf. Commission recommendations for Council Recommendations delivering Council Opinions on the stability or convergence programmes, which have been adopted at the same time of this communication.

[23] The preparation of an omnibus report under Article 126(3) TFEU covering twenty-six Member States, instead of country-specific reports under the aforementioned article, is a one-off approach taken in light of the exceptional workload related to the launch of the Recovery and Resilience Facility and the assessment by the Commission of the Plans submitted by Member States.

[24] The report does not discuss the situation of Romania, which is currently the only Member State that is subject to an excessive deficit procedure.

fulfilled by 23 Member States. The *debt criterion* as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled by 13 Member States. The outbreak of COVID-19 has had an extraordinary macroeconomic and fiscal impact, creating exceptional uncertainty, including for designing a credible path for fiscal policy. Taking into account the high uncertainty, the agreed fiscal policy response to the COVID-19 crisis and the Council Recommendations of 20 July 2020[25], the Commission considers that at this juncture a decision on whether to place Member States under the Excessive Deficit Procedure should not be taken. In the case of Romania, where an excessive deficit procedure was opened on the basis of data for 2019, the Commission recommends an update of the adjustment path targeting a correction of the excessive deficit in 2024. The Commission will reassess Member States' budgetary situation on the basis of the autumn 2021 Economic Forecast, and the 2022 Draft Budgetary Plans to be submitted by euro area Member States by 15 October 2021.

The quality of public finances is central in the design of fiscal policy. In the course of 2020, all Member States reacted very promptly with the adoption of emergency measures to fight the pandemic and support firms' and households' incomes. As health risks diminish, economic policy should shift from an emergency regime towards recovery-oriented objectives. The quality of the budgetary measures should ensure a sustainable and inclusive recovery. Member States should prioritise growth-enhancing investment, notably supporting the green and digital transition. A focus on fiscal structural reforms, including to enhance efficient spending and high-quality public finance resource management, is crucial. On the revenue side, reforms aiming at shifting taxation from labour to environmental taxes that are less distortive and preventing harmful tax competition and aggressive tax planning are also essential. It will help provide financing for public policy priorities and contribute to the long-term sustainability of public finances, including by strengthening the coverage, adequacy, and sustainability of health and social protection systems for all. After the immediate crisis response in 2020, several Member States have resumed plans to improve expenditure evaluation and review. Enhancing spending reviews, through capacity building, governance improvements and a tighter link with the budgetary cycle, features as an important reform in some recovery packages. Stronger policy evaluation and an increased focus on policy priorities play a more important role in budgetary planning. Some Member States are also developing green budgeting practices to step up climate and environmental actions. These practices will allow them to assess the green content of their budgetary policies and ensure coherence of public expenditures and revenues with environmental goals. The Commission continues its dialogue and support for the development and refinement of processes and practices that enhance the quality of public finance.

5. MACROECONOMIC IMBALANCES IN THE MEMBER STATES

The Commission has identified macroeconomic vulnerabilities related to imbalances and excessive imbalances for 12 Member States. These Member States have been selected for

[25] The Council recommended Member States to take all necessary measures, in line with the general escape clause of the Stability and Growth Pact, to effectively address the COVID-19 pandemic, sustain the economy and support the ensuing recovery. When economic conditions allow, Member States should pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment. Cf. OJ C 282, 26.8.2020, p. 1–187.

in-depth reviews in the 2021 Alert Mechanism Report[26]. Three Member States continue experiencing *excessive imbalances* (Cyprus, Greece, and Italy) and nine others are experiencing *imbalances* (Croatia, France, Germany, Ireland, the Netherlands, Portugal, Romania, Spain, and Sweden) in the sense of the Macroeconomic Imbalances Procedure. The roll-out of the Recovery and Resilience Facility will be key to reduce existing macroeconomic imbalances, as it will support reforms and investments that address the challenges identified over previous Semester cycles.

The main sources of imbalances are largely the same as a year ago, but risks increased. While the COVID-19 crisis has not fundamentally altered the nature of Member States' imbalances, it has implied a setback in the reduction of those imbalances and may increase the risks to macroeconomic stability. Government and private debt has increased visibly, to a large extent explained, on the top of the recession, by policies to address the pandemic and to support the economy and the recovery. Large current account surpluses persist in some Member States. Several Member States with high debts levels also have low potential growth. In these cases, the efficient use of the Facility to foster growth-enhancing investment and reforms will be instrumental. Debt repayment difficulties may translate into non-performing loans once support measures are phased out. By contrast, some vulnerabilities related to cost competitiveness pressures softened during the COVID-19 crisis.

At this stage, a revision of the classification of imbalances does not appear warranted. The COVID-19 crisis may increase the risks to macroeconomic stability, albeit not in a way that would require a revision of the imbalances classification at this stage. Persistently high uncertainty calls for close monitoring of imbalances and macroeconomic stability risks with a strong forward-looking perspective.

- Cyprus, Greece and Italy continue to experience excessive imbalances, linked to high government debts and high share of non-performing loans – despite continued and significant progress in this area. Cyprus and Greece combine that with high external debt and, Cyprus, also with high private debt. Moreover, potential growth remains too low to drive debt deleveraging.
- Imbalances in Croatia, Ireland, Portugal, and Spain combine high private, government and external debts, while in France the imbalances are driven by government and private debts, which continue to rise. Ensuring productivity and competitiveness gains remains important for these Member States. In Romania, competitiveness losses are abating, but the large current account deficit persists, and fiscal trends need to be firmly reversed after years of deterioration. Germany and the Netherlands record persistently large current account surpluses, linked to an excess of savings over investments, compounded by high private debt in the Netherlands. In Sweden, the high house prices are not moderating, and high and increasing household debt remains a concern.

Appendix 1 provides more details on the country-specific aspects of the imbalances analysis.

[26] Report from the Commission to the European Parliament, the Council, the European Central Bank and the European Economic and Social Committee: Alert Mechanism Report 2021, COM(2020) 745 final.

6. ADAPTING THE EUROPEAN SEMESTER

Given large overlaps between the European Semester and the early stages of the Recovery and Resilience Facility, it was necessary to temporarily adapt the 2021 European Semester cycle to the launch of the Facility. This has allowed the Commission and the Member States to focus this year's cycle on preparing the recovery and resilience plans as the main forward-looking reference document of the Member States' reform and investment agenda. Meanwhile, the surveillance of macroeconomic imbalances continued, with a focus on the emerging risks due to the COVID-19 crisis, that were, when relevant, addressed in the discussions with Member States on their draft plans.

The forthcoming 2022 Annual Sustainable Growth Strategy will outline the key elements of the upcoming European Semester cycle. The first year of implementation of the recovery and resilience plans will need to be monitored within the annual coordination framework under the European Semester. In this regard, the Regulation establishing the Recovery and Resilience Facility provides for twice-yearly reporting by the Member State on their progress in implementing their plans in the context of the European Semester. The monitoring of progress towards the principles of the European Pillar of Social Rights will need to be embedded in the European Semester, as highlighted by the EU leaders in the Porto Social Summit. The 2022 Annual Sustainable Growth Strategy will set out the concrete steps on how the Semester governance framework is to be structured in 2022. On that basis the Commission will engage in a dialogue with the European Parliament, the Council, Member States, social partners and all other relevant stakeholders.

7. NEXT STEPS

The Commission welcomes the approval of the Own Resources Decision by all Member States. This approval paves the way for the Commission to start borrowing under NextGenerationEU in order to disburse funds, including the pre-financing of grants and loans under the Recovery and Resilience Facility.

The Commission will adopt its proposals for Council implementing decisions on the recovery and resilience plans starting in the second half of June. The Commission looks forward to a swift adoption by the Council to ensure a timely implementation of the plans, allowing for a sustainable and inclusive economic recovery, in line with the conclusions of EU leaders at the Porto Summit. The Commission is also available to provide on-request technical assistance to the Member States and help the authorities make the best use of the EU funds.

The Commission welcomes the intensive and constructive cooperation between all EU institutions, in particular via the launch of the recovery and resilience dialogue. The strong involvement of the European Parliament will be crucial to contribute to greater transparency and accountability in the Facility's implementation. The Commission is fully committed to share all relevant information with the Parliament and the Council, and to give due consideration to the views expressed by the Parliament in the context of the dialogue, in line with the requirements of the Regulation.

The Commission calls on Member States to ensure that the recovery and resilience plans are fully implemented in a timely manner and in thorough dialogue with social partners, civil society and other stakeholders.

APPENDIX 1 - FINDINGS OF IN-DEPTH REVIEWS OF MACROECONOMIC IMBALANCES IN EU COUNTRIES

For the 12 Member States that have undergone an in-depth review, the classification of imbalances and excessive imbalances has been confirmed. The in-depth review (IDR) analysis looks at the gravity of the imbalances, their recent and prospective evolution and related policy responses. Relevant spillovers and the systemic cross-border implications of imbalances are also taken into account.

The context of the assessment of vulnerabilities this year differs from the analysis in last year's in-depth reviews. In 2020, policy efforts generally focused on addressing and cushioning the impact of the pandemic and supporting a sustainable recovery, which itself is set to lend support to the correction of imbalances, while there was also a need to control macro stability risks in the medium-term. The forward-looking perspective is therefore key in the risk assessment. However, uncertainty remains high, and it is still difficult to assess the full consequences of the crisis. This calls for continued and close monitoring of imbalances and macroeconomic stability risks. Looking forward, these imbalances were discussed with Member States in the preparation phase of their recovery and resilience plans as the Recovery and Resilience Facility provides a unique opportunity to address macroeconomic imbalances, investment and reforms needs. The analyses of policies in the present in-depth reviews were finalised before the formal submission of recovery and resilience plans and does therefore not draw on information included in these plans. While the Commission's assessment of the recovery and resilience plans is ongoing at the time of publication of this Communication and cannot be prejudged, an effective implementation of the recovery and resilience plans provides an opportunity to address existing imbalances.

In general, macroeconomic risks and vulnerabilities have the same origin as previously identified. The COVID-19 crisis has implied a setback in the reduction in macroeconomic imbalances observed in the past decade but not in a way to justify revising the classification of imbalances at this stage. Several Member States were combining high private, government and external debts already before the pandemic. In other cases, the debt-related concerns have been centred either on the government sector or the private sector. In 2020, all those debt-to-GDP ratios increased reflecting the slump in economic activity and the significant increase in borrowing, especially by corporations and governments in order to cushion the fallout of the pandemic and prevent an even more severe deterioration of the economic situation and of macroeconomic stability. Temporary moratoria on debt repayment by corporations and households have kept debts performing and reducing the risk of liquidity shortages.

Private and public debt dynamics can become more challenging going forward but are expected to improve with the recovery. Several countries concerned by high debts are marked by low potential growth, and the crisis may be further dampening growth, especially where more affected sectors account for a larger share of activity, which overall will limit the pace of deleveraging. That highlights the importance of effective implementation of the Recovery and Resilience Facility to enhance higher potential growth, support a marked recovery, and help tackling these imbalances. Rising debt repayment difficulties may translate into non-performing loans going forward, especially in those sectors more affected by the crisis and once moratoria on debts repayments and other support measures expire. Thus, while banks' resilience has improved over the past few years, it could be hit in a lagged and protracted way, and credit supply to the economy could be affected, in turn affecting the strength of the recovery.

External accounts have been mostly stable during the COVID-19 crisis. Current account deficits have generally changed little, as government and private sector net savings have been mutually compensating. The exceptions have been in countries most exposed to falling foreign tourism, where current accounts worsened more visibly in 2020 and may not fully recover this year or next. In parallel, large current account surpluses remain largely unchanged, as does the current account surplus for the euro area as a whole. Negative net international investment positions worsened in 2020 but are not expected to deteriorate further this year or next year. External financing conditions have been supportive, apart from a brief episode of heightened risk aversion in global financial markets immediately after the outbreak of the crisis and especially for non-euro area members.

The continued expansion of the pre-crisis years led to overheating pressures reflected in cost competitiveness losses and strong house price growth: the former has softened during the COVID-19 crisis, the latter less so. Cost competitiveness developments are expected to stabilise as wage growth moderates in a labour market that has clearly weakened with the COVID-19 situation, and a cyclical increase in productivity is further relieving pressure on unit labour costs this year and next. As for house prices, dynamism has continued to be observed in some countries, where risks of overvaluation have been more relevant. However, in some cases, it cannot be excluded that expiring moratoria on debt repayments and withdrawal of other temporary support measures may put downward pressure on housing prices and especially where household incomes have been more battered.

Countries experiencing excessive imbalances

- **Greece** is experiencing excessive imbalances. Vulnerabilities relate to high government debt, incomplete external rebalancing and high non-performing loans, in a context of high unemployment and low potential growth. The COVID-19 crisis has interrupted the adjustment process initiated in previous years. Government debt increased sizeably in 2020 and is expected to edge down only in 2022. Government debt is mostly held by official sector creditors, which, together with the large cash buffer, insulates Greece from short-term fluctuations. The current account deficit has widened recently and is forecast to remain large, in large part because of the impact of the COVID-19 crisis on the sizeable tourism sector. Despite marked decreases in recent years, non-performing loans remain large and risk increasing once temporary support measures are phased out. Efforts to strengthen growth prospects face headwinds from the depleted capital stock, an ageing population and outward migration of skilled labour. Low potential growth weighs on debt deleveraging.

- **Italy** is experiencing excessive imbalances. Vulnerabilities relate to high government debt and protracted weak productivity dynamics, which have cross-border relevance in a context of labour market and banking sector fragilities. The government debt ratio increased sharply in 2020, reflecting the fall in GDP and the fiscal response to the COVID-19 crisis, and is expected to edge down only in 2022. Labour productivity increased in 2020 but long-term productivity growth remains constrained by barriers to private and public investment and by limits to growth of the most productive firms. Activity and employment rates remain below the EU average. The very sluggish productivity growth, together with low employment rates, hamper potential growth, which in turn limits the room for debt deleveraging. While the Italian banking sector became more robust and resilient in the pre-COVID-19 crisis years, vulnerabilities remain. Notably, non-performing loans declined in recent years but are still relatively high and risk increasing once temporary support measures are phased out.

- **Cyprus** is experiencing excessive imbalances. Vulnerabilities relate to high stocks of external, government, and private debt, and still high non-performing loans, alongside a substantial current account deficit. The current account deficit deteriorated substantially in 2020 to a double-digit reading reflecting a marked drop in tourism exports amid the COVID-19 crisis and it is forecast to improve only slightly in the near term. External debt remains high and the negative net international investment position, even when excluding special purpose entities, is worsening in part due to the large current account deficits. The COVID-19 crisis interrupted the private sector deleveraging as the high debt ratios increased in 2020 mostly on account of the drop in GDP. Non-performing loans remain among the highest in the EU, despite visible reductions in recent years and risk increasing again once temporary support measures are phased out. The government debt ratio increased significantly in 2020 but is expected to return to a declining path already this year.

Countries experiencing imbalances

- **Germany** is experiencing imbalances. The current account surplus persists at high levels reflecting a subdued level of investment relative to savings and has cross-border relevance. Following a gradual decline since 2015, the current account surplus is expected to increase in 2021 and to adjust again downwards in 2022, remaining elevated but below its pre-crisis level. In 2020, public investment growth accelerated further as a response to the crisis, while private investment fell. In 2020, higher net savings of the private sector were largely offset by a higher government deficit, leading to limited changes to the overall current account. Moreover, investment remains moderate as a share of GDP despite the favourable financing conditions and persistent investment needs already before the COVID-19 crisis and the low risk to fiscal sustainability in the medium term. The net savings of households further increased in 2020 amid absent spending possibilities and are expected to broadly return to their pre-pandemic level in 2022.

- **Ireland** is experiencing imbalances. Vulnerabilities relate to large private and government debts and net external liabilities remain. Government debt remains high according to various metrics, with downside risks relating to possible changes in corporate taxation rules and reforms in international taxation. Private debt remains high. Corporate debt is inflated by the presence of multinational companies, most of which have very few linkages to the domestic economy. Household debt as a share of household gross disposable income remains amongst the highest in the EU. The net international investment position is still highly negative but improving and mostly reflects the activities of multinational firms and mutual funds with little connection to the domestic economy.

- **Spain** is experiencing imbalances. Vulnerabilities relate to high external and internal debt, both government and private in a context of high unemployment and have cross-border relevance. The net international investment position remains negative but should resume its gradual improvement in 2021. The negative impact of the COVID-19 crisis on tourism has been significant. The current account has worsened with the crisis but is expected to be around balance this year and next. Government debt increased substantially in 2020 as a result of the recession and of the support measures put in place to cushion the impact of the crisis; it is forecast to decrease more significantly next year on account of continuously high, yet improving, government deficits. The deleveraging by both the corporate and the household sectors halted in

light of the COVID-19 crisis. The unemployment rate went up in 2020 and is forecast to start falling in 2022.

- **France** is experiencing imbalances. Vulnerabilities relate to high government debt, weak competitiveness and low productivity growth, which have cross-border relevance. In 2020, government debt increased visibly with the recession and with the comprehensive measures to contain the COVID-19 crisis and is expected to edge down in 2022. Private debt is high and has also been growing for several years even if, in 2020, nominal debt increases were matched by an increase in firms' liquidity buffers. Despite positive developments before the COVID-19 crisis, previous competitiveness losses have not been regained. In addition, long-term productivity growth remains moderate, which also prevents further competitiveness gains, hampers potential growth and that way limits the room for public and private deleveraging

- **Croatia** is experiencing imbalances. Vulnerabilities relate to government, private and external debt, in a context of low potential growth. The current account turned negative in 2020, reflecting the impact of the COVID-19 crisis on Croatia's sizeable tourism sector, and is expected to recover only slowly. The negative net international investment position should resume its gradual improvement in 2021. The moderately high government debt ratio increased markedly in 2020 as a result of the recession and of the support measures put in place to cushion the impact of the crisis but is expected to return to a declining path this year. The private debt-to-GDP ratio increased in 2020, after several years of improvements, reflecting a sharp drop in GDP, accompanied by higher corporate borrowing needs. The banking sector has become more resilient, also since Croatia joined the Single Supervisory Mechanism, yet non-performing loans may increase once policies to protect corporates from the impact of the COVID-19 crisis are phased out.

- **The Netherlands** is experiencing imbalances. Private debt and the current account surplus remain high, and have cross-border relevance. The current account surplus declined in 2020. Nonetheless, it remains well above levels justified in light of the country's economic fundamentals and is expected to remain high. Despite an ongoing pension reform and recent tax changes addressing incentives to retain earnings within small and medium size enterprises, the structural drivers underpinning high household and corporate savings remain in place. Part of the external surplus can be attributed to statistical features linked to the role of multinational firms and is not expected to attenuate in the near future. Private-sector debt remains high, partly due to intra-group debt of multinationals, and increased further as a share of GDP in 2020. Household debt is increasing from an already high level on the back of continued house price rises.

- **Portugal** is experiencing imbalances. Vulnerabilities relate to large stocks of net external liabilities, private and government debt, and non-performing loans remain high, against a backdrop of low productivity growth. Government debt increased substantially in 2020 as a result of the recession and of the support measures put in place to cushion the impact of the crisis but it is forecast to decline moderately this year and next with narrowing budget deficits. The impact of the COVID-19 crisis on tourism is important, including for the near future. The current account turned into a deficit driven by the impact of the COVID-19 crisis on tourism. The negative net international investment position worsened in 2020 but should resume its gradual improvement this year. After the rapid deleveraging of recent years, private debt

increased in 2020, reflecting a sharp drop in GDP and financing needs of corporates in light of the crisis, while mortgage growth turned positive in 2020. Non-performing loans risk increasing once temporary support measures are phased out.

- **Romania** is experiencing imbalances. Vulnerabilities relate to a persistent sizeable current account deficit in a context of large government deficits, while previous overheating pressures are receding. The large current account deficit is forecast to remain high even if moderating marginally, and the negative net international investment position is no longer improving. The large fiscal deficit is forecast to decline only gradually this year and next, owing to the recovery and some fiscal consolidation. Net savings by the domestic private sector are not enough to cover those high fiscal deficits, and financing has become more reliant on the accumulation of external debt. In contrast, competitiveness losses seem to be abating as overheating pressures of earlier years cooled with the COVID-19 crisis. Legislative unpredictability continues to weigh on the broader business environment.

- **Sweden** is experiencing imbalances. Vulnerabilities relate to high and rising household debt and overvaluation risks in the housing market remain. Household debt has increased further and mortgage growth to households has remained strong. House prices have continued to increase, even faster than before the COVID-19 crisis, thereby compounding the risks of overvaluation. The banking sector is resilient, with relatively high profitability, ample liquidity, and comfortable capital levels, but elevated exposure to the commercial real estate market warrants attention.

APPENDIX 2 - PROGRESS IN IMPLEMENTING THE COUNTRY-SPECIFIC RECOMMENDATIONS

This assessment of progress looks at past policy action taken to address the challenges highlighted in the 2020 country-specific recommendations. It was finalised before the formal submission of recovery and resilience plans and does therefore not draw on information included in these plans. The country-specific recommendations were however discussed with Member States in the preparation phase of their recovery and resilience plans to ensure they are adequately addressed. Their assessment will be presented separately in the Commission's proposal for a Council Implementing Decision regarding each of the plans.

Tackling structural challenges is crucial for a sustainable recovery and continued growth. Implementing reforms to address structural vulnerabilities is key to improving not only the ability to withstand and cope with existing challenges but also to accomplishing the twin transitions in a sustainable and fair manner. More resilient Member States are expected to recover from the COVID-19 crisis faster and with greater strength, thus showing the importance of carrying-out reforms in order to be better prepared for the future.

Looking at reform progress from an annual perspective, Member States have made at least some progress in about 6 out of 10 of the country-specific recommendations addressed to them in July 2020. This significantly higher level of implementation than in previous years seems to be closely linked to the nature of the 2020 country-specific recommendations, which focused to a large extent on the immediate fiscal, economic, employment and social challenges of responding to the COVID-19 crisis. The bold action taken by the Member States to confront the crisis brought about by the pandemic seems to have led to a relatively high level of implementation.

The level of progress varies significantly between policy areas. Considering those policy areas in which a significant number of Member States received a recommendation in 2020, most progress overall has been achieved in access to finance, financial services, fiscal policy and fiscal governance and employment protection legislation. More specifically, the concerned recommendations refer to the need for continued and adequate access to finance and the need for fiscal measures, in line with the general escape clause, to effectively address the pandemic, sustain the economy and support the recovery. Member States have also made good progress with the recommendations on mitigating the employment and social impact of the crisis, including by (i) promoting, developing and enhancing flexible working arrangements; (ii) implementing short-time work schemes; and (iii) taking measures to provide adequate income replacement and access to social protection. By contrast, markedly less progress has been made in addressing recommendations on public administration, civil justice, the fight against tax evasion, education and skills and lifelong learning.

From a multiannual perspective, the level of implementation of the country-specific recommendations has remained broadly stable over the past few years. In particular, Member States have made at least some progress in implementing [around two-thirds] of all the country-specific recommendations since the start of the European Semester. However, the multiannual level of implementation has slightly decreased over the last 12 months, reflecting the fact that Member States have focused their policy action on immediate crisis mitigation. Overall, since 2011, Member States have made the most progress with recommendations on access to finance and financial services, followed by progress with legislation governing labour relations and employment protection. At the same time, progress has been particularly slow in reforming health and long-term care and broadening tax bases.