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2023 European Semester - Spring Package

{SWD(2023) 628-644 final}

1. INTRODUCTION

The EU economy has continued to show remarkable resilience in a challenging environment marked by Russia's unprovoked invasion of Ukraine. The EU has successfully reduced its dependence on Russian fossil fuels, contained the adverse impact on economic activity and entered 2023 on a better footing than expected. Rebounding from the stagnation experienced in late 2022, GDP growth is set to strengthen over the course of 2023 thanks to significantly lower wholesale gas prices and continued resilience in the labour market. Nonetheless, high inflation continues to affect the purchasing power of households, especially among vulnerable groups, leading to higher risks of poverty and weighing on European competitiveness, notably since energy prices remain significantly higher than in the rest of the world. Furthermore, the external environment marked by rising protectionism and geostrategic competition further underlines the need to safeguard the competitiveness and the open strategic autonomy of the EU economy. The steady implementation of the Recovery and Resilience Facility (RRF) is triggering major reforms and investments across a wide range of policy areas. The roll-out of the RRF is supporting the economic expansion and will boost Member States' resilience.

Sustaining the momentum for reforms and investments will be key to securing the EU's long-term prosperity, competitiveness, fairness and resilience. The European Semester, supported by the RRF and other EU funds, such as Cohesion Policy and the InvestEU programme, is at the centre of the EU's future-proof economic and employment strategy as pointed out in the EU's Green Deal Industrial Plan[1] and the long-term competitiveness strategy[2]. In particular, Member States should continue to make progress on decarbonising their economies, address labour and skills shortages and mismatches, support quality job creation, promote equal opportunities, boost digitalisation, research and innovation, reduce administrative and regulatory burdens, speed up and simplify administrative and permitting procedures, provide adequate framework conditions for investments at national and subnational levels and modernise their public administrations. The European Semester continues to provide the policy coordination framework for that purpose, guiding and monitoring the implementation of the RRF and of cohesion policy programmes in a complementary way and contributing to the implementation of the European Pillar of Social Rights and the EU 2030 headline targets for employment, skills and poverty reduction. The 2023 country reports[3], which the Commission published today, take stock of the challenges, including those related to the twin transition, social and economic resilience and competitiveness, in every Member State, and outline to what extent these challenges are being addressed in their national recovery and resilience plans (RRPs). The ongoing revisions of the RRPs and the inclusion of REPowerEU[4] chapters with additional funding in the form of grants and loans provide a further opportunity to effectively respond to these challenges, in particular with regard to implementing the Green Deal Industrial Plan and REPowerEU Plan.

[1] COM(2023) 62 final.
[2] COM(2023) 168 final.
[3] SWD(2023) 601 - 627
[4] Regulation (EU) 2023/435 of the European Parliament and of the Council of 27 February 2023 amending Regulation (EU) 2021/241 as regards REPowerEU chapters in recovery and resilience plans and amending Regulations (EU) No 1303/2013, (EU) 2021/1060 and (EU) 2021/1755, and Directive 2003/87/EC (OJ L 63, 28.2.2023, p. 1).

Building on the country reports' analysis, the Commission proposals for the 2023 country-specific recommendations (CSRs)[5] provide guidance to Member States on tackling key economic and social challenges that are only partially addressed or not addressed by the RRPs. The four dimensions of the EU's competitive sustainability – environmental sustainability, productivity, fairness and macroeconomic stability – remain at the heart of this guidance[6]. The proposed recommendations emphasise the need to ensure prudent fiscal policy in 2023-2024, in particular by phasing out the less targeted energy support measures currently in force and reducing debt in the medium term. The recommendations also call on the Member States to steadily continue, or in several cases accelerate, the implementation of their RRPs in view of the deadline of 2026 and to proceed with the swift implementation of cohesion policy programmes, in close coordination with the RRPs, including by ensuring adequate administrative capacities. The proposals for the recommendations also outline the energy-related reforms and investment challenges, including the reskilling and upskilling of the labour force that Member States are asked to address under REPowerEU and their national energy and climate plans[7]. The country reports and Eurostat's 2022 Sustainable Development Goal Monitoring Report also provide updated and consistent reporting on progress towards the Sustainable Development Goals (SDGs) across Member States. At EU level, in recent years, progress has been observed on various SDGs, with advancement being particularly strong towards ensuring decent work and economic growth (SDG 8) and reducing poverty (SDG 1). Significant progress has also been achieved on gender equality (SDG 5).[8] The country reports also include the Social Scoreboard, which provides a comprehensive overview of employment, equality, skills and social challenges related to the implementation of the European Pillar of Social Rights and the implementation of the Union of Equality strategies.

The constructive dialogue with Member States as well as strengthened inter-institutional dialogue at EU level will continue throughout the European Semester process. The close policy dialogue on the RRPs allowed the Commission and Member States to strengthen and deepen their cooperation on economic and social policies. This ensures broad ownership and is set to continue during the ongoing RRP implementation and their amendments expected in 2023, including in the context of REPowerEU. The topics covered in the country reports and CSRs offer a further opportunity to broaden the dialogue. The Commission will also continue its close dialogue with the European Parliament on key social and economic developments, and will continue to engage with it at each key stage of the annual European Semester coordination cycle.

The successful delivery of the European Semester and RRF priorities requires a permanent and structured involvement of social partners and other stakeholders and awareness raising at both EU and national levels. Continuous exchanges on social and economic developments in the EU take place through the biannual macroeconomic dialogue at political and

[5] COM(2023) 601 - 627

[6] See 2023 Annual Sustainable Growth Survey: COM(2022) 780 final.

[7] See Commission Notice: Guidance to Member States for the update of the 2021-2030 NECPs (C/2022/9264 final).

[8] See Appendix 3. On 15 May, the Commission has also published its first ever EU-level Voluntary Review of the implementation of the 2030 Agenda for Sustainable Development (COM(2023) 700 final), to be put forward at the 2023 United Nations High-level Political Forum on Sustainable Development. The Review reaffirms the EU's commitment to the 2030 Agenda for Sustainable Development in a whole-of-government approach, linking the internal and external dimensions.

technical level among the Council, the Commission, the European Central Bank (ECB) and the European social partners. In addition, the active involvement of social partners and stakeholders at EU, national and subnational level, as appropriate, through dedicated regular meetings (e.g. the RRF stakeholders' annual events) throughout all the stages of the European Semester and the RRF implementation process helps to jointly identify challenges, improve policy solutions and ensure broader ownership and transparency of the economic and social policy agenda[9]. Communication and information actions also contribute to raising awareness of the public and increase transparency about the support provided through the RRF[10].

The Commission presented legislative proposals for a reformed economic governance framework on 26 April 2023[11]. The key objective of its proposals is to strengthen public debt sustainability and promote sustainable, inclusive and resilient growth in all Member States through reforms and investment. The medium-term fiscal and structural plans that Member States will design and present form the cornerstone of the proposals. According to the Commission proposals, Member States would in their plans set out their expenditure targets, measures to address macroeconomic imbalances and priority reforms and investments over a period of at least 4 years. The new fiscal surveillance process would remain integrated in the European Semester, which would thus continue to be the central framework for economic and employment policy coordination ensuring the complementarity between the medium-term fiscal and structural plans and the investments and reforms included in RRPs and Cohesion Policy programmes. Swift agreement by the European Parliament and the Council on the proposals is an urgent priority, and the Commission supports the Council's resolve to conclude the work on the economic governance framework in 2023.

2. ECONOMIC AND EMPLOYMENT OUTLOOK

The better-than-expected performance of the EU economy in early 2023 and easing energy prices lift the growth outlook for this year and the next. Furthermore, common efforts to diversify energy supplies, fill gas storage facilities and reduce energy demand, coupled with mild weather, have cushioned the socio-economic impact of those tensions. Looking forward, lower energy prices, mending supply chains and the continued strength in the labour market are expected to support the EU economy. Though risk of gas shortages has significantly abated, uncertainty remains over the gas prices for next winter and beyond. Overall, economic activity in is forecast to expand at a slightly stronger pace than previously expected. EU GDP is expected to grow by 1.0% in 2023 and by 1.7% in 2024.

Inflation is projected to continue declining, but core price pressures are proving more persistent, impacting on businesses and eroding households' purchasing power. Headline inflation in the EU peaked at 11.5% in October 2022, and inflation divergences across EU and

[9] On 25 January 2023, the Commission proposed a Council Recommendation (COM(2023) 38 final), which sets out how EU Member States can further strengthen social dialogue at national level, as well as a Communication on reinforcing and promoting social dialogue at EU level. Moreover, the Commission will continue to make use of the existing fora under the European Semester to inform and involve social partners also on RRF implementation.

[10] The European Commission launched an interactive map with real-life examples of the positive change the projects financed bring: Recovery and Resilience Facility (europa.eu)

[11] COM(2023) 240 - 242 final.

euro area Member States reached historic highs. However, price pressures have progressively broadened as domestic economic players adapted to higher input prices. As a result, core inflation, which excludes the price of energy and unprocessed food, has proved more persistent, though it is expected to have reached its peak in the first quarter of 2023 and to decline gradually over the coming quarters. Similarly, food prices accelerated in the first quarter of 2023 but are expected to peak in 2023, in line with a moderation in agricultural commodity prices. In response to the high inflation, monetary conditions have been tightening and this trend is expected to continue. As a result, funding costs for banks have increased and lending standards have tightened, slowing down the flow of credit to the economy. While inflation is set to continue falling in 2023, it will remain well above target and continue to have an effect on households' purchasing power, especially among low- and low-middle income groups, and businesses.

The labour market remains strong and wage growth is expected to strengthen. The employment rate, which reached 74.8% in the last quarter of 2022, is close to its historical high. Slack in the labour market[12] and unemployment fell to record lows. The job vacancy rate for the overall economy is above its 2010-2019 average, despite a slight decline in the second half of 2022, and labour shortages are holding back production for a growing number of companies[13]. On wages, nominal compensation per employee increased by 4.9% in the EU in 2022 compared to 2021. However, this pace remains well below inflation, with very wide variations among industries and across Member States. As a result, real wages decreased by more than 4% in the EU in 2022, leading to a substantial erosion of the purchasing power of workers. The recent increases in statutory minimum wages in a number of Member States, together with higher negotiated wages, help mitigate losses in purchasing power experienced in 2022. In 2024, the labour market is expected to remain strong and wage growth is set to pick up, outpacing inflation.

The EU financial sector has proved resilient in the face of emerging challenges. Strong regulation, in particular thanks to the application of international standards to all banks, effective supervision and a solid crisis management framework, introduced in response to the global financial crisis, and progress in completing the Banking Union and advancing the Capital Markets Union have made the EU financial system more resilient. The impact of recent market turbulence in the US and Switzerland since March 2023 has been contained in the EU. However, this episode has highlighted the interconnectedness of global financial markets and the fragility of investor sentiment. It also highlights the crucial role of regulation, supervision and risk management of the banking sector in a challenging macro-financial environment. Persistent geopolitical uncertainties, protracted inflation pressure and the gradual pass-through of tighter monetary policy have put pressure on the financial system. Given the very high level of debt in some parts of the economy and across the globe, risks remain elevated.

[12] Labour market slack takes into account unemployed people, part-time workers who want to work more, people who are available to work but do not look for work, and people who are looking for work but are not immediately available. This broader definition better reflects the unmet need for employment.

[13] European Commission (2022), 'European Business Cycle Indicators – A closer look at labour shortages across the EU', *European Economy-Technical Paper*, 59.

3. BUILDING A ROBUST AND FUTURE-PROOF EU ECONOMY – KEY OBJECTIVES FOR THE 2023 COUNTRY-SPECIFIC RECOMMENDATIONS

Economic policy should continue to tackle the risks linked to high inflation, in particular for vulnerable households and companies, and address long-term challenges. Despite the decrease in energy inflation, it will take time for price pressures to disappear. Combating inflation remains a key policy priority in the coming period. This requires monetary and fiscal policies to be consistent. In that context, fiscal measures taken to respond to the energy price shock should be wound down in 2023. If energy prices increase again and support cannot be fully discontinued, targeted policies to support vulnerable households and companies – rather than wide and less effective support policies – will remain crucial. The moderate wage increases so far have not fuelled further price inflation, while corporate profitability has increased. Nevertheless, nominal wages are expected to continue increasing and the interaction with price developments should be closely monitored. The ongoing tightening of financial conditions has also put the emphasis on the need to monitor macro-financial risks and further advance on the Capital Markets Union and complete the Banking Union. Beyond short-term priorities, policy at Member State and EU level needs to continue addressing long-term challenges, including the need to strengthen the competitiveness, productivity, skills and resilience of the EU economy, taking into account demographic developments and to make swift progress on the digital and green transition, in line with the Green Deal Industrial Plan.

The RRF is essential to accelerate the twin green and digital transition and strengthen the EU's resilience to future challenges, while contributing to the implementation of the European Pillar of Social Rights; it should continue to be deployed without delay. Two years into its implementation, the RRF is receiving a high level of public support by European citizens[14], has delivered considerable financial support and helped the EU's post-COVID economic recovery and the strengthening of EU's resilience. All RRPs have been in place since the end of 2022, reflecting all or a significant subset of the relevant CSRs. Several Member States were helped in the preparation and implementation of their plans through the Technical Support Instrument. The Commission has so far processed 24 payment requests under the RRF, and has disbursed a total of over EUR 152 billion to date under the RRF for the successful implementation of reforms and investments. With the inclusion of REPowerEU chapters, the RRF has also demonstrated its flexibility to address newly emerging challenges linked in particular to the EU's energy security and the industrial transition to a net-zero economy. To fully reap these benefits, RRPs need to be implemented swiftly, including by addressing the risks of delays in a number of cases. While the implementation of the RRPs was broadly on track as of the end of 2022, some Member States are facing challenges in administering funds, due in part to limited administrative capacity or investment bottlenecks. The ongoing process of revising the RRPs represents an opportunity to address these issues and increase the absorption capacity of RRF funds. However, at the same time, it is expected that the revisions to the plans will also impact the disbursement schedule of RRF funds in 2023 and beyond. To ensure sufficient predictability of the EU's borrowing operations and at the same time provide to the budgetary

[14] Three-quarters of EU respondents (74%) think that the principle of solidarity at the heart of the RRF is a good approach for the EU to emerge stronger from the Covid-19 pandemic, while two-thirds of EU respondents believe it will have a positive impact on future generations (see Flash Eurobarometer 515 survey on the "EU Recovery Plan NextGeneration EU", in January 2023).

authority, as part of the Draft Budget 2024 procedure, adequate visibility in terms of funding needs in the months to come, it is important to properly reflect the expected delays in the planning of future payments. Simultaneously, the successful revision process of the plans will allow Member States to get back on track in 2024 and catch up on the disbursement schedule. In parallel, in addition to more than EUR 186 billion disbursed by the 2014-2020 cohesion policy programmes since the beginning of the pandemic to Member States, the 2021-2027 cohesion policy programmes will mobilise around EUR 505 billion for EU Member States and regions. These programmes also need to be implemented rapidly, including by addressing implementation capacity issues.

This year's country reports identify policy action needed at Member State level to overcome immediate economic and social challenges, while also increasing resilience, long-term competitiveness and productivity. The country reports provide a holistic analysis of Member States' resilience[15], economic and social developments and challenges, taking the regional dimension into account. They include an assessment of progress on the implementation of the European Pillar of Social Rights via the Social Scoreboard and on achieving the 2030 EU headline and national targets on employment, skills and poverty reduction, as well as the SDGs. They also pay particular attention to long-term competitiveness and productivity, while providing updated and more detailed analysis on energy security and affordability, the clean energy transition and environmental sustainability. Country reports identify challenges that are only partially or not addressed by the RRPs as well as any emerging challenges. They also take a close look at the progress on RRP implementation, providing examples of milestones and targets reached, while highlighting cases where implementation risks and delays should be addressed.

In line with the country report analysis, the Commission recommendation for CSRs reflect the challenges identified and the implementation status of the RRPs. The recommendations are divided into four subparts:

1. a recommendation on fiscal policy, including fiscal and structural reforms, where relevant;
2. a recommendation to continue or accelerate implementation of the RRP, including its revisions and the integration of REPowerEU chapters, taking into account potential country-specific implementation risks, and to swiftly implement the adopted cohesion policy programmes;
3. an updated recommendation on the clean energy transition in line with the REPowerEU objectives;
4. where relevant, an additional recommendation on outstanding and/or newly emerging economic or employment challenges.

[15] The resilience dashboards, developed by the Commission, aim to provide a holistic assessment of resilience in the EU and its Member States. They assess resilience as the ability to make progress towards policy objectives amidst challenges.

The updated, more granular recommendation on energy-related reform and investment challenges feeds into the ongoing finalisation of REPowerEU chapters and guides Member States in the update of their national energy and climate plans. The REPowerEU chapters as part of the RRPs, with the accompanying additional funding, should duly address the challenges identified by the CSRs with REPowerEU relevance[16]. The CSRs will provide Member States with guidance to tackle key challenges that are only partially or not addressed by the initial RRPs and will help implement the Green Deal Industrial Plan at national and regional level.

4. INCREASING COMPETITIVENESS AND PRODUCTIVITY IN A SOCIALLY INCLUSIVE WAY – OVERVIEW OF IDENTIFIED COMMON CHALLENGES

Beyond the timely implementation of the reforms and investments covered in the RRPs, Member States face a number of outstanding or emerging common and country-specific challenges.

4.1 Macroeconomic stability

The impact of high inflation induces a new vulnerability in a context where public debt needs to decrease. Coordinated policy action at EU and national level helped cushion the impact of COVID-19 and of the surge in energy prices and its economic and social impact, especially on vulnerable firms and households. However, these crises led to higher public debt in several Member States. More recently, fiscal policy measures put in place in 2022 to tackle the energy crisis have had sizeable fiscal costs. According to the Commission's 2023 Spring Economic Forecast, the net cost of these measures amounted to 1.2 % of annual EU GDP in 2022 and a similar amount in 2023. Fiscal policy should be prudent in order to ensuring debt sustainability, thereby also supporting monetary policy. In parallel, divergences in inflation rates and tightening financial conditions have increased macroeconomic vulnerabilities.

Strong EU and euro area fiscal policy coordination is instrumental in ensuring a consistent fiscal and monetary policy mix and will facilitate the task of monetary policy. In 2023 and 2024, fiscal policies should be prudent in order to ensure focus on medium-term debt sustainability while raising potential growth and ensuring the green and digital transition in a sustainable and resilient manner. Depending on their debt challenge, Member States should keep debt at prudent levels or ensure a plausible and continuous debt reduction in the medium term. The fiscal adjustment for 2024 should be consistent with the current legislation under the Stability and Growth Pact and all Member States should maintain or bring their deficit below the 3% of GDP Treaty reference value. As outlined in the Commission's Communication on fiscal policy guidance for 2024 of 8 March 2023[17], the fiscal component of the proposed country-specific recommendations incorporates those elements of the legislative proposals of 26 April 2023 that are consistent with the existing legislation.

Fiscal measures taken to respond to the energy price shock should be wound down. The continued decline in energy commodity prices is curbing headline inflation from its peak in October 2022, although core inflation remains high and is on an upward trend. Against this

[16] More information on the REPowerEU chapters and their link to the CSRs is available in the 'Guidance on Recovery and Resilience Plans in the context of REPowerEU' (OJ C 80, 3.3.2023, p. 1).

[17] COM(2023) 141 final.

backdrop, protracted non targeted fiscal support to households and firms strengthens inflationary pressures. This raises the likelihood of central banks stepping up monetary policy tightening, and would put pressure on financial stability. If renewed energy price increases necessitate support measures, these should be focused on protecting vulnerable households and firms, fiscally affordable and they should preserve incentives for energy savings. Furthermore, Member States should improve the quality and composition of their public finances, continue to protect nationally financed investment and ensure the effective use of the RRF and other EU funds, such as the InvestEU programme, in particular in light of the green and digital transition and the need to strengthen the EU's economic and social resilience. In light of the devastating floods that hit Italy in May 2023, the cost of direct emergency support related to those floods will be taken into account in subsequent assessments of compliance and will in principle be considered as one-off and temporary measures.

As uncertainty about the macroeconomic outlook remains high at present, the Commission considers that a decision on whether to place Member States under the excessive deficit procedure should not be taken this spring, as already indicated in its Communication of 8 March 2023 on fiscal policy guidance for 2024. At the same time, the Commission will propose to the Council to open deficit-based excessive deficit procedures in spring 2024 on the basis of the outturn data for 2023, in line with existing legal provisions. Member States should take account of this when executing their 2023 budgets and when preparing their draft budgetary plans for 2024 this autumn.

A balanced tax mix, effective tools to fight aggressive tax planning strategies and improved tax compliance contribute to the fair treatment of taxpayers and efficient funding of public services. Shifting part of the tax burden from labour to other types of taxes, including environmental and immovable property taxation, while duly taking account of the distributional impact of such a shift, would support the green transition and boost sustainable growth and job creation. Aggressive tax planning strategies by firms or individuals in one Member State can have negative spillover effects on the rest of the EU. This therefore calls for decisive and coordinated action. The adoption of the EU Minimum Tax Directive (Pillar 2) on a minimum effective tax rate of 15%, to be implemented by the end of 2023, has been a crucial milestone[18]. Similarly, the continued modernisation and digitalisation of tax administrations should further reduce compliance costs and boost tax revenue.

Tightening financial conditions have increased vulnerabilities and risks in some Member States, and divergent inflation across the EU may lead to competitive pressures. High nominal GDP growth driven by inflation helps reduce debt-to-GDP ratios in both the public and private sector in the short run, while higher interest rates feed only gradually into the cost of servicing debts. However, the tightening of financing conditions increase the risks associated with high debt levels. House prices grew strongly in several Member States in 2022, but the increases have started to moderate as incomes come under pressure and interest rates rise. In parallel, the divergence in inflation rates, accompanied by increases in profit margins and labour

[18] Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union (OJ L 328, 22.12.2022, p. 1). The Commission is also working on specific initiatives, including BEFIT and FASTER, and has proposed a series of measures to modernise the EU's Value Added Tax System (COM(2022) 701, COM(2022) 703 and COM(2022) 704) to simplify tax rules, cut red tape, and curb aggressive tax planning and tax avoidance practices.

costs, may lead to cost competitiveness losses in some industries and regions. Current account deficits have widened in some Member States, reflecting much higher energy import prices but also, in some cases, strong domestic demand.

The recent increases in interest rates have raised concerns about pockets of vulnerability in the financial sector, calling for careful monitoring. Progress made by the EU in strengthening banking supervision and completing the Banking Union are important steps to ensure macro-financial stability[19]. In addition, non-performing loans have been declining and continue to be addressed, while the rise in interest rates is improving the banking sector's profitability. Nevertheless, rising mortgage rates and the deterioration in debt servicing capacity due to a decline in real household income is exerting downward pressure on house prices in some countries. The commercial real estate sector in some countries saw similar falls amid higher financing costs and weaker occupancy rates. Against this background, monitoring asset quality, engaging with distressed debtors in a timely and proactive manner (in particular viable ones), further improving the efficiency of insolvency frameworks and further developing secondary markets for non-performing loans remain important. More broadly, the challenges related to digitalisation still remain and have even intensified in some areas, as demonstrated by more frequent large-scale cyber incidents. Risks relating to non-bank financial intermediation and those that may emerge with the increased use of decentralised finance need to be properly monitored and addressed. On all these issues, cooperation between national and European supervisory authorities as well as with the ECB and international regulatory bodies is of paramount importance.

The Commission has identified vulnerabilities related to macroeconomic imbalances or excessive imbalances in 11 Member States in the context of the macroeconomic imbalance procedure. For six Member States, recent vulnerabilities seem to be contained at present and temporary. Box 2 summarises the findings on macroeconomic imbalances in the Member States at this occasion; Appendix 4 provides more details.

[19] The EU is also finalising the negotiations on the Banking Package, and the Commission has recently adopted a proposal to improve the applicability of its crisis management and deposit insurance framework for smaller and medium-sized banks (COM(2023) 225 final).

Box 1: Update on surveillance under the Stability and Growth Pact

As part of the spring 2023 European Semester package, the Commission has adopted a report under Article 126(3) TFEU for 16 Member States. These consist of Belgium, Bulgaria, Czechia, Germany, Estonia, Spain, France, Italy, Latvia, Hungary, Malta, Austria, Poland, Slovenia, Slovakia and Finland. For all these Member States except Finland, the report assesses their compliance with the deficit criterion. In the case of Bulgaria, Germany, Estonia, Slovenia and Slovakia, the report was prepared due to a planned deficit in 2023 exceeding the 3% of GDP Treaty reference value, whereas the other Member States had a general government deficit in 2022 exceeding 3% of GDP. In addition, for France, Italy and Finland the report assesses compliance with the debt criterion in 2022 based on outturn data.

As already indicated in its Communication of 8 March 2023 on fiscal policy guidance for 2024, the Commission does not propose to open new excessive deficit procedures in spring 2023. Russia's war of aggression against Ukraine, together with the remaining macroeconomic and fiscal impact of the COVID-19 pandemic, creates uncertainty, including for designing a detailed path for fiscal policy. As regards Member States with a debt ratio above the 60% of GDP reference value, the Commission considers, within its assessment of all relevant factors, that compliance with the debt reduction benchmark would imply a too demanding frontloaded fiscal effort that risks jeopardising growth. Therefore, in the view of the Commission, compliance with the debt reduction benchmark is not warranted under the prevailing economic conditions.

Romania is the only Member State under an excessive deficit procedure, based on the pre-pandemic developments. On 3 April 2020 the Council decided that an excessive deficit existed in Romania based on planned excessive deficit in 2019. In its revised recommendation of 17 June 2022, the Council asked Romania to put an end to the excessive deficit situation by 2024 at the latest. Romania's general government deficit in 2022 was in line with the Council recommendation. At the same time, the adjustment in the structural balance was below the level recommended by the Council, while the nominal growth rate of net primary government expenditure was above the one recommended. The procedure is kept in abeyance.

The Commission will continue monitoring Member States' economic and budgetary situation. In the autumn, the Commission will adopt opinions on euro area Member States' Draft Budgetary Plans, to ensure that the 2024 budgets are consistent with the country-specific recommendations that are also part of the spring 2023 European Semester package and will be adopted by the Council later in 2023. In spring 2024, the Commission will propose to the Council to open deficit-based Excessive Deficit Procedures on the basis of the outturn data for 2023, in line with existing legal provisions.

Box 2: Macroeconomic imbalances in the Member States

The Commission has assessed the existence of macroeconomic imbalances for the 17 Member States selected for in-depth reviews in the 2023 Alert Mechanism Report. Of those, 10 Member States had been identified with imbalances or excessive imbalances in the last annual cycle of surveillance under the Macroeconomic Imbalance Procedure. The other 7 were deemed to display risks of newly emerging imbalances. As part of this year's surveillance cycle, and to inform the identification of imbalances and excessive imbalances in these year's in-depth reviews, the Commission examined the impact of common shocks on the economies of selected Member States and published three thematic notes – on inflation, house prices and external sustainability[1].

The assessment of macroeconomic vulnerabilities is marked by uncertainty in the face of high inflation. If divergent inflationary dynamics were to continue, cost competitiveness could be undermined in Member States with high inflation, which could result in increasing vulnerabilities. At the same time, high inflation comes with the risk of tighter financing conditions. Inflation also has adverse distributional consequences. A return to low and converging inflation trends across the EU would lower these concerns. Similarly, the strong increase in housing prices since 2020, together with the sharp increase in financing costs and pressure on real household incomes, raises the prospect of price corrections, in particular in Member States with more overvalued property markets.

Long-standing imbalances related to public and private debts have resumed their downward trend aided by nominal economic growth, in particular high inflation. Private sector and public debt ratios have been declining, as nominal GDP growth has had a strong denominator effect. The tightening of financing conditions adds risk, particularly in countries and sectors where variable interest rates are prevalent or where (re)financing needs are higher; exchange rate volatility may weigh on debt servicing where debts are held in foreign currencies. On the external side, high nominal GDP growth reduces the value of countries' external positions in terms of GDP, while the sharp decline in trade balances led to an overall reduction in current accounts, also for net-creditor countries. However, the further reductions in energy prices from their mid-2022 highs are expected to strengthen current accounts in 2023, deficits and surpluses alike, with some Member States still recording significant current account deficits and surpluses. The banking sector weathered the pandemic well, and non-performing loans have continued to fall, particularly in countries where they were highest.

The Commission took a number of decisions under the Macroeconomic Imbalance Procedure. Vulnerabilities are receding in Cyprus to lead to an improvement in its classification of imbalances. Conversely, in Hungary, vulnerabilities have increased to an extent that leads to a new finding of imbalances. Some Member States being subject for an in-depth review for the first time in recent years were not found experiencing imbalances at this juncture. Developments are generally favourable in the remaining Member States analysed but relevant challenges remain. Implementation of the country-specific recommendations under the European Semester

[1] 'External Sustainability Analysis', *European Economy-Institutional Papers* 196; 'Housing Market Developments', *European Economy-Institutional Papers* 197; 'Inflation Differentials in Europe and Implications for Competitiveness', *European Economy-Institutional Papers* 198.

and the policy agenda embedded in the RRPs should support a further reduction in macroeconomic vulnerabilities.

- Cyprus is experiencing imbalances after experiencing excessive imbalances until 2022 as vulnerabilities related to private, government, and external debt have overall declined but remain a concern.

- Hungary is now found to be experiencing imbalances. Risks are tilted on the downside, and imbalances may become excessive in the future if policy action is not urgently taken.

- Germany, Spain, France, the Netherlands, Portugal, Romania, and Sweden continue to experience imbalances.

- Risks in Romania are tilted on the downside, and imbalances may become excessive in the future if policy action is not urgently taken. On the other hand, vulnerabilities are receding in Germany, Spain, France and Portugal to the extent that a continuation of these trends next year would provide ground for a decision of no imbalances.

- Greece and Italy continue to experience excessive imbalances, but their vulnerabilities appear to be receding, including due to policy progress.

- Czechia, Estonia, Latvia, Lithuania, Luxembourg, and Slovakia are not found to be experiencing imbalances as vulnerabilities seem overall to be contained at present.

Appendix 4 details the country-specific aspects for the 17 concerned Member States.

4.2 Energy and environmental sustainability

Despite achievements on security of energy supply in recent months, preparing for next winter does not leave room for complacency. Over the last year, the EU has made remarkable progress in saving energy, diversifying its energy supplies and optimising existing infrastructure. EU natural gas consumption dropped by 17.7% from August 2022 to March 2023 compared with average gas consumption for the same months between 2017 and 2022[20]. The share of Russian pipeline imports in total EU gas imports dropped to 7% in January 2023 from around 50% historically. This results from a combination of measures taken by the EU and national governments, structural demand changes, but also high prices. Seaborne liquified natural gas (LNG) played a leading role in replacing Russian gas volumes, with a sharp increase from 81 bcm in 2021 to around 135 bcm in 2022. New LNG projects should further increase the EU's LNG import capacity while avoiding unnecessary lock-ins for the future. However, a potential complete halt to the Russian gas supply, infrastructure incidents, droughts and unplanned maintenance of power plants could create concerns for the EU's security of supply, requiring continued vigilance. The diversification effort via LNG will be strengthened in 2023 with the first joint gas purchases and the intensification of the outreach to alternative gas suppliers. In addition, measures in the REPowerEU chapters of Member States' RRPs together with cohesion policy programmes, revenues from the EU Emissions Trading System, financial support from the

[20] Eurostat, 19 April 2023.

Innovation and Modernisation Funds and the InvestEU programme are expected to contribute to energy security through boosting clean energy alongside energy efficiency and incentivising energy demand reductions, as well as address energy poverty, tackle internal and cross-border transmission and distribution bottlenecks. Furthermore, it remains crucial to streamline investments, simplify permitting procedures and overcome barriers to enable the deployment of renewables and their integration into the grid. Efforts should also be made to support electricity storage and grid resilience to deal with increasing supply and demand variability.

With the approval of a large part of the 'Fit for 55' package, the focus should now turn to the implementation of measures to meet the climate, energy and transport targets. The package strikes a balance between pricing, targets, standards and support measures to deliver on the 2030 climate target set in the European Climate Law. The higher 2030 climate, transport and energy targets and the EU's decision to reduce dependence on Russian fossil fuels imply that the green transition should continue to accelerate. The forthcoming challenge involves the steadfast implementation of the planned and/or agreed measures. At the same time, defining new climate and energy policy measures is necessary to meet the higher 2030 ambition. The update of Member States' national energy and climate plans will be conducive to this. The plans, which should take into account the latest CSRs[21], provide short-, medium- and long-term investment predictability and are crucial for mobilising the large-scale investments needed to achieve the 2030 and 2050 climate objectives[22]. Further efforts are needed in most areas such as adaptation to climate change , including for sustainable water management, the food systems, including the preservation of soils and halting the loss of biodiversity, and other land use sectors. In parallel, Member States need to deliver on the other environmental policy objectives agreed at EU level, including achieving zero pollution for air, water and soil. The annual investment gap to deliver on the EU's environmental objectives beyond climate and energy is estimated at EUR 110 billion[23]. Budgetary planning should take into account contingent liabilities linked to climate-related risks and green budgeting practices should be further developed to redirect public investment, consumption and taxation to green priorities.

Strengthening the green transition of our industries will reduce the EU's overall dependence on fossil fuels and increase our resilience to energy supply shocks. Many companies, particularly small and medium-sized enterprises (SMEs) and those in energy-intensive industries, have been severely impacted by energy price increases, even after taking into account government support. Policies should continue to focus on promoting the green transition in areas such as the energy efficiency of industrial and manufacturing processes and buildings, the decarbonisation of industry and the circular economy[24]. Synergies with the digital transition should be maximised. Member States, through their RRPs, should continue investing in renewable or fossil-free hydrogen in the hard-to-abate applications in industry and certain transport sectors, such as road transport, maritime and aviation. Moreover, further reducing environmentally harmful subsidies and integrating the polluter pays principle would help internalise costs of nature degradation and encourage resource efficiency and productivity. To

[21] Commission Notice: Guidance to Member States for the update of the 2021-2030 NECPs (C/2022/9264 final).
[22] See also COM(2022)83 final and SWD(2022) 230 final.
[23] COM(2022) 438 final.
[24] Accelerating the transition to a circular economy can increase the EU's open strategic autonomy and significantly contribute to primary energy savings.

ensure that no person and no region is left behind, distributional, territorial and social impacts should be factored in. The Just Transition Fund should be well deployed to contribute to a fair transition for the territories most affected, including by supporting reskilling and upskilling measures.

Member State action to shorten and simplify permitting procedures is critical for accelerating the manufacturing and deployment of renewable energy and other net-zero solutions. Lengthy and complex permitting procedures at national level constitute a major bottleneck in the deployment of renewable energy sources in most Member States. In 2022, based on the reporting from businesses, the Single Market Enforcement Taskforce[25] reviewed around 170 process-related barriers to permitting for renewable energy sources across the Member States and agreed to remove more than 80 of them. Notable examples include lengthy procedures, understaffed permitting authorities, fragmented decision-making and lack of coordination, leading to inconsistent decisions and timing across regions.

The faster expansion and upgrade of the electricity transmission and distribution infrastructure, including cross-border interconnectors, is a key condition for integrating a significantly higher share of renewable energy sources and for the further electrification of demand. Member States should focus on new long- and short-term energy storage facilities to ensure flexibility and security of supply in energy systems with a high share of variable renewables. Member States' ambition to deploy offshore renewable energy (111 GW by 2030) underlines the need for Member States to swiftly develop crucial offshore grids and the necessary onshore grid reinforcements.

A strong and innovative manufacturing capacity in clean tech value chains will accelerate the green transition. To strengthen the resilience and competitiveness of the net-zero technologies in the EU and make the EU energy system more secure and sustainable, the Commission proposed the Net Zero Industry Act in March 2023[26]. At the same time, Member States need to further leverage their talent, intellectual assets and industrial capabilities and further encourage private investors to participate in EU-based start-ups and scale up innovations[27]. Member States should also focus on overcoming challenges related to the shortage of skilled workers in various clean energy technology segments. Strengthening the competitiveness of the clean energy sector is key to delivering on the REPowerEU plan and the EU's longer-term ambition[28].

Clean tech manufacturing needs to secure access to critical raw materials, including through diversification, recycling and substitution. Meeting the EU's green and digital transition objectives requires access to secure, sustainable and diversified sources of critical raw materials, reducing our dependence on single suppliers and building secure and sustainable supply chains for mining, processing and refining and for recycling. In this context, capitalising on and expanding cooperation with EU trading partners, including by engaging in mutually beneficial strategic partnerships with emerging markets and developing economies, will be key. Circular economy solutions and business models also imply significant opportunities to pursue

[25] Single Market Enforcement Taskforce (2022), 'Report 2021-2022'
[26] COM(2023) 62 final.
[27] See also COM(2022) 332 final.
[28] COM(2022) 643 final.

strategic autonomy objectives while being respectful of the environment. Designing for recyclability, recycling and advancing the transition to a circular economy are priorities of the Critical Raw Materials Act[29]. This should be complemented by Member States, for instance regarding permanent magnets and the reuse of extractive waste. Coherent strategies should be developed that not only remove obstacles but also promote the exploration, extraction, processing and recycling of materials across Europe. More generally, the transition of EU industries to circularity is yet to materialise, as resource productivity only marginally increased between 2012 and 2021.

4.3 Productivity

A well-functioning single market reduces gaps in productivity and competitiveness between EU Member States and regions. The single market has underpinned Europe's prosperity since it was created three decades ago. EU businesses benefit from a "home market" of over 450 million consumers for their products, easier access to a wide range of suppliers and lower unit costs, whereas EU citizens benefit from more innovation, lower prices and higher standards of safety and environmental protection because of the competition between companies[30]. Moreover, it protects the EU from major demand or supply shocks and can help to contain price pressures at times of high inflation. In the medium to long term, it can help address supply chain vulnerabilities and support scaling-up capacities for the twin transition and EU's resilience and security. Although the single market is fundamental to the EU's global attractiveness, average productivity growth has slowed down in the last few decades and been weaker than in other major economies, hampering the competitiveness of EU companies[31]. In several Member States and EU regions, productivity is actually stagnating, resulting in growing disparities in particular within EU Member States. There are also significant regional disparities in access to education, research and innovation and mobility, further accentuated in rural and outermost areas and in extremely remote areas such as the outermost regions where access to essential and social support services remains a challenge in general. The implementation of the cohesion policy programmes and the RRPs until 2026 will contribute substantially to improving the EU's competitiveness and boosting EU cohesion. Beyond investment measures, including under the InvestEU programme, the RRPs include reforms aimed at simplifying the regulatory environment at national and regional level, speeding up access to finance and improving SME growth and resilience by reskilling and upskilling employees or strengthening their research and development capacities.

A genuine single market for services would also bring substantial productivity gains. EU service markets face several challenges, including low competitive pressure, lower productivity levels and lower growth rates than manufacturing, poor integration of cross-border services and low professional mobility. Reducing regulatory restrictions at national level would increase competition and facilitate workforce mobility and increase the offer of services where most needed. It would strengthen the competitiveness of manufacturing industries that also source many professional services and increasingly offer their products in combination with services. However, progress has been slow in reducing regulatory barriers, and in some cases reforms

[29] COM(2023) 160 final.
[30] COM(2023) 162 final
[31] COM(2023) 168 final.

have been reversed and a high level of restrictions remain[32]. For example, regulatory barriers are particularly prevalent in key business services (legal, accountancy and for architects) in many Member States. The construction sector, key to the green transition, often suffers from authorisation and qualification requirements that are unnecessarily burdensome. Fragmented responsibilities and activities reserved for several professions and specialisations (in particular architects and civil engineers) further impact the free movement of professionals. In retail services, the level of restrictions remained either unchanged or even higher for many Member States in 2022 compared to 2018[33].

Removing regulatory obstacles, while ensuring good governance and the respect for the rule of law, increases institutional resilience and improves the business environment. 60% of the barriers that EU businesses report facing today are of the same type as those reported 20 years ago. Most of these relate to national regulation and administrative practices that can be addressed directly by Member States. The benefits of removing Member State-level barriers to the single market for goods and services alone could add EUR 713 billion to the whole economy by the end of 2029[34]. Tackling legislative and administrative obstacles is supported by reforms under the RRF, and the Commission has invited Member States to further strengthen reforms in this area as part of their ongoing revisions. This complements the work of the Single Market Enforcement Taskforce, as mentioned above. The use of SOLVIT[35] for addressing problems related to the application of single market legislation is also increasing, especially among business stakeholders. Good governance and respect for the rule of law, in particular independent, quality and efficient justice systems[36], functioning and effective tax systems, as well as effective insolvency and robust anti-corruption and anti-fraud frameworks are also key determinants of an economy that works for people and help improving the business environment. Furthermore, the Commission will make a fresh push to rationalize and simplify reporting requirements for companies and administrations, with the aim to reduce those burdens by 25%, without undermining the related policy objectives.

Well-functioning capital markets are crucial to funding the green and digital transition and supporting EU macroeconomic resilience and the EU's open strategic autonomy. Public financing, in conjunction with accelerating the Capital Markets Union, can unlock the significant amounts of private financing required for the twin transition. While progress has been made since the Capital Markets Union initiative was launched in 2015, EU capital markets remain fragmented and underdeveloped, showing the need for further concrete action. In a climate of rising interest rates, many businesses, particularly SMEs, have difficulties accessing finance. Exacerbated by high energy prices, late payments also constitute a barrier to the resilience of businesses, in particular SMEs. This calls for stepping up collective efforts to advance, involving policymakers and market participants across the EU[37]. Further gains in EU productivity and

[32] COM(2021) 385 final.
[33] European Commission, 2022 update of the Retail Restrictiveness Indicator, *forthcoming*.
[34] COM (2023) 162 final,16.3.2023.
[35] SWD(2022) 325 final.
[36] In addition to the European Semester, the Commission's Rule of Law Report also covers in one of its pillars the functioning of justice systems.
[37] The European Commission will publish an SME Relief Package in June 2023 and has recently tabled proposals to make EU clearing services more attractive and resilient, harmonise certain corporate insolvency rules across the

competitiveness will come from more innovative and safe payment systems and from an open finance framework that will allow us to reap the benefits of digitalisation.

Digitalisation plays an important role in increasing competitiveness and requires a workforce with stronger digital skills, including for SMEs, and further digitalisation of public services. A digitally skilled population increases technological progress and drives productivity. The digitalisation of SMEs is indispensable for increasing their innovation potential and competitiveness. This can be strengthened by comprehensive action, as suggested by the two recent proposals for Council recommendations on proposed digital education and skills[38], in which the structured dialogue on digital education and skills prepared the ground. The digital transformation of governments, which includes broadening the range and interoperability of public services available online and the availability of open data, improves business efficiency. Furthermore, the digital transition strengthens the green transition, as digital technologies like space data and services play a significant role in climate action[39]. The Digital Decade policy programme offers a roadmap to unlock the EU's digital transformation potential, paving the way for a more competitive Europe.

Public procurement markets need open competition to deliver the best value for public money. The number of public tenders with only one bid has been increasing in recent years. In 2022, it reached the highest share at EU level (37%) since the adoption of the 2014 Public Procurement Directive[40]. Efforts by Member States to reduce this share are needed to create a level playing field. Public procurement can stimulate supply chains by diversifying demand. Used strategically with the focus not only on price, it can also improve quality, resilience and sustainability. Through the Net-Zero Industry Act, it should become easier for innovative, sustainable SMEs, or for consortia including SMEs, to participate in procurement[41]. Where possible, tenders should be designed in a way that allows SMEs to participate.

Innovation is one of the main drivers of stronger productivity growth, but it faces several bottlenecks. Shortages of highly skilled staff in science, technology, engineering and mathematics (STEM) have become a common challenge for most Member States, undermining the growth potential of firms, including in high-innovation, high-technology sectors. Innovation is highly concentrated in some Member States and EU regions, particularly in capital regions and other metropolitan regions, and remains much higher in Northern and Western Europe. Stronger innovation performance is held back by a series of shortcomings such as insufficient and/or irregular public R&D investment, weak academia-business linkages in most Member States or ineffective public support for business innovation. Breakthrough innovations are for example impacted by a lack of scale-up ventures, difficulties in accessing capital, regulatory burden and barriers in the single market. Many measures are being implemented in the RRPs. Cohesion policy investments and other initiatives such as the Regional Innovation Valleys will also help address these challenges.

EU, and alleviate the administrative burden for companies of all sizes, in particular SMEs, for listing and remaining listed: COM(2022) 696 final.

[38] COM(2023) 205 final; COM(2023) 206 final.

[39] See for example the EU action plan for the digitalisation of the energy system: COM(2022) 552.

[40] Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC Text with EEA relevance (OJ L 94, 28.3.2014, p. 65).

[41] See also the New European Innovation Agenda: COM(2022) 332 final.

4.4 Fairness

While the EU labour market has so far proved resilient, high inflation and uncertainty could affect labour market prospects and are affecting households. The labour market in the EU achieved a record employment rate of [74.8%] in the [fourth quarter] of 2022, marking substantial progress towards the 2030 employment rate target of at least 78%. Labour and skills shortages remain high and above 2019 levels, but started declining in the second half of 2022 amid a continued positive overall labour market performance. Nonetheless, the slowdown in economic activity is expected to translate into more muted labour market developments in 2023 and 2024, while regional disparities in the labour market remain high with employment rates lower than 50% in some regions. At the same time, sizeable employment gaps persist for some population groups, including women and young people. Steep increases in prices, especially for food, energy and transport, have affected the purchasing power of low- and lower-middle income households in particular. These items represent higher shares in their consumption baskets, calling for well-targeted social policy measures. In this context, responsive wage policies, and effective collective bargaining are key to promoting adequate real wage developments, especially for low-income workers. In this regard, regular updates of minimum wages, play an important role. The adoption of the EU minimum wage directive[42] creates a positive momentum for measures ensuring adequate minimum wages.

To mitigate the loss in purchasing power and prevent an increase in poverty risks, social protection systems need to be safeguarded and strengthened, including their adequacy and sustainability. Continuous monitoring of the social situation and prompt policy responses are needed to prevent people falling into poverty or social exclusion, including energy poverty, and exacerbating existing inequalities. In the context of the rising cost of living, closing gaps in access to adequate and sustainable social protection and social inclusion systems plays a key role in minimising the impact of high inflation on vulnerable people, alongside wage developments that mitigate the loss in purchasing power in particular for low earners. Structural or ad hoc mechanisms to adjust social benefits in response to high inflation are important to maintain their adequacy, while ensuring that the respective costs remain fiscally sustainable. At the same time, social protection systems and inclusion systems need to preserve work incentives and actively promote labour market participation and integration, including through integrated quality services. Population ageing, the burden of chronic diseases, new health demands and new technologies will also require the creation of more jobs, with changing skill sets, in the health and social sectors. Access to affordable, quality and sustainable healthcare and long-term care needs to be improved. E-health continues to transform the way people access and receive healthcare, requiring an increasing level of digital skills as well as higher versatility from the health workforce.

Education and training systems are key to addressing and preventing labour and skills shortages. The largest labour shortages are currently in healthcare and long-term care, hospitality, construction, ICT and related occupations, and in key sectors for the green transition

[42] Directive (EU) 2022/2041 of the European Parliament and of the Council of 19 October 2022 on adequate minimum wages in the European Union (OJ L 275, 25.10.2022, p. 33).

such as renewables and energy efficiency. Beyond cyclical developments, skills shortages reflect structural changes in the EU economy, including population ageing and the ongoing green and digital transformations, which leads to changing skills requirements. At the same time, they expose the existing weaknesses in education and training systems. While improving, the share of young people not in employment, education or training remains high in some Member States. Already in 2018, one in five 15-year-olds lacked basic skills, and young people from disadvantaged backgrounds were almost six times more likely to underachieve academically. In the last few years, the pressure on education and training systems has increased as they have had to cope with the impact of the pandemic, lack of appropriate digital infrastructure and the growing shortage of teaching staff, at all levels of education, particularly in subjects most relevant for the twin transition. While tertiary educational attainment is on the rise, the share of STEM (science, technology, engineering, and mathematics) graduates falls short of labour market demand in most Member States. Strengthening the quality, inclusiveness and labour market relevance of education and training systems at all levels throughout the Union remains key for strong labour markets and a fair transition. Similarly, increasing the labour market participation of women, young people and underrepresented and vulnerable groups, such as persons with disabilities, people with a migrant background and Roma, remains a major opportunity for inclusive growth and equality.

In particular, the development and acquisition of skills and competences relevant for the green transition is becoming more pressing. It is becoming increasingly important to ensure that all workers, in particular those in sectors and regions more affected by the green transition, can benefit from the employment gains of a net-zero economy. Vocational and technical profiles will be particularly sought after in light of the accelerated energy transition and technological transformation in the context of the EU Green Deal Industrial Plan. Member States face significant and growing labour shortages, while low training provision in key sectors could create bottlenecks in the transition to a net-zero economy. The challenge is even stronger in some peripheral or economically stagnant regions. In this context, it is crucial that Member States support the anticipation, acquisition and provision of skills for the green economy, as highlighted in the CSRs to all Member States and in line with the Council Recommendation on ensuring a fair transition towards climate neutrality, to match labour market needs and offer equal opportunities for all. Promoting upskilling and reskilling for public sector workers at all levels (including local administration) would also accelerate investments and reforms necessary for the green transition.[43]

The RRF and cohesion policy funds, in particular the European Social Fund Plus, help address challenges in education and training systems at all levels. Supported measures include enhancing access to early childhood education and care, curriculum reforms, modernising higher education, facilitating the transition from the education system to the labour market, creating upskilling and reskilling opportunities – in particular for skills relevant to the green transition – as well as reforming and modernising active labour market policies. By

[43] The EU Technical Support Instrument (TSI) will facilitate exchanges between officials from national and/or regional administrations through the flagship initiative PACE (Public Administration Cooperation Exchange) as a way to enhance administrative capacity and foster best practices (Regulation (EU) 2021/240 of the European Parliament and of the Council of 10 February 2021 establishing a Technical Support Instrument, OJ L 57, 18.2.2021, p. 1).

supporting an accelerated requalification of the workforce towards skills relevant to the green transition, the dedicated REPowerEU chapters to be included in the existing RRPs will ensure additional funding for reforms and investments in this area. Coupled with these increased investments, including under the InvestEU programme, the ambitious and sustainable legal migration policy proposed by the Commission in its Skills and Talent package[44] can also help address labour and skills shortages and unlock the full potential of the European workforce. The European Year of Skills 2023 will provide fresh impetus to engage stakeholders and mobilise public and private funding in order to address skills shortages and medium- to long-term labour shortages in particular in digital and green skills[45].

Since the start of the Russian war of aggression against Ukraine, nearly 4 million displaced people have been welcomed in the EU under the Temporary Protection Directive. Labour market inclusion is fundamental for displaced people to be financially independent, support their families and contribute to the host community[46]. According to available estimates[47], between 600 000 and 1 million beneficiaries of temporary protection have found employment across the EU, while more than 350 000 have registered as jobseekers. Language barriers are a major obstacle to getting displaced people into work, making the provision of language training of crucial importance. The swift validation of skills and recognition of qualifications, including in sectors in demand such as healthcare, is also important to ensure that people can access work that matches their skills and experience. Many Member States have already taken important steps to facilitate this process, in line with the Commission's guidance[48], using also the funding flexibilities provided by CARE (Cohesion Action for Refugees in Europe). As many beneficiaries of temporary protection are women with children, the availability of early childhood education and care services is a particularly critical precondition for their labour market participation.

The implementation of the European Pillar of Social Rights continues to guide upward social convergence in the EU. Two years after the Porto Social Summit and the commitments made on the 2030 headline targets on employment, skills and poverty reduction, putting in place the necessary reforms and investments to make progress towards the national targets remains a priority for Member States. This is key to supporting upward social convergence and social cohesion in the EU. As part of the Spring Package, the Commission also proposes to carry over the Employment Guidelines to the next annual cycle. This follows a major change in 2022 to

[44] COM(2022) 657 final.

[45] The European Year of Skills 2023 aims to address skills shortages and medium- to long-term labour shortages by reskilling and upskilling the European workforce and by ensuring better matchmaking between supply and demand in the labour market.

[46] COM(2023) 140 final.

[47] It is difficult to estimate the actual number of beneficiaries of temporary protection that are employed across the EU due to the unavailability of data from some Member States and differences in the type of administrative sources used. In particular, some countries report the cumulative number of 'notifications of employment' (i.e. the declarations submitted by employers when hiring Ukrainian citizens), which corresponds to the number of jobs created rather than to the number of people actually employed.

[48] Communication from the Commission on Guidance for access to the labour market, vocational education and training and adult learning of people fleeing Russia's war of aggression against Ukraine (OJ C 233, 16.6.2022, p. 1).

better reflect the post-COVID environment and most recent policy initiatives, as well as growing discussions on the importance to ensure sustainable and inclusive wellbeing

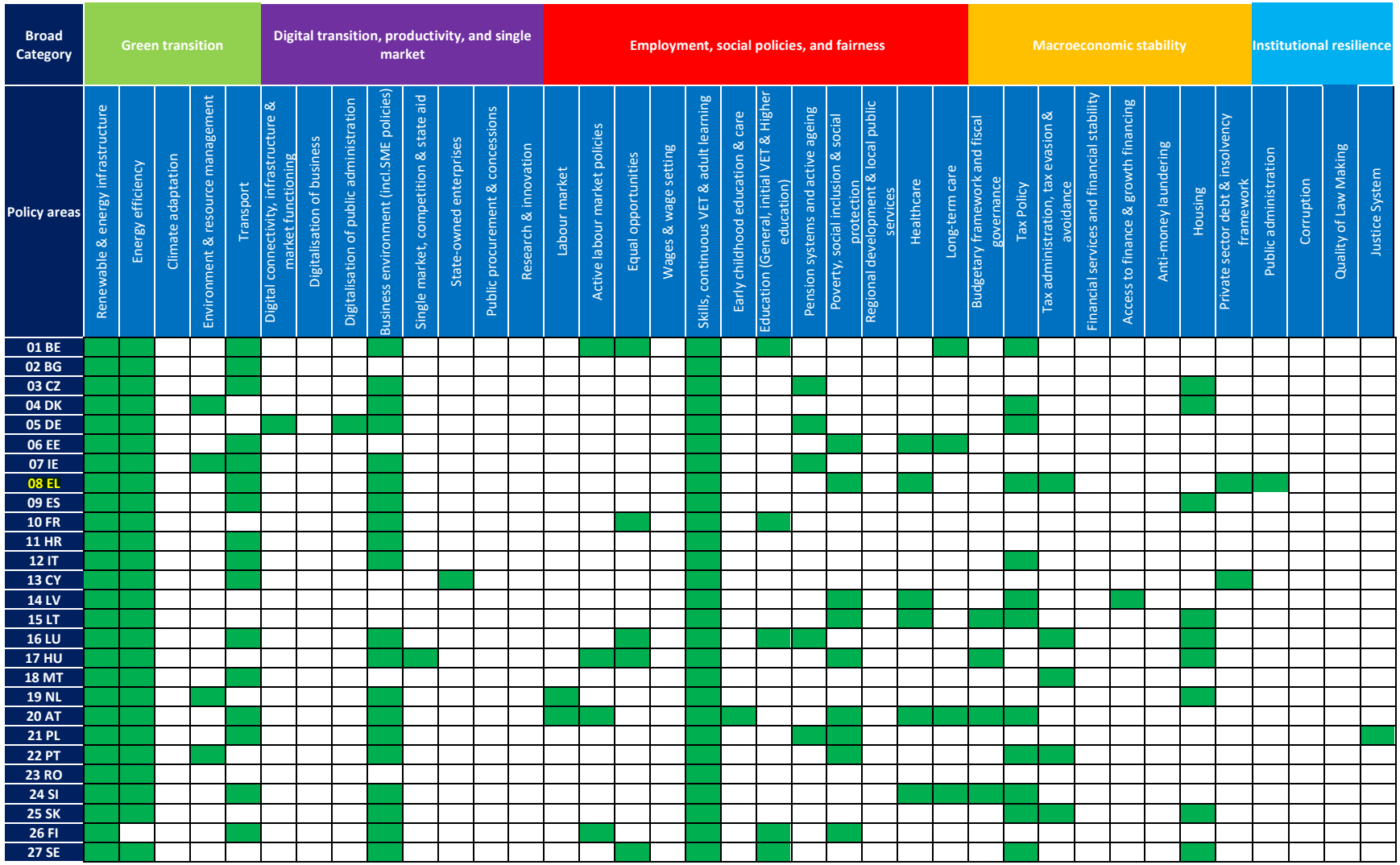
5. CONCLUSION

In the face of the current geopolitical reality and complex economic and social challenges, the EU seeks to build a robust and future-proof economy that secures competitiveness and long-term prosperity for all. This requires an integrated approach across all policy areas to increase productivity, resilience, fairness and sustainable growth throughout the whole economic base. The European Semester provides the right policy coordination framework for that purpose, also embedding implementation of the RRF and of cohesion policy programmes. While RRP implementation is well underway in some Member States, in others it faces the risk of delays with regard to the indicative implementation calendars agreed in the Council Implementing Decisions. While the implementation of the 2014-2020 cohesion policy programmes will come to an end in 2023, the recently adopted 2021-2027 programmes offer an opportunity to boost investment in full complementarity with the RRF. To ensure lasting progress, Member States should continue to focus on the full and timely implementation of the RRPs until 2026 and proceed swiftly to implement the recently agreed cohesion policy programmes. The envisaged revisions of the RRPs, including REPowerEU chapters with additional funding along with the cohesion policy programmes, are an opportunity to respond to persisting challenges identified in the context of the European Semester, including in the area of climate and energy.

The 2023 country reports provide a snapshot of the economic, labour market and social developments and challenges that Member States are currently facing. The analysis of the challenges underpins the 2023 CSRs. This year's European Semester pays particular attention to the topic of long-term competitiveness and productivity, while also providing an updated, more detailed analysis of energy security and affordability. The Commission calls for ambitious action by Member States to address the vulnerabilities exposed by recent crises and identified in the country reports at national and regional level. This includes strengthening resilience and productivity, facilitating access to financing, providing affordable energy, reducing strategic dependencies, accelerating the circular economy transition, ensuring the skills for the future, supporting the creation of quality jobs and making the economic, scientific, industrial and technological base fit for the green and digital transition while leaving no one behind.

The Commission calls on the European Council to endorse and on the Council to adopt the Commission proposals for the 2023 CSRs. It also calls on all EU Member States to implement the recommendations fully and in a timely manner, in close dialogue with their social partners, civil society organisations and other stakeholders.

APPENDIX 1 – OVERVIEW OF THEMATIC AREAS COVERED IN THE COUNTRY-SPECIFIC RECOMMENDATIONS



APPENDIX 2 – PROGRESS IN THE IMPLEMENTATION OF THE COUNTRY-SPECIFIC RECOMMENDATIONS

The 2023 European Semester takes stock of the Member States' policy action to address structural challenges identified in the CSRs adopted since 2019. Following the establishment of the RRF as a key tool to deliver EU and national policy priorities, the 2023 CSR assessment takes into account the policy action taken by the Member States to date[49] as well as the commitments undertaken in the RRPs, depending on their degree of implementation. The assessment therefore reflects the current, still relatively early stages of implementation of RRPs, rather than the level of progress that could be achieved assuming a full implementation of the plans until 2026[50].

Figure 1: Current level of implementation of 2019-2020 CSRs

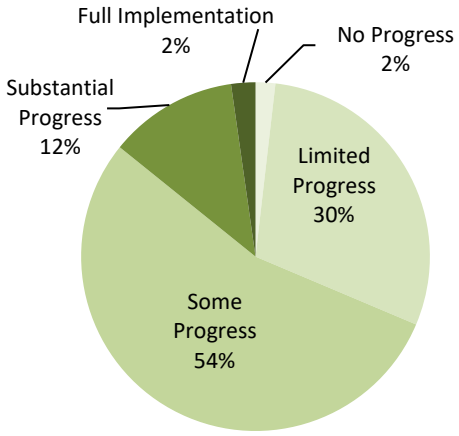
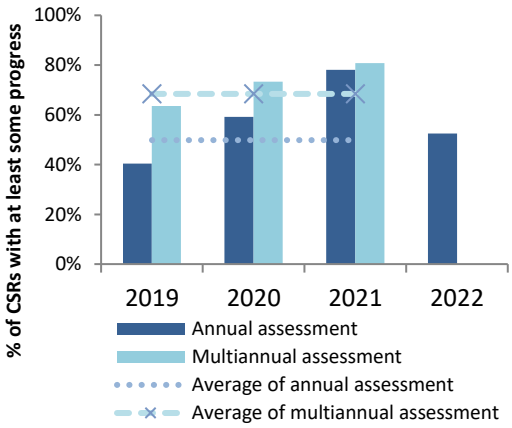


Figure 2: Implementation of 2019-2022 CSRs: annual assessment in each consecutive year versus implementation to date



Note: The multiannual assessment in Figure 1 looks at implementation of 2019-2020 CSRs from the time the recommendations were first adopted until publication of this Communication. In Figure 2, annual assessment shows the progress recorded in the first year after CSRs adoption while the multiannual assessment shows this year's assessment of past CSRs. Note that the 2021 CSRs only relate to fiscal policy.

From a multiannual perspective, at least some progress has been recorded for 68% of the 2019-2020 CSRs (see Figure 1). Compared to last year's assessment, additional progress has

[49] Including policy action reported in the national reform programmes as well as in RRF reporting (biannual reporting on progress in the implementation of milestones and targets and resulting from the payment request assessment).

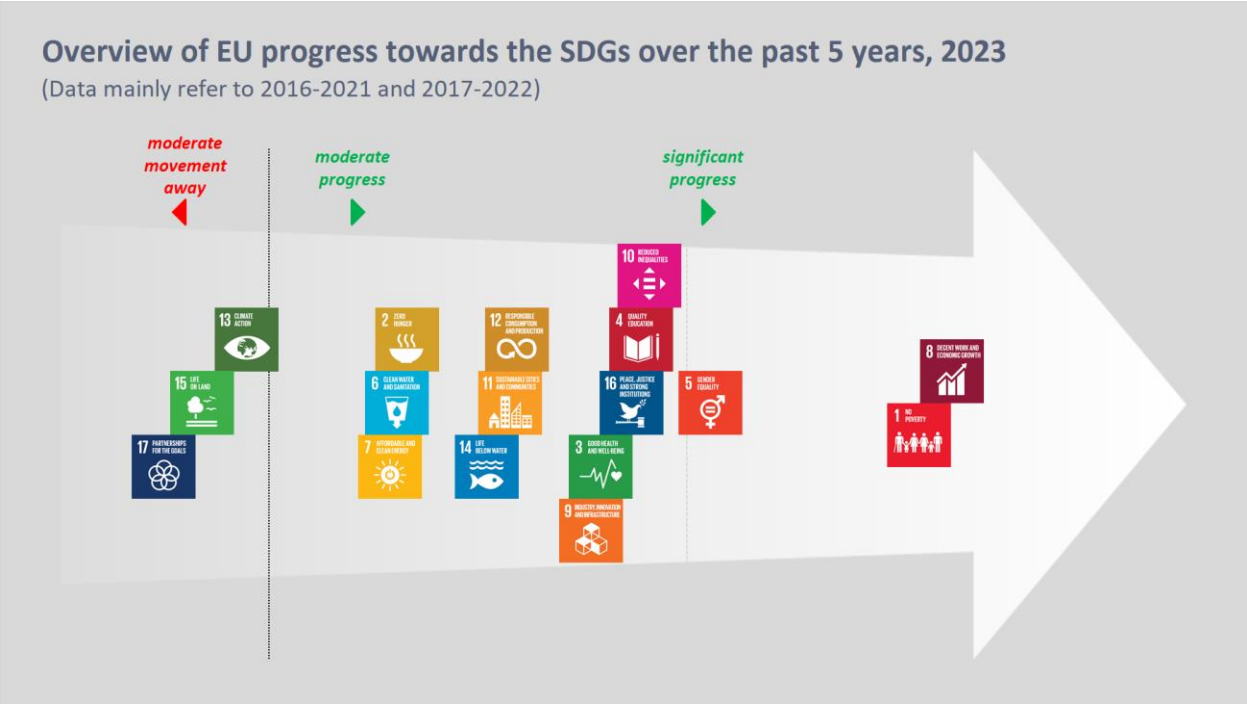
[50] Member States were asked to effectively address in their RRPs all or a significant subset of the relevant CSRs, in particular those of 2019 and 2020. The CSR assessment presented here takes into account the degree of implementation of the measures included in the RRPs and of those done outside of the RRPs at the time of assessment. Measures envisaged in the Annexes of the adopted Council Implementing Decisions on the approval of the assessment of the RRPs, which have not yet been adopted or implemented but are considered as credibly announced in line with the CSR assessment methodology, warrant 'limited progress'. Once implemented, these measures can lead to 'some/substantial progress' or 'full implementation', depending on their relevance.

been made on both 2019 CSRs of a structural nature and more crisis-oriented 2020 CSRs. The percentage of these CSRs having achieved at least some progress of implementation has thus steadily increased from 59% in 2021, via 63% in 2022, now reaching 68%. This shows clearly the incentives provided by the RRF since 2021, whose performance-based approach is expected to continue reinforcing CSR implementation in the years to come. Member States have made most progress in recent years on access to finance and financial services, followed by labour market functioning, anti-money laundering and business environment. At the same time, progress has been less visible in the areas of the single market, competition and state aid, housing, long-term care and pension systems.

Progress in the implementation of the recommendations adopted in 2022 has also been substantial. Member States have made at least 'some progress' in almost 52% of the recommendations addressed to them in July 2022 (Figure 2). Considering those areas in which a significant number of Member States received a recommendation in 2022, most progress overall has been achieved on budgetary framework and fiscal governance, followed by transport, business environment and energy efficiency. By contrast, less progress has been made in addressing recommendations on taxation policy.

The results of the 2023 CSR assessment, together with those of previous years, will be available on the Commission website.

APPENDIX 3 – EU-WIDE PROGRESS ON SDG IMPLEMENTATION



Note: The figure above shows the pace at which the EU has progressed towards each of the 17 goals over the most recent five-year period according to the selected indicators. The method for assessing indicator trends and aggregating them at goal level as well as more detailed analyses are available on the Eurostat website: Overview – Sustainable development indicators – Eurostat (europa.eu).

Over the last five-year period assessed, the EU has made significant progress towards ensuring decent work and economic growth (SDG 8) and reducing poverty (SDG 1). Significant progress has also been made towards achieving gender equality (SDG 5). Good but more moderate progress has also been achieved towards the goals on reducing inequalities (SDG 10), ensuring quality education (SDG 4), fostering peace and personal security within the EU's territory and improving access to justice and trust in institutions (SDG 16), health and well-being (SDG 3), despite the setbacks caused by the COVID-19 pandemic, and on innovation and infrastructure (SDG 9). Progress towards the remaining goals - zero hunger (SDG 2), clean water and sanitation (SDG 6) and affordable and clean energy (SDG 7) - has been less significant.

More progress is expected for three goals – climate action (SDG 13), life on land (SDG 15) and global partnerships (SDG 17) – as EU Member States are set to implement the higher level of ambition in the environmental targets set at EU level. Regarding climate action (SDG 13), the EU has set very ambitious and unparalleled climate targets for 2030 and, as compared to past trends, they will require more efforts. The EU has already put in place the policy measures to deliver these additional efforts, notably via the 'Fit for 55' package, with a revision of the EU emissions trading system (ETS), and the Effort Sharing Regulation that sets binding annual greenhouse gas emissions targets for Member States. In the area of energy, the EU has also set more ambitious targets for 2030. This implies that stronger progress is expected to be visible in

the coming years in the area of energy efficiency and renewable energies in the EU, as well.[51] Concerning life on land (SDG 15), even though terrestrial protected areas have increased since 2013, the EU continues to face steady declines in common bird and grassland butterfly populations. Additional efforts needed to reverse the degradation of ecosystems are envisaged in the EU 2030 Biodiversity Strategy, in the EU forest strategy for 2030 launched this year and in the EU Soil Strategy, which sets a 2030 objective on restoring degraded land and soil and combatting desertification. Regarding partnerships for the goals (SDG 17), the trend partially reflects cyclical effects and notably the increase in public debt resulting from the COVID-19 crisis.

[51] Moreover, data for 2021 were strongly affected by the severe floods in Germany, Luxembourg, and Belgium and in 2021 net greenhouse gas emissions, even if still below pre-pandemic levels, partially bounced back from the low levels hit during the pandemic.

APPENDIX 4 – FINDINGS OF IN-DEPTH REVIEWS OF MACROECONOMIC IMBALANCES IN EU COUNTRIES

Imbalances or excessive imbalances have been identified in 11 out of the 17 Member States for which an in-depth review was carried out. 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 IDRs have been informed by the findings of three thematic notes, on i) external sustainability, on ii) inflation differentials and their implications for competitiveness, and (iii) on housing market dynamics, which focussed on a number of the Member States selected for an IDR in the current round.[52]

High inflation marks the backdrop against which imbalances are now evolving. Persistent high inflation may adversely affect competitiveness if not matched by productivity gains, and can lead to macroeconomic imbalances developing or exacerbating, in the presence of other vulnerabilities. This can occur if inflation becomes entrenched, particularly in the presence of price-wage spirals, possibly exacerbated by increased profit margins, that spill into the prices of tradable goods and services. This is more likely to be the case the higher the domestic valued added into exports is. It can then negatively impact competitiveness, possibly resulting in increased external indebtedness. Inflation also brings challenges for households whose incomes currently lag well behind prices, resulting in a loss of purchasing power and having adverse distributional consequences. For those firms that are not able to pass through their increased costs into prices, persistent inflation hampers debt-servicing, possibly impacting the financial sector and slowing down economic growth through receding consumption and investment. Bringing down inflation requires policy efforts, including by reining in demand, which may in turn affect short-term GDP growth. This is a particular concern where core inflation is well above the EU or euro area averages and risks persisting; in those cases bringing down inflation cannot rely on monetary policy alone.

Inflation divergence across Member States is at historically high levels. A part of the divergence in inflation is related to the differentiated impact of the higher energy and food prices on the various countries, reflecting their different sourcing of energy, diverse economic structures and related energy demand, as well as the share of energy and food in consumption. However, for several countries it is accompanied by other sources of inflationary pressures, including increases in unit labour costs and corporate mark ups and profits. In addition, government spending, including support measures, have in some cases contributed to inflation differentials among EU and euro area countries. In countries where inflation results to a large degree from energy prices pass-through, the normalisation of energy prices should be sufficient to bring down inflation differentials, in the absence of other effects materialising and as long as prices adjust down where needed. Yet where inflation results mostly from domestic price pressures, related to wages and profits dynamics, it may be more difficult to swiftly unwind the

[52] These notes were published on 5 April 2023 as ECFIN institutional papers.

inflation dynamics, particularly if those price dynamics are more lasting or rooted in more permanent factors and thereby structural measures may be needed to lead to more competition in certain markets.

Inflation differentials are a heightened concern within a monetary union and that calls for special attention. In a monetary union, divergent inflationary effects make the task of the monetary authority particularly difficult, as the uniform transmission of changes in monetary stance to all parts of the union may be impaired. As the re-alignment of domestic costs and prices via changes in the nominal exchange rate is not an option, persistent inflation differentials can entrench lasting competitiveness losses and structural shifts that may be difficult and costly to overcome; they may require additional tightening of fiscal policy to dampen any excess demand, reduce the build up of vulnerabilities and avoid the need for more damaging corrections in the future.

For non-euro area countries, the nominal exchange rate can adjust to counter any competitiveness pressures, but that can also entail risks. In particular, devaluation and depreciation can usher in further inflationary pressures as imported goods and services become more expensive. At the same time, the cost of foreign-currency denominated debt increases and can lead to higher risk premium on issuing sovereign debt and in borrowing from abroad.

High private and government debt ratios continued declining in 2022, sometimes even at accelerated pace, but vulnerabilities remain. After the pause in deleveraging caused by the COVID-19 crisis, debt-to-GDP ratios have since reduced with higher nominal GDP growth. This marks a return to the long-standing trend of deleveraging, which has seen marked declines in debt ratios over the years for many countries. In some high debt cases, debt-to-GDP ratios declined more in 2022 than in the previous years, due to the strong denominator effect. Nonetheless, debt ratios remain high and, particularly for government debt, sometimes still visibly above their pre-COVID-19 crisis levels. In some cases, the reduction in government debt ratios has been limited by the support measures enacted to mitigate the impact of the higher energy prices.

Continued nominal GDP growth is projected to support further deleveraging, but in a context of less favourable financing conditions. Strengthening potential GDP growth, in particular by effectively implementing the RRPs, will further support a reduction of debt-to-GDP ratios. While high inflation currently increases nominal GDP and reduces the indebtedness as a share of economic output, inflation is expected to come down while tighter financing conditions may weigh on the servicing of high debts. This is more of a concern where interest rates are variable or change more rapidly or where financing needs are higher; debt and borrowing in foreign currencies may compound those concerns for some countries. In those cases, changes in perceptions or risk appetite of financial markets cannot be excluded, requiring sound economic and fiscal policies.

External positions have typically been weakened by a shock to energy import prices, with domestic demand buoyance contributing further in some cases. Trade balances have declined

significantly across the EU as energy import costs have increased. Still, some countries were more affected than others due to their dependency on fossil fuel energy and the geographical sourcing of that energy. In addition, in some cases, the deterioration in current accounts has been magnified by falling non-energy balances where domestic demand growth has been very strong. Conversely, further recovery of cross-border tourism has helped containing the deterioration in the current accounts of some large net-debtor countries with significant tourism sectors, but in some cases that was not enough to avoid significant current account deficits. Large current account surpluses declined too, but remained significant.

Going forward, lower energy import prices are expected to increase the current accounts of nearly all Member States in 2023, deficits and surpluses much alike. The large negative net international investment positions (NIIPs) improved further in 2022 supported by nominal GDP growth and despite worsening current accounts; they are expected to improve further this year and next but at a lower pace, reflecting the lower nominal GDP growth and in some cases the persistence of large external borrowing needs. Despite the increase in current accounts that should result from the reduction in energy prices, in a number of cases, current account deficits may continue to be weaker than in recent years and their evolution should be closely followed. Current account surpluses, which declined in 2022, are projected to increase in 2023 as the energy price effect reverses, but to more moderate levels. A stabilisation of energy prices at a higher level or persistently higher inflation are risk factors that could lead to lasting deterioration in external balances. The inflow of RRF funds will support the external position in a number of cases over the coming years.

House prices continued to grow strongly for most of 2022 but a cooling of housing markets was evident in the later months. Nominal house prices continued to accelerate in most Member States over 2022, pushing price-to-income ratios further up. The trend changed over the course of the year with house price growth starting to cool down and a number of countries recorded falls in nominal prices in the second half of 2022. Tighter financing conditions together with falls in real household incomes have dampened housing demand and started a correction in house prices.

Going forward, house prices are expected to moderate further amid tightening financial conditions and incomes that are under pressure, while housing supply is buffeted by rising construction costs. Where house prices seem to be more overvalued and where price increases have occurred alongside high – and rising – household indebtedness, households and lenders may display increased vulnerability to downward corrections of house prices. In particular, those countries where variable interest rates prevail may be more affected as debt service obligations rise rapidly, particularly where mortgage terms are long and interest forms a sizeable part of monthly payments, and possibly hit consumption and GDP. At the same time, some Member States are marked by additional concerns around their commercial real estate sectors, which in some cases have been particularly hit by the higher financing costs. Beyond the immediate future, supply constraints that were already present before the pandemic can be expected to persist over the coming years, which altogether may contain prices falls but remain a bottleneck to increases in the housing stock; in fact, construction activity has recently fallen in some

countries. If unaddressed, those supply constraints may lead to renewed upward price pressures and deteriorating affordability over the medium term.

The banking sector has shown increased strength, benefitting from past reforms, but vulnerabilities may increase in the current macroeconomic context. Member States with high legacy non-performing loans continued to reduce them, sometimes substantially so. However, should downside risks such as a worsening of the economic outlook, and heightened volatility in financial markets materialise, this could raise issues for banks' balance sheets. Higher interest rates should help banks' profit margins but can also create challenges if households and non-financial corporations struggle on servicing their debts. In Member States with a strong banks-government nexus, increased financing costs for the sovereign may also pose a risk for banks. Exposure to housing and especially commercial real estate sectors may become a source of concern in some countries.

Table 1: MEMBER STATES CLASSIFICATION UNDER THE MIP

	2022 IDRs outcomes	2023 IDRs outcomes
No imbalances	HR, IE	CZ, EE, LV, LT, LU, SK
Imbalances	DE, ES, FR, NL, PT, RO, SE	**CY**, DE, ES, FR, **HU**, NL, PT, RO, SE
Excessive imbalances	**CY**, EL, IT	EL, IT
p.m.: No IDR	*AT, BE, BG, CZ, DK, EE, FI, **HU**, LV, LT, LU, MT, PL, SK, SI*	*AT, BE, BG, DK, HR, FI, IE, MT, PL, SI*

Note: Member States with classification changed between 2022 and 2023 are marked in bold in both columns.

Other Member States not experiencing imbalances

Czechia *is not found to experience imbalances. Vulnerabilities relate to price competitiveness and house prices, but seem limited going forward as household debt is contained and inflation is expected to decelerate significantly faster than the EU average.* The economy was strongly affected by the energy price shock with inflation rising fast. A loose fiscal stance since the pandemic has also contributed to the acceleration of inflation. While overall price pressures remain elevated, cost competitiveness is projected to partially recover going forward amid falling energy prices, without there being any immediate external sustainability challenges. Inflation is expected to decelerate significantly faster than the EU average. However, if inflation persists, that could pose some risks for Czechia's competitiveness. The recent deterioration of the current

account warrants close monitoring going forward. In recent years, demand for housing increased strongly, spurred by low interest rates, high income growth and loosened macroprudential measures, and supply of housing did not keep up. House prices grew more strongly during the pandemic but started to moderate in mid-2022 amid higher interest rates and stricter lending conditions. However, risks of a significant house price correction appear to be low, household debt is contained, and the banking sector is sound; a continued limited supply response over the medium-term would nonetheless continue to drive prices up. Continued efforts are needed to rein in inflation. Bringing inflation down quickly requires a strong deceleration in demand growth, which in turn can be achieved by sufficiently tight monetary and fiscal policy.

Estonia *is not found to experience imbalances. Vulnerabilities relating to competitiveness and house price developments have recently increased but overall seem to be contained at present.* Wages and especially prices grew strongly in 2022, but the competitiveness losses seem limited, while the current account has recorded only a small deficit and is forecast to come close to balance this year and next. Nonetheless, inflation and wage pressures, if persistent, risk impairing Estonia's competitiveness, particularly as core inflation is well above the euro area average. House prices have grown strongly since the pandemic, but do not show signs of overvaluation. House prices are likely to moderate, given the interest rate rises and the recent economic recession. Moreover, household debt and borrowing are relatively moderate and the financial sector is sound. The policy setting is overall favourable, although some additional efforts could help to address the risks from the identified vulnerabilities. Continued counter-cyclical fiscal and macroprudential policies, reinforced when needed, would be important in that respect. Fostering competition in the domestic market could help to manage price pressures.

Latvia *is not found to experience imbalances. Vulnerabilities relating to external borrowing and housing remain mild; risks to competitiveness are pertinent, but overall seem contained in the near future.* The recent widening of the current account deficit was significant, but the deficit is expected to narrow substantially this year and further in 2024. Latvia's net international investment position, which improved markedly in the past decade, is expected to remain broadly stable. Nonetheless, inflation and wage pressures, if persistent, risk impairing Latvia's competitiveness, particularly as core inflation is well above the euro area average. While house price growth has been elevated recently, the house price overvaluation does not appear to be substantial. Moreover, house price growth slowed down in late 2022, mortgage lending has been weak, and household debt is limited and falling in terms of household income. Latvia faces key structural economic challenges related to declining labour supply, which has contributed to fast unit labour cost increases and risks impairing competitiveness over the medium term. The policy setting is overall favourable, although some additional efforts could help to address the risks from the identified vulnerabilities. Policies to safeguard competitiveness, including measures to increase the quality and quantity of labour supply, would be important in that respect. Shortening the construction permitting process would help supporting housing supply and improve the housing market situation.

Lithuania *is not found to experience imbalances. Vulnerabilities relating to price competitiveness, external balances and house price developments have recently increased but overall seem to be contained at present.* The economy was strongly affected by the energy price shock with inflation rising fast; however, Lithuania's competitiveness is projected to recover slowly as energy prices are falling. The current account deteriorated markedly in 2022 on

account of the increased energy import prices but is forecast to move close to balance this year. Going forward, mild current account deficits will not compromise external sustainability given its sound stock position. Nonetheless, inflation and wage pressures, if persistent, risk impairing Lithuania's competitiveness, particularly as core inflation is well above the euro area average. House prices have grown strongly since the pandemic, but there is no evidence of overvaluation and prices are now moderating given the interest rate rises and the economic recession underway. In addition, household debt is low, and the banking sector is well capitalised, highly profitable and records low non-performing loans. The policy setting is overall favourable, although some policies could help to address the risks from the identified vulnerabilities. Continued counter-cyclical fiscal and macroprudential policies, reinforced when needed, would be important in that respect. At the same time, more focus on fostering competition in the domestic market and policies to increase the quality and quantity of labour supply could help to manage price and unit labour cost pressures.

Luxembourg *is not found to experience imbalances. Vulnerabilities relating to high house prices and high household debt have recently increased but overall seem to be contained so far and are expected to ease over the medium term.* Strong population growth alongside increased mortgage credit, incentivised by fiscal support, has pushed up demand for housing, while supply has been restricted by the limited land available for construction and by land hoarding. The widening gap between housing demand and supply has resulted in strong house price increases with growing risks of house prices overvaluation and deteriorating affordability. House prices clearly cooled in late 2022, and the number of housing transactions declined sharply, as the rise in interest rates have led to a turn in the market. However, a sharp correction in house prices is not expected as incomes are holding up well and the supply shortage is expected to continue. Household debt is very high in terms of disposable income and has been increasing while borrowing cooled somewhat in late 2022. Households' financial assets are also substantial, indebtedness increases towards the higher levels of income and wealth, and the banking sector is sound, which overall mitigates macro-financial risks. Additional policy efforts, including by stepping up and prioritising the adoption and implementation of recent measures, including recurrent taxes to increase the supply of buildable land, combined with the ongoing reform of land-use planning, could help to boost housing supply, including through the supply of affordable and social housing targeted to those most in need. The efficiency of the rental market could be improved too. In addition, reducing the mortgage interest deductibility, which was recently significantly increased, would reduce the fiscal incentives to borrow which supports high house prices.

Slovakia *is not found to experience imbalances. Vulnerabilities relating to competitiveness, housing, household debt and external balance have been increasing, but overall seem contained in the near future and are expected to ease as economic conditions normalise.* The economy was strongly hit by the energy prices shock with inflation rising fast. Core inflation and unit labour costs growth are well above the euro area average. While they are forecast to normalise, there is the risk that pressure on cost competitiveness could take time to unwind, and that strong domestic demand will continue to put pressures on external accounts. The current account deteriorated markedly in 2022 owing to higher energy import prices as well as marked falls in net exports of non-energy goods. The current account deficit is forecast to improve mildly but to remain large in 2023 and 2024, despite the falling energy prices. Nonetheless, external sustainability risks are assessed to be limited in the near term. Government deficits are forecast

to be significant this year and next and to correct from 2024. House prices appear to be mildly overvalued after several years of marked growth. That occurred alongside high borrowing, which is now cooling, and a strong increase in household debt, which altogether present some risk for financial stability. However, the banking sector remains well capitalised, highly profitable and recording low non-performing loans. Continued efforts are needed to tackle Slovakia's economic vulnerabilities. In particular, excess demand should be reined in to support the correction of the current account deficit and the core inflation differential vis-à-vis the rest of the euro area. That can be achieved by ensuring adequate fiscal consolidation and measures to address household debt, while retaining housing affordability through property taxation and measures supporting housing supply.

Member States experiencing imbalances

Cyprus *is experiencing imbalances after being identified with excessive imbalances until 2022. Vulnerabilities related to private, government and external debt have overall declined but remain a concern.* In particular, high debts including non-performing loans have decreased significantly and are expected to continue doing so, while current account deficits remain an issue. Private debt has been decreasing since 2015, except in 2020 amid the COVID-19 crisis, and is expected to continue declining this year and next supported by nominal GDP growth. Still, higher interest rates could put pressure on debt service though, as variable interest rate loans prevail. Private and external debt stocks are affected by the presence of special purpose entities in Cyprus, which elevate the levels but pose limited risks to the economy. Non-performing loans held by banks have declined very markedly over recent years thanks to non-performing loans sales, write-offs, cash repayments, curing and debt-to-asset swaps. The government debt has been steadily falling; it declined below its pre-pandemic level and is expected to fall further in 2023 and 2024. Despite the recovery in tourism, the large current account deficit widened in 2022, reflecting robust domestic demand as well as high energy prices; it is expected to decrease somewhat this year and next but to remain large. The policy response has been favourable. Several measures included in the RRP are expected to help diversifying the economy, support export growth, and alleviate the over-reliance on oil imports. As part of the RRP, a package of amending laws on credit-acquiring companies and credit servicers was adopted in mid-2022, improving their working environment and supporting non-performing loans reduction. Following several extensions, the suspension of foreclosures came to an end this February: an effective foreclosure framework is key to encourage borrowers to participate in loan restructuring, further reduce non-performing loans in the economy, help reduce private indebtedness, and enhance payment discipline.

Spain *continues to experience imbalances. Vulnerabilities related to high private, government and external debt, which have cross-border relevance, are receding but remain present*. External debt and especially private debt ratios declined over the 2010s' and, after a temporary interruption in 2020, resumed their decline in 2021 and are expected to continue declining favoured by economic growth. However, they remain at still elevated levels. The external position has benefited from a current account that has been in surplus for a decade even if it has narrowed more recently reflecting the impact of the pandemic on tourism exports and of the higher energy prices in 2022. The government debt remains high. In 2022, it has resumed the downward trajectory that delivered improvements before the pandemic driven by strong nominal GDP growth, but remains above pre-pandemic levels. At a more moderate pace, prospects are for

a continuation of this reduction in 2023 and 2024, underpinned by policy measures in the RRP. The financial system showed resilience in face of the recent shocks induced by the pandemic and the energy crisis. Unemployment has been decreasing again, but it still stands high and pockets of vulnerability remain, including very high long-term and youth unemployment. Potential risks affecting the further narrowing of vulnerabilities relate mainly to the impact of the tightening of financial conditions on households and firms' financial positions as well as on the medium to long-term sustainability of government debt in face of the current market conditions and population ageing. Policy progress has been favourable and continuing implementing the RRP should deliver further improvements.

France *continues to experience imbalances. Vulnerabilities related to high government debt, and competitiveness and low productivity growth, which have cross-border relevance, remain present but have shown signs of reduction.* Government debt has been declining since the rebound in GDP in 2021, following an increase during the pandemic. In 2022, various fiscal measures significantly mitigated the impact of the energy crisis but slowed debt reduction. Debt is forecast to further decline this year and next, but it is projected to enter an upward trend again thereafter in the absence of policy action, remaining high and above pre-pandemic levels, and medium-term fiscal sustainability challenges remain high. Policy measures taken in recent years aiming at enhancing potential growth might help correct the projected increase in public debt in the medium term. Several reforms have been adopted to boost cost competitiveness. A small positive effect on competitiveness is already visible, and their full impact is expected to materialise over the coming years. Likewise, labour productivity is expected to benefit from the effective implementation of planned investments and reforms. The French economy displayed resilience over the last year, as cost competitiveness was less affected by increases in energy prices than in the rest of the euro area. Exports are improving owing to the further recovery of cross-border tourism and the aircraft industry, which were much affected by the pandemic. While private sector debt increased during the worst of the pandemic, higher corporate borrowing went hand in hand with increases in equity and accumulation of liquidity buffers. Higher interest rates may make public and private deleveraging more difficult. The policy response has been favourable, but there remain challenges, centred on public finance management. An effective implementation of recently adopted reforms remains central to further reduce vulnerabilities, namely the reform of public finances management and the new mechanism to conduct annual public spending evaluations. Both actions are crucial to continue to curb expenditure and keep public debt on a sustained downward trend. Moreover, the government has adopted a reform of the public pension system that is expected to help public debt sustainability.

Germany *continues to experience imbalances. The persistent large current account surplus, reflecting also subdued investment relative to savings, which has cross-border relevance, has been gradually reduced, most recently amid the energy crisis, but is expected to increase markedly.* The current account surplus receded slowly until 2019 with a gently increasing domestic investment ratio and a falling trade balance and has since been marked by unusual economic circumstances. It decreased markedly in 2022 on the back of higher import energy prices, along with a narrowing of the non-energy trade surplus and a recovery in tourism imports. In 2022, the surplus remained above the levels suggested by the country's fundamentals and it is expected to rebound markedly in 2023 and remain almost unchanged in 2024, but it is projected to stay below the MIP threshold. Wages are forecast to grow strongly, supporting domestic

demand, while unit labour costs may grow faster than in the rest of the euro area. Nonetheless, consumption and investment are temporarily dampened by high inflation. In recent years, house prices have shown sharp increases, even if easing somewhat since mid-2022. Housing supply cannot catch up with demand amid weak residential investment, which may add to continuing risks of overvaluation. A further reduction of vulnerabilities would benefit from the timely and effective implementation of the public investment initiatives and removing of obstacles to investment.

Hungary *is experiencing imbalances. Vulnerabilities related to very strong price pressures and external and government financing needs have increased and are significant.* Inflation has risen significantly and has not yet started moderating visibly. Should inflation remain elevated for an extended period, it would further undermine cost competitiveness and could leave financing costs elevated. The large current account deficit was strongly increased by the higher energy prices in 2022, and short-term external debt has risen. Improvements in the current account this year and next hinge on the expected further moderation of energy prices, but the current account deficit is nonetheless forecast to remain non-negligeable in 2023 and 2024. The high energy intensity of the economy is important for current account dynamics. The government deficit has been large, only partly driven by the policy responses to the pandemic and the energy crises, and accounts for much of the external borrowing of the economy. The government debt ratio decreased thanks to marked nominal GDP growth, but that may be challenged by a slowdown in activity and the persistence of high deficits. Sovereign borrowing costs have increased since 2021, and the government is facing an increasing interest burden, while debt maturity is still relatively low. House prices doubled over five years but price increases halted in late 2022. However, the likelihood of a substantial nominal price drop seems limited amid low household indebtedness, and also in light of the current high inflation environment. Policy inconsistencies have exacerbated the identified vulnerabilities. Effective coordination and clear demarcation of macroeconomic policies, underpinned by a strong institutional policy framework, is instrumental to safeguard fiscal and external sustainability as well as to anchor expectations. Timely and full implementation of structural reforms included in Hungary's Recovery and Resilience Plan is expected to help reduce macroeconomic vulnerabilities and support growth and adjustment in the medium term.

The Netherlands *continues to experience imbalances. Vulnerabilities relating to high private debt levels and a large current account surplus, which have cross-border relevance, persist despite some signs of reduction.* The current account surplus, despite recent data revisions, and private debt are large by international standards as well as above the fundamentals of the economy. The large current account surplus dropped in 2022, driven by worsening terms of trade, with the current account in constant prices increasing, and by a widening of the deficit in primary incomes. With improving terms of trade, the surplus is expected to rebound markedly in 2023 and stabilise in 2024. Limited policy progress has been made but more needs to be done to reduce obstacles to investment. Non-financial corporation and household debt remains high: the latter is more of a concern as it makes households vulnerable to shocks, with those risks exacerbated by the high and rising overvaluation of house prices. Going forward, debt is expected to continue on its moderately decreasing path. Despite moderately falling house prices, pressure on the housing market remains, notably as new housing construction remains significantly below government targets. At the same time, debt-financed homeownership

continues to be subsidised by favourable taxation, while policies regarding the private rental market risk undermining its development.

Portugal *continues to experience imbalances. Vulnerabilities related to high private, government and external debt are receding but remain present.* After a temporary interruption due to the outbreak of the pandemic, private sector and government debt ratios returned to declining paths in 2021 and are expected to continue declining, favoured by economic growth. While they are now below pre-pandemic levels, they remain at still elevated levels. The clearly negative NIIP improved too, both before and after the pandemic, and external indebtedness is projected to further recede, supported by continued economic growth despite some slowdown in 2023. The small current account deficit worsened marginally in 2022 reflecting higher energy prices but that deterioration was mitigated by the further marked recovery in exports, especially of tourism. Going forward, the assumed continued easing of energy prices and a further increase in tourism exports, as well as ongoing policies in support of energy efficiency and renewables, are projected to balance the current account and to further support adjustment in the NIIP. House prices have grown strongly for several years, while non-performing loans continued to decline from already moderate levels. The main risks to the further narrowing of vulnerabilities relate to the impact of the tightening of financial conditions and to an uncertain external environment, and their potential impact on economic growth. Policy progress has been favourable, with a particular focus on the RRP, and continuing implementing the RRP should deliver further improvements.

Romania *continues to experience imbalances. Vulnerabilities relate to external accounts, linked to large government deficits, while overheating pressures have increased.* The large current account deficit worsened considerably after the pandemic-induced recession and makes the economy vulnerable to external funding shocks. The continuation of large current account deficit risks driving the NIIP further into negative territory. Signs of overheating are clearly visible, with core inflation uncomfortably high, wage growth well in double digit territory and a relatively low unemployment rate. Cost competitiveness indicators are expected to stabilise, but structural issues persist. The exchange rate appears to be above the level suggested by fundamentals and remains heavily managed. The government deficit has been large for several years and has accounted for much of the excess of demand and of the subsequent external deficits; even if improving, the government deficit is forecast to remain significant this year and next. The narrowing of the government deficit in 2022 was mainly driven by marked nominal GDP growth, which in turn rests much on overheating domestic demand. Risk premia and sovereign borrowing costs are significantly higher than in the pre-pandemic years. Given the ongoing tightening in global liquidity conditions, it will be important to reverse ongoing trends. Going forward, fiscal adjustment should be the preferred way to bring demand more in line with supply and to contain domestic and external deficits. Full implementation of tax and pension reforms included in the RRP as well as adherence to fiscal targets under the excessive deficit procedure would go a long way in containing current dynamics.

Sweden *continues to experience imbalances. Vulnerabilities relating to its real estate market and high private debt persist.* Real estate prices are high, and have been rising until recently. House price increases have gone hand in hand with rising private debt. In 2022, against a backdrop of marked tightening in monetary and financing conditions, real estate prices started to decline visibly in what seems to be the start of an unwinding of the accumulated vulnerabilities. Prices remain significantly overvalued and are expected to decline further. The turnover in the real

estate sector has recently declined markedly, and, as a result, demand for newly built dwellings has also fallen. The adverse developments have, so far, been limited to the construction and real estate sectors, which are now declining sharply after years of high growth. As a whole, the Swedish economy is expected to contract in 2023, with the changes in monetary conditions affecting the balance sheets of households and commercial real estate companies and their room to consume and invest. The impact of increased interest rates on mortgage payments is substantial, due to the prevalence of variable interest rates and very long duration mortgages. The impact of changing conditions on the financial sector has been limited; the sector is strong and records high profit margins and risk-weighted capital ratios, likely serving as a bulwark against a propagation of the real estate sector problems to the wider economy through the financial sector, although it is highly exposed to real estate. Policy progress has been limited. In particular, the tax system continues favouring homeownership through low recurrent property taxation and promotes debt-financed housing acquisition through significant tax deductibility of mortgage interest payments. In addition, the inefficient rental market has seen limited reform.

Member States experiencing excessive imbalances

Greece *continues to experience excessive imbalances. Vulnerabilities relating to high government debt and a high stock of non-performing loans in the context of high unemployment have been receding, but its external position has deteriorated.* A key concern is that the current account deficit markedly widened in 2022, despite the recovery in tourism revenue. Even though it is forecast to narrow somewhat this year and next, the external deficit is set to stay well above the level that is required to ensure a lasting improvement in the net international investment position. While the government debt-to-GDP ratio remains the highest in the EU, it improved markedly in 2022, largely thanks to strong nominal GDP growth, and it is expected to recede further in 2023 and 2024. Non-performing loans recorded a sharp fall last year building on large reductions in earlier years, yet remain high and continue to weigh on banks' profitability and lending capacity, which in turn impinges on the capital deepening and on the productivity growth of the economy. The policy response has contributed to the unwinding of imbalances and the implementation of the RRP represents a major opportunity to tackle remaining structural weaknesses. Yet more efforts are needed, in particular to ensure that external balances are put on a firmly improving path, and that non-performing loans decline further including through increasing the effectiveness of debt enforcement and improving the secondary non-performing loans market.

Italy *continues to experience excessive imbalances. While there have been some improvements, vulnerabilities related to high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in financial markets, which carry cross-border relevance, persist.* Italy's long-standing vulnerabilities have receded somewhat over recent years but remain significant and are not expected to unwind quickly. Persistent low productivity growth has been a key factor behind Italy's protracted weak economic growth, which slows down government debt deleveraging, dents employment opportunities and impacts banks' balance sheets. The government debt ratio further declined in 2022 along with the economic recovery. However, it remains high and constitutes a substantial fiscal sustainability challenge. The public debt ratio is forecast to further decline by 2024 but to increase in the medium term in the absence of consolidation measures. The government has implemented further measures to support the resilience of the financial sector and non-performing loans have significantly

declined, but banks are still significantly exposed to the sovereign. Some progress has been made with policies to tackle imbalances, but sustained efforts are warranted and the implementation of the RRP remains the key policy priority as it includes comprehensive reforms and significant investments. Putting the high government debt on a firm downward path, in a context of rising debt servicing costs and rising age-related costs, requires a multipronged approach relying on prudent fiscal policies with adequate primary surpluses, growth-enhancing investments and reforms, greater tax compliance as well as an efficient use of national and European resources. Italy is facing challenges that, alongside a continued strong implementation of the RRP, would benefit from additional policy efforts, notably in the areas of taxation, fiscal framework and pension systems as well as in the areas of demography, labour market, and energy.