Austria:

House prices and rents have risen considerably, but the impact on consumption and financial market risks is contained. Housing prices and rents have been increasing steadily since 2005, mostly driven by developments in Vienna. This can be linked to excess housing demand. Despite increases in mortgage lending, financial market risks are contained for now. The impact on private consumption seems also relatively limited. Rising rents were partly due to an increased share of privately financed housing completion. Despite rising construction and land prices, squeezing the availability of affordable housing, housing assistance expenditure per capita decreased in most regions, especially in Vienna.

Investment

Investment is contributing strongly to GDP growth, but is expected to slow down in line with the economic slowdown. In 2017, investment grew by 3.9 %. Capacity expansion needs in response to strong economic growth also led to solid increases in acquisitions of machinery and equipment, which grew by 4.6 %. In addition, after several years of subdued growth, the construction sector rebounded in 2017, growing by 3.5 %, mostly driven by the increase in residential housing. In 2018, total investment is expected to have grown at a slightly slower pace. This reflects the overall moderation in economic growth in the second half of the year, driven mainly by decreasing external demand (European Commission, 2018a). Long-term economic growth will depend on ensuring that sufficient investment will be directed towards productivity-enhancing factors, including digitalisation, skills, research and innovation (see Section 3.4).

Housing

House prices and rents have grown considerably in the past decade, but the impact on private consumption and financial market risks seem to be contained. Housing prices and rents have been increasing steadily since 2005. The

Increases seem to be mostly driven by the developments in Vienna. Despite increases in mortgage credit growth, financial market risks seem to be contained for now. Also the impact on private consumption is relatively limited, which is due to a low homeownership rate coupled with a large share of social housing (see Section 3.2). The increase in house prices can be linked to excess demand, which peaked in 2016. Since then, signs of a relaxation are apparent as house price growth has slowed and housing supply is increasing, while demand is set to decline. The increasing share of privately financed housing together with decreasing public financing in this sector, might have contributed to rising rents (see Section 3.4).

The 2017 Intergovernmental Fiscal Relations Act has introduced many changes but cannot be considered a major step towards increased tax autonomy or a more transparent distribution of competences. Table 3.1.1 outlines the main elements introduced by the 2017

Intergovernmental Fiscal Relations Act and the current state of play in their implementation. Interestingly, the *Länder* have not yet used their new leeway to raise additional revenues by increasing the rates for the housing subsidy contribution.

Housing market and real estate financing

House prices in Austria have been increasing for the past decade, but recent data point to a deceleration. Since 2005, nominal house prices in Austria increased by more than 80 %, surpassing those of most euro area 11 ([24])

countries (European Commission, 2018c). More recent data points to a relaxation of the situation, as house prices have been growing more moderately, increasing by 5.3 % in 2017 and with nominal year on year growth declining to 4.9 % in Q3-2018.

Indicators point to a possible overvaluation of house prices. In 2017, house prices were overvalued by 13.8 %. This is somewhat above the Austrian National Bank (OeNB) estimate of 11.1 % in Q2-2018 (see Graph 3.2.2). These developments mask large regional differences (see Section 3.4.3). The price to income ratio and price to rent ratio have also been above long-term average since 2012, pointing to the decreasing affordability of homeownership (see Section 3.4.3). House prices have increased considerably faster than incomes, though from a low pre-crisis level. In 2017, a 100 m² dwelling cost 10.6 times the annual household income on average ([25]), somewhat above that of most euro area countries.

While house prices and rents have been increasing, the impact on households' private consumption has been limited. With 55 %, Austria has the second lowest homeownership rate of the EU, with a decreasing trend. Out of the 45 % of the population living in rentals, approximately 20 % live in public housing apartments and 40 % in homes of limited-profit organisations with strict rental regulation. Overall, 18 % of the population is directly affected by the increasing rents ([26]). Despite the substantial increases in prices and rents, the share of housing costs in aggregate disposable income has been relatively stable since 2008, declining to 17.9 % in 2017, after peaking in 2013 at 19.2 %. It is also below the average of 18.9 % in euro area 11 countries in the same year. The share of actual rents in final consumption expenditure increased by 0.9 percentage points between 2005 and 2017 to 3.8 % and by 1.2 pps for imputed rents ([27]), both remaining below the average in euro area 11 countries.

Housing supply and demand

Together with house prices, rents increased strongly, notably in Vienna. The increase in house prices and rents in Austria in the past decade has been largely driven by developments in Vienna. Since 2015 however, prices have also picked up in the rest of the country. While in Vienna, house prices are estimated to be overvalued by 21.4 % for Q2-2018, overvaluation for the whole of Austria is estimated at only.

11.1 % ([53]) (see Section 3.2). Similarly, rents increased by 50 % in Vienna since 2005, which is above the aggregate in the rest of the country ([54]). The increase in rents is problematic for the capital, as more than three quarters of its market is made up by rentals with a high share or private rentals: 34 % versus an average of 14 % in the rest of Austria ([55]). Additionally, rising construction and land prices are putting pressure on the availability of social housing, especially in the low and medium-price sector (GBV, 2018a). In November 2018, the city of Vienna adopted an amendment to the Vienna Building Code (new construction areas will have a legal two-thirds quota for the building of subsidised dwellings), with the aim of increasing the availability of affordable housing (RIS, 2018).

Housing demand was particularly strong in the past decade, exceeding housing supply and contributing to price increases. Demand for housing increased strongly after 2011. This holds especially for Vienna, where population growth was particularly high. Until 2010, housing demand was mostly driven by decreasing household sizes. Since then, net migration has been the main contributor. In contrast, housing supply, as measured by the completion of new dwellings, dropped considerably after the crisis. This accumulated an estimated excess demand since 2009, reaching 55 000 dwellings in 2016. This likely contributed to the strong increase in housing prices; demand is estimated to have peaked in 2016. In 2017, building completion increased again and investment in construction also picked- up. Investment in construction includes not only investment in new buildings but also renovations. Rising number of building permits hint at an increase in housing supply in the coming years. This should help to decrease the pressure on the housing market. Demand and supply are expected to be in line again in 2020 (Schneider, 2019).

An increase in the share of privately financed dwellings and constructions costs contributed to rising house prices and rents. The evolution in the housing market has been accompanied by a change in the structure of housing supply. Since 2005, the share of completion of privately financed housing has increased, while the completion of publicly funded housing decreased (GBV, 2018b). Due to strict rental regulations linked with public funding and subsidies, the share of buildings that are without rental control increased, likely contributing to increasing rents. The decrease in construction of publicly financed buildings is linked to the relative decline in real housing assistance expenditure by 20% since 2010. While housing assistance expenditure per capita decreased in all regions, the largest decrease can be found in Vienna and Lower Austria (OeNB, 2017). The regional differences and overall decrease in public investment in housing assistance and social housing can be linked to the abolishment of the earmarking of housing funds in 2008. This allows for the use of the redemption of housing loans for non-housing purposes (Mundt, A., Amann, W., 2010, pp 35-44).

Austria's inflation rate is expected to stay around 2 % in the coming years, remaining also above the euro area level. The strengthening of the economy is mirrored by robust headline and core inflation, which stood at 2.1 % and 1.9 % in 2018, respectively. The thriving tourism sector is contributing to rising services prices, especially in hotels and restaurants, but increasing rents also contributed to the overall price increase. Rising wages and strong domestic demand are expected to boost domestic price pressure, mainly in the service and industrial goods sector. With 2.0 %, Austria's headline inflation is expected to remain above the euro area average of 1.4 % for 2019 and

1.5 % for 2020 (see Graph 1.2).

Belgium:

Further investment in transport infrastructure and energy transition, innovation, education and training would strengthen Belgium's long- term growth potential, while helping to address regional disparities. Total investment in Belgium is among the highest in the EU at 23.5 % of GDP in 2017. The relatively good performance overall is due to private investment. By contrast, low public investment has led to a decrease in the quality of the national infrastructure, especially roads and railways. The renovation of the old building stock, which predates the introduction of energy norms, will contribute to meet the 2020 and 2030 emission reduction targets. In the light of Belgium's commitment to fully phasing out nuclear energy by 2025, there is a need for major investment in power generation, as well as interconnection capacity, smart grids and storage. Addressing labour shortages, especially of employees with backgrounds in science, technology, engineering and mathematics, will require investment in the training and education system. There are important needs in terms of social infrastructure (Early Childhood Education and Care, social housing, schools) and workers in the social sector. Digitalisation of public services and justice, as well as the reinforcement of certain regulators, would improve institutional governance. Annex D identifies key priorities for support by the European Regional Development Fund and the European Social Fund Plus, building on the analysis of investment needs and challenges outlined in this report.

Investment has also been supported by housing and the public sector. Low mortgage interest rates and low yields on alternative investment assets played a role in the sustained real estate investment growth seen since 2014, which slowed down however in 2017. The local government investment cycle in the run-up to local elections in 2018 drove public investment in 2017-2018, although to a lesser degree than in previous cycles. The public investment-to-GDP ratio of around

2.2 % is expected to edge up over 2018-2020 (see Graph 1.2), but to remain among the lowest in the EU.

Taxes on rental income are low in Belgium. When immovable property is rented out for housing purposes, it is not the rental income received but the outdated cadastral income (indexed value of 1975 estimated income) that is included in the personal income tax base. Using the actual rental income received as the tax base and granting a tax deduction for related expenses would make the tax system more asset-neutral and less distortive. A Commission study (European Commission, 2019a) estimated that taxing net rental income would have a positive budgetary impact of 0.3 % of GDP. This additional revenue could be used in a more growth-friendly way, for example to further reduce the tax burden on labour. Moreover, making all rental expenses fully tax-deductible could stimulate the building sector, improve the quality of the housing stock (encouraging energy-saving investments) and help reduce the informal economy. Any reform should, however, be carefully considered against the background of (rental) housing market policies and of its budgetary impact.

FINANCIAL SECTOR AND HOUSING

The financial sector appears relatively sound, but its profitability is under pressure. Bank solvency is good; the capital adequacy ratio was stable at 18.4 % in June 2018. Credit quality is high, with low non-performing loan ratios. Banks remain relatively profitable, with return on equity ratio close to 9 % in 2017 (above the euro area average of 5.6%), but slightly weakening since the beginning of 2018. The challenges for banks remain largely the same as last year: a high cost- to-income ratio, a relatively high banking tax, the obligation to pay a minimum interest rate (0.11 %) on regulated savings accounts (which puts net interest margins under pressure in the current low interest rate environment), digitalisation, compliance costs, clients changing preferences and intense competition. In light of the delayed privatisation of Belfius, state ownership remains substantial.

Dexia still represents a sizeable, but relatively stable contingent liability of EUR 33.5 billion (7.4 % of GDP) for the Belgian state.

The contributions to the Belgian Deposit Guarantee Scheme (DGS) are not invested in a segregated, diversified portfolio of low-risk assets. As explained in previous country reports, the absence of a ring-fenced and autonomous DGS is not optimal from a financial stability perspective. Contributions to the Belgian DGS (around EUR 3.4 billion altogether in December 2017) directly enter the federal budget as tax revenues and contribute to reducing the deficit. If the DGS needs to intervene and compensate depositors, Belgium will have to finance the entire cost of the intervention from the budget.

Insurers' solvency has been broadly stable, even though traditional life insurance business continues to suffer from the low interest rate environment. Insurers' average solvency ratio has improved slightly from 176 % in 2016 to 192 % in 2017. As in other Member States, this ratio sometimes benefits significantly from particular adjustments of the Long-Term Guarantee package of EU measures. Life insurance slowly moves from traditional, guaranteed interest rate contracts to unit-linked contracts. Some insurers have also taken measures to accelerate the transition to a more sustainable business model, including by selling part of their legacy portfolio (see European Commission, 2018a). Finally, life insurance premiums are taxed more than contributions to accumulating investment funds ('*SICAV de capitalisation*'), limiting the asset-neutrality of the tax system.

Access to finance

Small and medium-sized enterprises (SMEs) continue to have good access to finance although the situation has relatively deteriorated. Belgium is performing well in equity funding and professional 'business angel' funding for new and growing firms. Belgian corporates tend to be significantly less dependent on loans from the financial sector than their EU peers. This relative (albeit decreasing) preference for equity over debt might be partly due to the former Belgian regime of "notional interest deduction". The market capitalisation of Belgian quoted non-financial corporations reached 67.3 % of GDP in 2017, higher than the EU average (54.2 % of GDP) confirming the preference for equity. The borrowing cost for small loans relative to large ones is half the average cost in the EU. However, the number of rejected SME loan applications has increased marginally. This finding is in line with the 13.6 % of respondents to the SAFE survey who indicated that banks were less willing to provide loans in 2017, against 9.7 % in 2016. Meanwhile, access to public financial support appears to improve, with only 9.7 % those respondents indicating a drop in 2017, against 14.2 % in the previous year.

Lending to non-financial corporations has accelerated and will require specific monitoring. Because of the persistent low interest rate environment, credit growth remains substantial. In particular, the year-on-year growth of loans to non-financial corporations, corrected for sales and securitisation, is the highest in the euro area (10.1 % in October 2018, against 2.8 % in the euro area) and needs to be closely monitored. While credit developments are supported by a broad-based trend, specific one-off factors also played a role, like merger and acquisition operations and advance payments of taxes by non-financial corporations. Households' indebtedness

The increase in households' debt since 2005 remains in line with fundamentals, while substantial. Belgian households' indebtedness overtook the euro area average in 2015 and reached 59.8 % of GDP in 2017, against 56.9 % of GDP in the euro area. By contrast, indebtedness has started to decline on average in the euro area in the wake of the financial crisis. Households' debt remains however close to the level suggested by economic fundamentals. Households' private debt norm ([24]) points to limited deleveraging needs for Belgium (around 10 %) according to the prudential threshold.

Belgium house prices currently present limited signs of overvaluation. After a period of dynamic growth between 1998 and 2008 (5 % average annual increase) house prices have risen by 2.2 % on average annually in nominal terms since 2008 and by 0.7 % per year in real terms. Steadily increasing house prices explain part of the increase in households' debt, as the latter is mostly mortgage-based. Traditional indicators (price to income, i.e. affordability and price-to-rent i.e. dividend) signal a potential 15 % overvaluation gap of Belgian house prices. However, a more sophisticated indicator developed by the European Commission, which takes into account housing demand and supply fundamentals like interest rates shows no evidence of overvaluation, whereas the National Bank of Belgium valuation model only finds a slight overvaluation (6.5 %) (National Bank of Belgium, 2018).

In April 2018, a macroprudential measure addressing risks in the residential mortgage market entered into force. ([25]) The measure aimed at addressing several risks, including loose credit standards, rising households indebtedness, a substantial share of vulnerable households, a relatively high banking exposure to mortgages and the possibility of a future correction in real estate prices. By increasing banks' resilience to a downturn in the mortgage market, this measure has achieved its primary objective. At this (still early) stage, it does not seem to have affected mortgage interest rates or credit growth.

The generally favourable wealth position of households is considered as a positive factor further softening sustainability concerns about households debt. Belgium households hold more assets on average than euro area households and have positive net assets positions. Nevertheless, the distribution of assets and debt points to pockets of vulnerability. 3 % of outstanding mortgage debt is held by households that have a mortgage loan-to-value above 80 % and pay more than half of their income in debt service. Moreover, 5.9 % of debt is held by households that have a mortgage loan-to-value above 80 % and do not have enough liquid assets to serve more than 2 months of debt payments. It implies that, because financial wealth is unequally distributed, a severe unemployment shock with income loss could hurt many mortgage- indebted households involving a significant part of total outstanding mortgage debt (Du Caju, 2017).

In parallel, there are important investment needs in social housing. In Belgium, the percentage of social housing compared to total housing market is rather weak (6.5 % of all dwellings), in particular in comparison to the Netherlands (34 %) and France (18.7 %). All regions are affected, in particular Brussels where the demand would be double to the offer.

The building stock in Belgium is old and a large part has been built before the implementation of energy norms. In a recent study the Federal Planning Bureau estimated that the annual renovation rate in the residential sector to ensure the energy transition in Belgium according to both the 2030 Climate and Energy framework and a low-carbon economy in 2050 would have to increase from 0.7 % to 1.3 %, which would represent roughly 800.000 housing units over the period 2019-2030. On average, 30 % of firms' building stock satisfies high energy efficiency standards, which is notably less than the EU average (37 %). The difference from the EU average is higher for the large Belgian firms. The final report on carbon pricing puts forward even more ambitious annual renovation rates of 2.6 % of the residential building stock (~120.000 buildings per year).

Czech Republic:

The Czech Republic performs relatively well on the indicators of the Social Scoreboard supporting the European Pillar of Social Rights. The labour market is strong and the country is one of the best performers in addressing the overall risk of poverty and the social exclusion rate. However, the country shows a low participation in early childhood education and care. Gender inequalities in terms of pay and employment remain high due to parental leave rules and a lack of affordable childcare and long-term care facilities. While the poverty rate is low, there is a lack of affordable and quality social housing and the personal indebtedness of certain socio- economic groups and homelessness are increasing.

The affordability of housing is deteriorating due to increasing prices. Both house prices and the volume of mortgage lending have grown fast since 2016 on the back of economic expansion, strong wage inflation and supply constraints. House prices are estimated to be slightly overvalued but still below the level of significant risk. In this context, the Czech National Bank has issued macro-prudential recommendations, which, however, are not binding. Furthermore, the central bank has reacted to the increased activity in the credit market and inflationary pressures, by increasing the base rates 7 times in 16 months.

Most regions have unused potential and require tailored support based on their specific needs. While richer regions suffer from housing unaffordability and pressures on the suburban transport networks, the poorest areas face weak connectivity, demographic pressures, social exclusion, and low focus on innovation. Tailored measures could address these disparities and increase positive education outcomes, foster upskilling and improve the infrastructure.

The lower investment in transport infrastructure can increase regional disparities. Being a transit country places great demands on the Czech Republic's infrastructure and its different forms of transport. However, investment in transport infrastructure is below EU average levels. The completion of the European transport corridors is far from being finalised and the suburban transport infrastructure remains deficient, limiting the ability to commute for work and housing affordability. Weak transport links also deter business activity, particularly in remote regions.

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The distribution of opportunities and challenges is concentrated in certain areas. In general, rural regions are poorer, have a lower productivity, higher gender inequalities, increasing levels of homelessness, high indebtedness, a higher early- school leaving rate, low capacity to innovate and acute demographic challenges (Graph 1.6). These regions also witness increasing numbers of socially excluded localities and seizure orders, while facing a lack of affordable social housing. The gap between Prague and Brno and the less developed regions has further increased, most visibly compared with the Northwest region. Migration towards richer regions is increasing the process of suburbanisation in metropolitan areas, putting pressure on the housing stock and infrastructure networks (see Section 3.4.3).

House prices are estimated to be slightly overvalued. Both housing prices and the volume of mortgages have grown fast since 2016, on the back of economic expansion, strong wage inflation and supply constraints. Depending on the methodology used, house prices are estimated to be overvalued in the range of 0 to 10 %, still below the level of significant risk. In addition, household debt is still moderate compared to the EU average, despite increasing in the recent period. To control credit growth, the CNB has implemented a number of measures directed at lenders and borrowers.

Receipts from labour and consumption taxes have been increasing. Net social contribution revenues have increased in recent years on the back of a buoyant labour market and economy. By contrast, revenues from direct taxes, which mostly include taxes on income and wealth, are still significantly below the levels seen in the EU and EA. The share of direct taxes collected from households (mainly from labour income), for example, accounts for 4.0 % of GDP compared to 9.2 % in the EA. On the other hand, the implicit tax rate on employed labour is higher than the EU average ([7]) due to a higher reliance on social contributions (Graph 3.1.1). As a share of GDP, receipts from the corporate tax (3.5 %) have been slightly above the EA average (2.7 %). While the recurrent property tax is one of the least harmful taxes to economic growth (OECD, 2010), the receipts collected in the Czech Republic remain very low. In addition, the tax deductibility of mortgage interest decreases the cost of home ownership, contributing also to the housing price dynamics ([8]). Environmental tax intake remains relatively low, representing only 5.9 % of all taxes and social contributions collected in 2017.

Housing market

Housing prices grew swiftly in 2017 but the escalation moderated in 2018. According to Eurostat, deflated house prices in the Czech Republic grew by 9.1 % on average in 2017, one of the fastest growth rates in the EU. However, these have moderated since the end of 2017, growing by 5.7 % year-on-year in Q3-2018. Since the beginning of 2015, the 23 % cumulative growth has been one of the highest in the EU and has outpaced real wage growth by more than 10 pps. As a result, housing affordability has been deteriorating.

Estimates indicate moderate positive valuation gap in the Czech housing market in the range of 0-10 %. Three standard metrics ([15]) of the degree of imbalance, based on historical averages for price-to-income and price-to-rent ratios, suggest little overvaluation of the housing market in 2017 (Graph 3.2.3). The highest gap relates to the price- to-income ratio compared to historical average. This estimate is close to the CNB's model-based approach, which suggests that in mid-2018 apartment prices were around 10 % above levels consistent with fundamental factors.

According to the CNB, the affordability of apartments declined between 2015 and 2017. This relates to both price-to-income and debt- service-to-income ratios (CNB, 2018)**.** Some analyses on the price-to-income ratio (OECD, 2018) confirm this assessment and estimate that affordability in Q2-2018 was very close to the 2008 price levels. Other sources suggest the Czech Republic is the country with the least affordable own housing in 2017 in a sample of 12 EU countries ([16]). Affordability of housing may further deteriorate due to increasing interest rates on mortgages.

The debt of the borrowers should not exceed nine times their net annual income. To address the risk linked to loans with high loan-to-value ratios and take into account borrowers' ability to repay, the CNB has introduced two supplementary recommendations as of 1 October 2018. In terms of debt-service-to-income, applicants should spend no more than 45 % of their net monthly income on debt service. The debt-to-income rate was set at nine times the net annual income. Furthermore, only 5 % of the new loans provided in a trimester may exceed the limits on the debt-to-income and debt-service-to-income ratios. Through the new measures, the CNB intends to reduce borrowers' vulnerability and cool the housing market. The three recommendations are complementary and their interaction could lead to even stricter limits.

Certain private banks suggest the new debt- service-to-income limits are the most constraining factor as they prevent standard housing loan applicants from obtaining the maximum value of a loan.

Interest rates for new mortgages have increased slightly but are expected to have only a limited effect on demand. The average rate has moved from an historical low of 2.1 % in November 2016 to 2.6 % in September 2018 in line with the increase of the 2-weeks repo interest rate from 0.05 % to 1.75 %. Thus, new borrowers could face higher debt service costs due to higher mortgage rates and the fact that, until recently, their incomes have grown more slowly than housing prices. The new debt-service-to-income limit and the recommendation that lenders should assess clients' debt servicing capacity for a scenario of a 2 pps lending rate increase should protect future borrowers. Mortgage rates are still relatively low and attractive for clients, both in terms of consumer price inflation and income growth.

Recent data on started dwellings and building permits indicate a drop in the coming quarters. The number of completed dwellings grew by 4.6 % year-on-year in 2017 based on the nationwide average, but declined by 4 % in Prague. The completion of dwellings accelerated in the three first quarters of 2018 and reached a 20.2 % year-on-year growth in Q3-2018. As a result, figures on construction output and investment in construction obtained from the national accounts have been buoyant during that period. These dynamics may change, as the number of started dwellings decelerated in 2018 and its year-on-year growth rate turned negative (-1.6 %) in Q3-2018. Moreover, labour shortages and associated wage pressure are becoming a particularly acute constraint in the construction sector.

Burdensome planning procedures continue to limit housing supply. Demand has continuously outstripped supply in some regions, particularly in Prague and other large cities, contributing to the increase in house prices. Although completion of new dwellings is enough to absorb the low demographic growth of the country, household size fell to 2.37 persons in 2017 ([17]). Meanwhile, the expansion of Airbnb and other shared accommodation companies helps to explain the rise of real estate prices in Prague. Because of sustained housing demand growth, sufficient supply could mitigate upward pressures on prices and affordability.

The flow of newly issued building permits remains far below historic averages. The number of building permits for dwellings issued in 2017 was 3.4 % higher than in 2016 but was the fifth lowest in the last 20 years. Although the trend has been positive since 2015, the outturn of 2017 noticeably decelerated compared to

2016 (7.3 %). The outlook is not positive, as 2018 is expected to end in the red (-3.1 % year-on-year growth in Q3- 2018). In this context, a new construction law is under preparation (see Section 3.4). The regulatory burden is also augmented by regional disparities and planning rigidities. A new metropolitan plan for Prague is under discussion, to replace the old one adopted back in 1999. On average, 21 procedures need to be undertaken to receive a building permit in the country, compared to 12.5 across OECD countries (World Bank, 2018a).

Over-indebtedness and property seizures have multiple causes, notably unpayable mortgage loans. High mortgage loans related to rising housing costs (see Section 3.2), high consumption on credit, failed business projects, lack of social capital, poor financial literacy, and loss of income from economic activity are among the causes on the debtor side. As for the creditors, insufficient screening of loan applicants is highlighted. Lastly, the institutional set-up via arbitration clauses, difficulties in penalising usury, regulation allowing deliberate abuse of the system by creditors.

There is a growing number of socially excluded localities. Housing exclusion and homelessness, high indebtedness and unemployment affect the most vulnerable groups, including Roma. The number of socially excluded localities has almost doubled in 2006-2014 but in the Moravskoslezský and Karlovarský regions it has more than tripled (see Country Report 2015). Recently, the inhabitants of socially excluded localities have been moving to more remote municipalities with less functional infrastructure.

Housing exclusion and homelessness are increasing among low-income households, while related policies are lacking implementation. The draft Act on Social Housing, which was supposed to set eligibility and quality criteria for access to social rental housing, was not adopted in 2018. The current legislation does not sufficiently address the lack of affordable and quality social housing and its negative social impact and there are no plans to revise it until 2023. Instead, the government plans to replace it with a subsidy- credit programme called 'Construction'. This program would finance social housing for people at risk of exclusion, but above all accessible housing 'in the public interest', e.g. to attract bottleneck public professions in the municipalities. However, the proposal lacks an integrated approach combining social services with housing, despite the proven success of piloted ESF projects, such as Rapid Rehousing. Regional social disparities were also supposed to be addressed in a coordinated approach of the 'RESTART' strategy. However, implementation of the social aspects has been limited due to lack of political support. Further investment, including in food and basic material assistance for the socioeconomic integration of the socially excluded is also needed.

A harmonised rollout of financial instruments is vital for addressing all investment needs. As interest rates for commercial loans are increasing and the Czech Republic is to receive less EU funds in the future programming period, there is room for financial instruments to be used more broadly, mainly in the form of preferential loans or in combination with available grants. The use of venture capital, business angel funds and revolving funds is also rather low. Most investment needs are in areas such as support to SMEs, start-ups and social entrepreneurship, student mobility, housing, regeneration of brownfields, energy efficiency, digitalisation, broadband networks and waste management. In addition, the European Fund for Strategic Investments is not fully used to address needs related to revenue-generating and cost- saving activities. In this regard, there may be a need to develop appropriate structures and introduce demand-side measures to increase the attractiveness of financial instruments.

An efficient suburban transport infrastructure can increase labour mobility and affordability of housing. While the process of suburbanisation has been developing in metropolitan areas, the suburban transport networks are lagging behind, particularly as regards the rail infrastructure. An efficient and integrated commuting system (including park & ride and car sharing systems) could potentially increase affordability of housing (see section 3.2), positive education outcomes, health and social services in the large agglomerations, while also ensuring better mobility for the labour force. Measures could be undertaken in coordination with sustainable urban mobility planning (including low emission zones in the cities). This could improve the health and safety of people affected by the breaches of the air quality standards, resulting partly from ageing commercial vehicles.

Metropolitan areas face pressures on their transport infrastructure, high costs of living and lack of affordable housing. Despite having higher productivity, better education, improved innovation capacity and better connectivity, Prague with its adjacent areas in Central Bohemia and Brno suffer from certain negative externalities. Of particular importance is the process of suburbanisation which requires these places to upgrade their transport networks (i.e.: completion of the Prague Ring) and find innovative solutions regarding housing affordability.

Social challenges at regional level are increasing. Priority investment needs have been identified to **promote the socio-economic integration of the most deprived**, **and to improve access to social, healthcare and long-term care services with a view to reducing health inequalities,** including by developing infrastructure, and in particular to:

- further promote a coordinated approach to the socioeconomic integration of the socially excluded, such as the Roma, including through food and basic material assistance, access to employment, health and social services, financial counselling, targeted education/training, and measures to tackle housing exclusion;
- support de-institutionalisation of care particularly for children under 3, people with disabilities, the elderly and people with mental disabilities; cooperation between health and social services; strengthen and improve access to primary care particularly for vulnerable groups; integration of care and prevention.

Denmark:

The favourable economic environment has helped reduce the current account surplus and brought down the level of household debt, but challenges remain. Labour market and pension reforms have helped bring the number of people in employment to historically high levels. However, companies are increasingly reporting shortages of skilled workers, and the government is falling behind on its 2025 targets to boost productivity growth and the supply of labour. Although high on the government's reform agenda, productivity growth has been particularly weak in domestically oriented services sectors. Savings surpluses have arisen in Denmark, and are reflected in its still sizeable current account surpluses. This has increased the value of households' housing and pension assets. The value of these assets remains higher than household debt, and policy measures have strengthened households' resilience to economic shocks. However, the high level of household debt, combined with overvalued housing prices, make households vulnerable to sudden changes in interest rates or the economy.

Although housing price inflation is gradually slowing down, property prices remain overvalued. While housing price increases have so far been driven by the main urban areas, these increases are gradually spreading to the remaining parts of the country. Strong residential construction activity, a new property taxation system, and macroprudential measures should reduce housing price inflation.

Household consumption is forecast to remain the main driver of economic growth, while the contributions of other GDP components are projected to weaken. A number of fiscal measures (2) are expected to boost household incomes in the coming years, supporting robust private consumption in the future. Rising house prices are forecast to maintain some of the impetus for investment in housing, but as the number of housing permits has been declining continuously since their peak in the fourth quarter of 2016, growth in housing investment is set to slow down from the second half of 2018 (see Section 3.2). The outlook for exports and equipment investment is projected to deteriorate as growth in Denmark's main trading partners is expected to weaken. Trade-related uncertainties could negatively affect exports. Imports are set to remain robust due to the continuing strong domestic demand.

Housing market and private indebtedness

The housing market is gradually slowing down, but housing prices remain overvalued. Buoyant residential construction and forthcoming changes to property taxation and valuation are all dampening housing price inflation. Stark regional housing price divergences have started to ease with nationwide trends being driven by property price increases in areas adjacent to urban agglomerations. Despite their slower increase, housing prices remain above their underlying fundamentals, entailing the risk of a disorderly correction with negative effects on the real economy and the financial sector. The risk has also been highlighted by the European Systematic Risk Board (ESRB, 2016).

Danish households have continued to reduce their debt, but the deleveraging process may have come to a temporary halt in 2018. Household debt has fallen from 274.5 % of disposable income in 2014 to 255 % in 2017, while the debt-to–GDP ratio fell from 131.5 % to 128 % during the same period. While lending to households hovered around a 1.5 % in 2018, weak nominal GDP growth in 2018 indicates a stagnating indebtedness ratio. Commission estimates indicate further deleveraging is needed as household debt exceeds levels consistent with economic or prudential fundamentals (Section 3.1).

Danish households remain vulnerable to sudden changes in interest rates and income shocks. The risks for the real economy are amplified by the high level of household debt. Danish households have one of the highest debt-servicing ratios in the EU, and despite positive developments, the share of interest-only, variable interest rate loans, which are the most sensitive to shocks, remained high. Half of the mortgage loans are still interest-only. Following an interest rate or income shock, most households would still be able to service their debt, but such events could markedly decrease consumption and investment. Although the latest macroprudential measures have been effective in restricting the availability of new risky mortgage loans (i.e. high loan-to-value and debt-to-income mortgage loans), it will take time until the positive effects will be visible in the overall mortgage stock and effectively reduce overall risks.

The 2011-2012 recommendation to strengthen the stability of the housing market and the financial sector in the medium-term was dropped following several initiatives from Danish authorities. Macroprudential measures to safeguard financial stability have been adopted. These include the 'supervisory diamond' aiming at reducing risky lending by commercial banks and mortgage institutions (to be fully implemented by 2019 and 2020, respectively). The introduction of a loan-to-value cap for mortgage loans, and a 5 % compulsory down-payment for new loan applications, also aims to reduce risky mortgage lending. More recent measures include the activation of the countercyclical buffer in 2018, which will reach 1.0 % of risk-weighted assets in 2019. Further macroprudential measures took effect from 1 January 2018 requiring amortisation for mortgage loans with high loan-to-income values subject to variable interest rates. A reform from May 2017 will re-align property taxes with actual property values by 2021, putting an end to the pro-cyclical property tax, which also fuelled regional house price divergences. However, progress with the new valuation system behind the property tax reform has been delayed.

Denmark continues to have one of the highest mortgage debt tax biases in the EU. Denmark is among the nine countries in the EU with mortgage tax relief. This implies a preferential treatment by the tax system of debt-financed housing. Gruber et al. (2017) highlight how deductions for mortgage interest expenditure induces households to increase indebtedness. Some steps have been taken to reduce mortgage interest deductibility for high mortgage interest payers between 2012 and 2019.

Different technical assumptions lead Danish authorities and the European Commission to project different debt trajectories in the future. Public debt is expected to have fallen to 33.3 % of GDP in 2018. Under the European Commission baseline scenario, government debt is expected to fall to 10.8 % of GDP in 2029 (see Annex B). The Danish authorities, however, expect public debt to fall less by 2029. This is primarily due to reforms in the financing of housing and of housing taxation, which will result in a build-up of government assets and liabilities (Ministry of Transport, Building, and Housing, 2017). These reforms are expected to reduce the financing costs of housing and to allow homeowners to postpone property tax increases.

HOUSING MARKET AND PRIVATE INDEBTEDNESS

Housing market

The housing market appears to be switching into a lower gear. With the exception of a peak in the first quarter of 2018, the annual growth rate of nominal housing price has moderated from 6.3 % in 2015 to 3.0 % in the third quarter of 2018. Nationwide housing price trends have been recently fuelled by property price increases in areas adjacent to urban agglomerations. However, increases in these areas have also moderated since the second quarter of 2018.

It also appears that housing price pressure has started to moderate in the Copenhagen area. Denmark has so far been the EU country with the most significant divergence between property prices in the capital city and the rest of the country (European Commission, 2017b; and Gaál, 2017). Notwithstanding a surge at the beginning of 2018, quarterly real housing price growth for both family houses and apartments has been moderating in the capital city. The number of dwellings for sale jumped in 2018, and an increase can be observed in the amount of time that dwellings are advertised on the market in Copenhagen. Besides high price levels, several additional factors appear to support a broader geographical spread of housing price growth and lower demand in the capital area.

Rapidly increasing residential construction kept pace with increase in housing prices. Having bottomed out in 2013, residential construction has been growing at an average annual rate of 7.7 % since 2014, increasing its share of GDP from 3.7 % in 2013 to an estimated 5 % in 2018, above its long-term average of 4.7 %. Copenhagen has experienced the largest rise in construction activity. The number of new dwellings per head of population is still below the level reached in the first quarter of 2008 in the country as a whole, but they are well above this 2008 level in Copenhagen (Graph 3.2.2). As a result, following several years of shortages, the housing stock increase now appears to match population growth in the capital area, with a dampening effect on housing prices.

The decline in building permits indicates slower construction growth in the near future. The number of building permits has decreased 21 % since the fourth quarter of 2016. This indicates weaker housing constructions going forward. New dwelling construction has not been targeted only at owner-occupiers: almost half of the newly constructed dwellings in the last five years in Copenhagen have been for private rentals. Since these new rental dwellings are not subject to rent control (as compared to the rental dwellings built before 1991 that still comprise still around 80 % of the existing stock), these new constructions will increase the flexibility of the rental market, supporting labour mobility.

The new property tax system could already be having an impact on the housing market. The new system taking effect from 2021 will restore the link between property market valuations and taxation. The updated valuation system will mean that dwellings (particularly apartments) situated in urban areas will be subject to higher taxation. The anticipated new system may therefore already be dampening price increases in the Copenhagen area while supporting prices for dwellings outside cities (Danmarks Nationalbank, 2017).

Housing prices in Copenhagen have been increasingly driven by foreign investors. In 2011, almost no foreign investors were active in Denmark's residential property market. By contrast, foreign capital was responsible for half of the property purchases in 2017, mainly by investors from Norway, Sweden, Germany and the United States. The market appears to have peaked in the first quarter of 2018, after which the share of foreign investors in property purchases started to decline. These trends are in line with those of other main capital cities, as current global financial conditions support similar changes in housing prices in advanced economies (Alter et al 2018).

Despite the slower increases, housing prices remain higher than predicted by underlying fundamentals. The overall valuation gap ([10]) shows a potential overvaluation of around 10 % in 2017. While the price-to-income and price-to-rent indicators have continued to increase above their long-term average, prices have been relatively stable compared to the model based estimations. The European Systemic Risk Board has also issued a warning in 2016 to Denmark pointing at medium-term vulnerabilities in the residential real estate sector due to increasing housing prices and high household debt (ESRB, 2016).

Household indebtedness

While households have been reducing their debt since the peak in 2009, the deleveraging process may have come to a temporary halt in 2018. The deleveraging process has been more pronounced when household debt is compared to disposable income. This ratio fell from 274.5 % in 2014 to 255 % in 2017, while debt-to-GDP fell only modestly from 131.5 % to 128 % during the same period (Graph 3.2.4). The household-debt-to-financial-assets ratio has decreased even faster, from 61.7 % in 2008 to 41.7 % in 2017, which is the lowest value since 2000. While lending to households remained modest, hovering at a growth rate around 1.5 % in 2018, weak nominal GDP growth in 2018 indicates a stagnating indebtedness ratio. Nevertheless, strongly rising household disposable incomes, higher nominal GDP growth rates and stable flows of credit suggest continuation of the slow deleveraging trends from 2019.

Commission analyses suggest a need for further reductions in household debt. Despite its gradual decrease, Danish households' gross indebtedness remains the highest in the EU and well above what fundamental drivers would suggest. Danish households' gross indebtedness is also well above the level generally associated with higher risks of a banking crisis. ([11]) These benchmarks suggest a need for further deleveraging of a magnitude of 30 % to 60 % of GDP in order to limit potential macro-financial stability risks. In the aftermath of the real estate crisis in 2008, the financial sector remained resilient. However, the impact on the real economy has been significant, causing suppressed domestic demand even ten years after the crisis and a potentially altered household consumption pattern (Section 1).

Although there have been positive changes to the composition of the mortgage stock since 2014, the developments are less favourable when compared to pre-crisis levels. The share of variable-interest-rate mortgages (with interest rates fixed for less than a year) has reduced from its peak of 39 % in 2011 to 25 % in 2018, similar to the levels in 2008. Interest-only loans with variable interest rates, which are the most sensitive to the rise of interest rates, have been stagnating at around 11 % of the total mortgage stock since 2013, higher than their 2008 level. The share of interest-only loans remained high and rather stable hovering at around 45 % of the total mortgage stock since 2008.

Danish households remain vulnerable to sudden changes to interest rates and income shocks. Although amortisation, as a share of GDP, has risen, debt servicing costs as whole have fallen due to decreasing interest rate expenditure. That being said, debt servicing costs of Danish households are still one of the highest in the EU. The interest rate sensitivity of the mortgage stock on average is relatively moderate, it is sizeable for highly indebted households. A 1 percentage point increase in interest rates would have reduced households' total disposable income on average by 0.7 % in 2016. But for the most indebted households an interest rate increase of 1 percentage point, would have reduced disposable income by 2.7 % despite the impact of generous mortgage interest deductibility (Danmarks Nationalbank, 2018a). With an income shock of this magnitude, most households would still be able to service their debt. However, considering the high debt servicing ratio, such a shock could markedly decrease consumption and investments.

The Danish authorities have adopted several macroprudential measures to increase the resilience of households. In 2016, the Financial Supervisory Authority adopted 'seven best practices' for mortgage lending in high growth areas. However, these guidelines had only limited impact on reducing new loans with high debt-to- income levels (Danmarks Nationalbank 2018b). New and stricter macroprudential measures were put in place at the beginning of 2018. As a result, the share of risky loans ([12]) decreased markedly from 12 % in the fourth quarter of 2017 to 6 % in the second quarter of 2018 at national level. The share of risky loans has fallen the most in Copenhagen, declining from 19 % to 8 % during the same period (Ministry of Industry, Business and Financial Affairs, 2018a). Although the latest macroprudential measures appear to be effective for new loans, it will take time until the positive effects will be visible in the overall mortgage stock. Therefore high household debt and the high share of risky loans within the overall mortgage stock continues to represent a macroeconomic risk.

Macroeconomic perspective

At an estimated 21.7 % of GDP in 2018, aggregate investment in Denmark has risen above EU average levels. Public investment continues to remain high. Corporate investment is gaining momentum, reaching levels above its average for the past three decades. However, it remains broadly in line with the economic cycle. Moreover, household investment has picked up from low levels, supported by rising housing prices.

Denmark is implementing its recently launched strategy for the collaborative economy. A recent Eurobarometer survey (European Commission, 2018b) indicates that 26 % of respondents from Denmark (EU: 23 %) have used a service offered via collaborative platforms, most frequently in the transport and accommodation sectors. In May 2018, the government and several opposition parties reached an agreement on more attractive conditions for the collaborative economy. As part of the agreement, a one-stop-shop for companies has been established serving as a single point of contact providing information and guidance on rules. Moreover, the government wants to increase and simplify tax deductions for incomes generated from short-term accommodation rentals up to 70-100 nights per year (depending on the municipality) and the private hire of cars and boats, as long as these activities are intermediated by platforms that report the income generated to the tax authorities. The government thereby seeks to promote entrepreneurship and transparency and to facilitate tax compliance in the sector. This approach, recently implemented by follow-up legislation adopted in December 2018, seems therefore to incentive the development of the collaborative economy. Draft legislation on short- term rental of accommodation is also being discussed. These developments also benefitted from the work done by the Disruption Council.

Finland

Focusing investments ([2]) on human capital, on research and innovation, and on energy and transport infrastructure, would strengthen the long-term growth potential of Finland. While the overall investment level in Finland appears largely satisfactory, investing further in people's skills, education and training and in coordinated professional services to the unemployed and the inactive is needed to offset workforce losses from population ageing, reduce inactivity and long-term unemployment and potentially increase productivity. Employment would also benefit from investment in social inclusion. The ratio of research and development to GDP has not yet recovered from the crisis years and appears insufficient to diversify exports towards higher tech goods in the medium-term. Amid dispersed population, a lack of affordable housing in growth centres and transport bottlenecks may prevent people from moving to find jobs. The decarbonisation of energy intensive industries and the transport sector will also require higher private and public investment. Annex D identifies key priorities for support by the European Regional Development Fund and the European Social Fund Plus over 2021-2027, building on the analysis of investment needs and challenges outlined in this report.

Inactivity and unemployment traps are a barrier to a better use of the labour force. One of the main barriers to getting people back to work comes from the benefits system and the combination of different types of allowances. The social assistance and the housing allowance form a substantial part of this barrier. These and other benefits are phased out rapidly as income increases, which creates a risk that taking up work might not be sufficiently financially rewarding. The complexity of the benefits rules combined with red tape result in people being put off going back to work.

Levels of household debt are high, but servicing of the debt remains solid. Low interest rates and the improved economic outlook have increased the overall volume of lending, especially through housing corporations (which provide a distinctive form of home ownership). Household debt therefore remains at a historically high level. It is mostly at variable rate. Consumer credit is also rising rapidly. The lack of a comprehensive (collecting both positive and negative information on debtors) credit registry prevents banks from having a clear overview of households' overall debt. However, the non- performing loans ratio of the banking sector remains one of the lowest in Europe and banks are well capitalised. The authorities have already taken and are considering further pre- emptive measures to restrict the rising household debt.

A new Finnish wage-setting model has emerged, but labour mobility remains rather limited. In the new wage-setting model, pay rises in the non-tradable sector are linked to the increases first agreed in the exporting sectors. However, no formal agreement on this model has been reached. Wage increases are expected to be kept in check, but upwards pressure on wages is likely as the labour market gradually tightens. Labour shortages are growing in certain sectors as a result of skills shortages and population ageing, while a lack of affordable housing in growth centres may limit possibilities to move to find jobs. A fully modernised legislative framework on zoning and planning is considered.

Finland still has the highest level of construction investment in the EU, especially housing construction. Beyond favourable conditions provided to borrowers, this reflects an ongoing move of the population from rural areas to dynamic urban centres. Housing construction is a non-productive category of investment. However, amid limited regional labour mobility, it is expected to contribute to allocative efficiency usefully (see sections 3.2.3 and 3.4.1).

Housing market

Overall, house prices in real terms remained broadly unchanged in 2018. The prices of new buildings increased marginally, while the prices of the existing stock decreased. In real terms, house price indices clearly show no price pressures. House prices relative to rent levels and income continue to face a downward trend. This development is most likely the result of a high number of newly completed houses with the residential construction sector being at the peak of the cycle. While prices are stable on average, there are sizeable regional variations, with Helsinki metropolitan area and growth centres booking solid price increases and the rest of the country seeing a constant decrease in housing prices (Section 3.2.3).

HOUSING MARKET

House prices in real terms remained broadly stable. In both 2017 and 2018, prices increased modestly in nominal terms, fluctuating around the inflation rate. The valuation gap closed in 2017 (see Graph 3.2.2). Overall, there are no signs of a price overvaluation at national level.

Large regional price disparities are a constant feature of the Finnish housing market. Most of the housing demand is concentrated in the Greater Helsinki area and other growth centres, where most of the new jobs are to be found. The average price per square metre in 2018 in the Greater Helsinki area was hovering above EUR 3 600 whereas in the rest of the country (Greater Helsinki area excluded) it was around EUR 1 600. Despite the moderating effect of a large supply of new housing units in recent years, prices have been increasing faster than income in growth centres. Migration from the countryside to urban areas is continuing, which is clearly having an impact on prices upwards in growth centres and downwards in rural areas. The larger the price gap is, the greater the barrier to labour mobility, especially for lower-skilled workers and families with limited revenues.

It seems that housing construction peaked in 2018. Residential construction expressed as a share of GDP (see Graph 3.2.3), after increasing rapidly in 2016-2017, is estimated to be in 2018 on a similar level as in years 2005-2007 (6.4-6.6 %). Strong housing demand, coupled with low interest rates and rising incomes underpinned the construction sector in recent years. However, the data on residential building permits (in square metre of useful floor area) shows that the construction growth is levelling off. In addition, reported labour shortages indicate that the construction sector is reaching its full capacities. Due to the many projects already started, the momentum might still be strong enough to keep construction level in 2019 similar to 2018. Given the outlook of accommodative monetary policy, it is unlikely that the demand for housing starts to fall markedly, in particular in the prospering regions.

HOUSEHOLD DEBT

At 67.2 % of GDP in 2017, the household debt level is high. Household indebtedness has increased steadily over the last two decades, although it remains below Finland's Nordic peers. In 2017, it increased by 0.2 percentage points only. The relatively low increase can be attributed to a higher growth of GDP. In terms of debt-to-gross disposable income ratio, household debt increased by 2.1 percentage points to 116.0 %. As the value of households' assets increased, the debt-to- financial assets indicator decreased by 0.2 percentage point to 46.1 %.

Quarterly indicators for Q2-2018 show that the debt-to-GDP ratio started to marginally decrease. In parallel, the household savings rate, while at historically low levels, started to increase marginally. If this momentum persists in the second half of 2018, it might represent a turning point in the trend.

The stock of mortgage loans continues to grow. At the end of July 2018, the stock of mortgage loans amounted to EUR 97.1 billion (equivalent to 78 % of the households debt), reflecting an annual growth rate of 2.1 % (see Graph 3.2.4) compared to July 2017. The stock of loans to non-financial corporations amounted to EUR 83 billion, of which loans to housing corporations and rental housing companies accounted for EUR 30.2 billion. The latter segment displays the strongest year-on-year growth rate of over 10 % in the same period due to both ongoing new construction and renovation works.

Average repayment periods are increasing and mortgages are taken at variable rates. Most of the new loans have longer average repayment periods than the existing stock. For the new loans taken in July 2018, the average repayment period was around 20 years, with 60 % of loans being between 20 and 26 years. The majority of the current stock of loans have variable interest rates (usually linked to euribor) and 97 % of new loans have variable rates. Households' total debt includes the exposure to debt contracted by housing corporations. Some households may rely on financing their equity share in housing corporations through unsecured high yielding non- bank loans, which creates potential risks. Overall, the share of loans secured by real estate property in the banks aggregate balance sheet increased over the past three years from 35 % to 43 %.

Consumer credit is rapidly expanding. At a 5 % yearly growth rate (in September 2018 compared to September 2017), it is backed by growing private consumption and the popularity of small non-deposit taking (and thus unregulated) lenders. In view of that, the authorities have stepped up work on a comprehensive Credit Registry that would collect both positive and negative information on debtors and would thus provide a full picture of the creditworthiness of each borrower. Launched in 2019, the registry will take a few years before it is up and running.

Meanwhile, a working group comprising the authorities and stakeholders also discusses additional steps to limit the ability of households to take on further debt, in particular a legislation aiming to cap the debt-to-income ratio.

There are large regional disparities in indebtedness. The disparities grew over the last decade and their development is strongly correlated with house price developments. Indebtedness increased in the country overall but the highest increases were in growth centres (Bank of Finland, 2018).

The authorities have taken pre-emptive macroprudential measures to restrict rising households' indebtedness. The Finnish Financial Supervisory Authority has imposed since January 2018 a minimum average risk-weight of 15 % on all residential mortgages and, since July 2018, a mortgage cap at 85 % of the fair value of the collateral posted at the time of loan approval. The government is also phasing out the tax deductibility of the mortgage interest service. While Finland gradually reduced the share of interest eligible for tax deduction, it still amounted to 50 % in 2018. Mortgage tax relief creates a bias for higher household borrowing and can lead to an increase in macroeconomic risks.

Inactivity traps and social benefits

Inactivity and unemployment traps remain high. Social assistance and the housing allowance as well as other benefits are phased out rapidly as income increases, which creates the risk that taking up work might not be sufficiently financially rewarding. Furthermore, adequacy of benefits is very high ([17]) but their rules are very complex. Combined with administrative practices, this can result in 'bureaucratic traps'. Uncertainty surrounding the level of benefits and the time to reinstate them reduces the attractiveness of short- term or part-time work. The real-income register available to various authorities (see section 3.1) has the potential to address some of the bureaucratic traps related to reinstating the benefits. From 1 April 2019, the uncertainty surrounding the level of benefits will be partly alleviated by a change in the regulations concerning the period when income from part-time or short-time employment is taken into account and has an effect in the amount of unemployment benefit change.

Overall, investment in Finland remained above the EU average, but was predominantly devoted to construction (see Box 3.4.1.)**.** At around 22 % of GDP in the latest four quarters, overall investment remained among the highest in the EU, and was slightly on the rise. However, construction accounted for 59.4 % of overall investment, an increase by 3 percentage points in comparison with a year ago. At 13.3 % of GDP, it was the highest in the EU, and was still rising. Housing construction, one of the least productive categories of investment accounted for almost 50 % of total construction.

Investment needs

Focusing investments on human capital, on research and innovation, and on energy and transport infrastructure would strengthen Finland's long-term growth potential. Untapped human capital can hinder the progress of inclusion and employability and reduce the potential for increases in productivity (see Section 3.3). In parallel, research and innovation intensity has not yet recovered from the crisis years and appears insufficient to diversify exports towards higher- tech goods in the longer term. Amid dispersed population, lack of affordable housing in growth centres and transport bottlenecks may hinder labour mobility. Long distances to external markets are weighting on exporting businesses. The decarbonisation of the energy intensive industry and the transport sector will require higher private and public investment. Research and innovation are also needed to match Finland's carbon neutrality objectives.

2/ Some problems remain in the labour market. A new Finnish wage-setting model has emerged. In this model, pay rises in the non-tradable sector are linked to the increases first agreed in the tradable sector. However, no formal agreement on this model has been reached (see Section 1). Also, obstacles to local bargaining persist, mostly for small and medium-sized enterprises and start-ups (European Commission, 2018b). Low labour mobility partly reflects housing and transport bottlenecks (Poghosyan, 2018 and International Monetary Fund, 2018).

Recent analyses point to a relatively limited regional mobility in Finland compared to EU peers. The huge geographical distances across regions and the relatively low population density constitute natural impediments to cross-regional labour mobility, which is further hindered by housing cost differentials at regional level not matched by regional wage differentials (International Monetary Fund, 2018, and Poghosyan, 2018). The limited regional labour mobility can therefore contribute to persistent labour shortages in certain sectors (see Graph 3.4.8).

France:

Investment remains at a high level, accompanied by the Great plan for investment 2018-2022. Investment represented 22.5 % of GDP in 2017. After several years of contraction, government investment increased again in 2016 and is expected to continue increasing up to 2020. Business investment should ease gradually while remaining dynamic. Housing investment, by contrast, slowed down markedly in 2018 and is set to remain subdued. Under the Great plan for investment 2018-2022 (*Grand plan d'investissement 2018-2022*), France has also planned measures for a total of EUR 57 billion to sustain the greening of the economy, address skills mismatch, foster innovation and digitise public services.

Public and private investments need to prioritise actions to strengthen research and innovation, facilitate the energy and climate transition, improve skills, tackle unemployment, and adapt to the future of work, as well as to respond to inequalities within the country. Improving education, training and innovation performance could stimulate potential growth over the medium term. In a context of emerging skills mismatch, vocational training, together with appropriate employment support and active inclusion, can improve labour market conditions, especially for disadvantaged groups. At the same time, the French authorities have adopted plans to promote investment in the energy sector, which would also contribute to exploit the untapped potential for private investments that remains in renewable energy and buildings' energy efficiency. Investments to improve connectivity, affordable housing, healthcare and transport, especially in more disadvantaged areas, would help to address inequalities within the country. Annex D identifies key priorities for support under the European Regional Development Fund and the European Social Fund Plus for the 2021-2027 period in France, building on the analysis of investment needs and challenges outlined in this report.

After a strong year in 2017, GDP growth in France moderated in 2018. GDP growth stood at 1.5 % in 2018, after registering 2.2 % in 2017 ([2]). Temporary factors, such as strikes in the transport sector, school holidays or unusually warm weather, weighed on French activity at the beginning of 2018. Economic activity accelerated slightly in the second half of 2018, but was impacted by social protests at the end of the year. In this context, private consumption stagnated in the fourth quarter despite several fiscal measures favourable to purchasing power enacted before the social unrest (a decrease in social contributions, a cut in the housing tax and increases in social benefits). Investment remained dynamic overall, although less buoyant than in 2017. Housing investment slowed down markedly following very high growth in 2017, while corporate investment eased more gradually. Public investment eased somewhat. Import growth decreased sharply in 2018, while exports remained robust, though somewhat less so than in 2017. As a result, the contribution of net exports to GDP growth increased to 0.6 percentage point.

GDP growth rate is set to decrease in the near future, while remaining above potential. Private consumption growth is forecast to slowly recover Fiscal measures, including the new measures adopted at the end of 2018, should provide support to purchasing power. Nevertheless, their overall effect on private consumption could be limited in the first few months, translating instead into precautionary savings, in line with the persistence of low consumer confidence levels. Investment growth is set to cool down in 2019 and 2020, as spare capacities are gradually reabsorbed. Public investment is set to keep increasing. Corporate investment is forecast to cool down gradually although staying at a high level, while housing investment is expected to remain subdued. In addition, net exports are expected to be neutral in 2019 and 2020, in line with a rebound in imports. GDP growth is expected to reach 1.3 % in 2019 and 1.5 % in 2020 (see Graph 1.1). Inflation is forecast to reach 1.4 % in 2019 and 1.7 % in 2020, after registering 2.1 % in 2018, as a consequence of increases in oil price and in excise duties

Increasing households' debt does not seem to be a source of concern in the near future. Since 1998, households' debt-to-GDP has kept increasing, uninterrupted by the crisis. The net borrowing flows of recent years have often been in excess of what would be warranted by those fundamentals. Nevertheless, the current debt level (58.6 % of GDP) seems aligned with what fundamentals would suggest. Interest payments are also at a low level and in line with the euro area levels but they could increase in the future as a consequence of the possible monetary policy normalisation. However, the stock of credits is mostly signed with fixed interest rates, which should limit the impact of a potential rise in interest rates (see Section 4.2).

Still, households' private debt mostly consists in mortgage credits and the evolution of the housing market should be closely monitored. The growth of the mortgage stock was particularly rapid (above 5% over the previous year) in 2017 (European Commission, 2018c). As regards the cycle of investment in houses in volume, the gap compared to trend turns positive in 2017 and the first three quarters of 2018, recovering from a trough in 2015 (Bricongne and Pontuch, 2017). At the same time, according to the European Commission's indicators, France presents convergent signs of overvaluation of house prices since 2005 (see Graph 1.8). Overvaluation gaps are on a downward trend since 2011 but slightly increased in 2017. Indeed, real house prices started to rise again in 2016 after 4 years of decline. Overall, according to the European Commission's indicators, the house price gap signals a potential overvaluation of around 10 % in France in 2017 (see Graph 1.8). However, other analysis integrating the evolution of mortgage rates reach the opposite conclusion of no overvaluation (Lalliard, 2017). Heterogeneous developments in house prices can be observed across cities and property types, pointing to the need to monitor house prices at a regional level. Like in other European countries, real house prices in the capital have tended to grow faster than prices at the national level in recent years (ECB, 2017a, Box 3). For houses, cities such as Marseille, Lyon, Toulouse, Bordeaux and Montpellier seem to have higher price-to-income ratios and lower rental yields than the country as a whole in 2017. For apartments, Paris, Bordeaux and Strasbourg have the lowest rental yields (Durre, 2018).

Housing

Public spending on housing amounts to 1.8% of GDP in 2017 (*Comptes du logement, 2017*). A recent reform changes housing policy to improve its efficiency. In 2017, EUR 23.3 billion have been spent on housing benefits in public housing or the private sector *("aides à la personne"*) and around EUR 19 billion on subsidised loans and tax incentives ("*aides à la pierre*"). Personalised housing allowances (*Aide Personnalisé au Logement, APL*) have decreased in 2018 in social housing, alongside a reduction of rents, and are planned to decrease in real terms (for all beneficiaries) in 2019 and 2020. The social security financing law for 2019 provides that personalised housing allowances (APL) allowances will be based on a household's current income (last 12 months), and not on its income of the two previous years. This measure to be implemented in 2019 should generate EUR 700 million of savings this year. In parallel, since 2018 some of the tax expenditures that encourage rental housing investment have been reduced in non- tense areas, to target specific areas where housing supply is insufficient (e.g. the Paris area, cities with more than 250 000 inhabitants). This responds to the observations made by the French Court of Auditors on schemes supporting rental housing investment (worth EUR 1.7 billion in 2016) which are believed to have a limited impact on housing supply and in particular tense areas (*Cour des Comptes, 2018a*).

The housing tax continues to be reduced in 2019. For 80% of households, the housing tax (*taxe d'habitation*) is further reduced by 35 % in 2019 for a cost of EUR 3.8 billion. Part of the decrease of the housing tax effective in 2018 has been offset by an increase in the rate decided by some local authorities. The increase remained overall modest, of 0.49 pps on average in 2018 (v.0.73 pps in 2017). Authorities plan to fully abolish the tax for the remaining 20 % richest households.

The elimination of the housing tax calls for a comprehensive reform of the financing of local authorities. An update of the immovable property tax base for housing properties could be announced in 2019 (See Box 4.1.1)**.** Such an update has already been introduced in 2017 for commercial properties. Authorities could pursue the reform to the benefit of housing properties. Updating the tax base from its outdated 1970 value might entail redistributive effects which may call for a gradual implementation and others specific adjustments. For example, the update of the tax base for commercial properties is being gradually implemented with 10 years transition phase revenue neutral to avoid strong effects. Consultations with stakeholders (and in particular local authorities) will be necessary to ensure a smooth implementation.

Assessing the budgetary and distributional effects of alternative scenarios to reform the immovable property tax in France

Like many other EU countries, France has not comprehensively updated the tax base (‘*valeur locative cadastrale*’) of the immovable property tax *(‘taxe foncière’)* since 1970. France applies a correction coefficient to outdated property values, which does not reflect appreciations and depreciations of property values resulting from the different development of urban areas. These outdated property values generate distortions and potential inequitable effects. The immovable property tax is a direct local tax payable annually by owners of real estate. In 2017, revenues ([1]) of this recurrent property tax reached EUR 32 billion (1.35 % of GDP) to the benefit of local authorities, which determine part of the total tax rates. The elimination of the housing tax by 2022 *(‘taxe d'habitation’*) calls for a comprehensive reform of the local government financing system. Such a reform, including an update of the immovable property tax base, could be announced in 2019.

The European Commission’s Joint Research Centre simulated an uprate of the immovable property tax to better reflect properties’ market values ([2]). To this end, the microsimulation model EUROMOD ([3]), has been enriched with the latest data on reported tax from the EU-SILC([4]). The baseline scenario, reflecting tax-benefit rules in place in 2017, reproduces the current situation of outdated cadastral values. Two alternative reform scenarios are then used to reform the immovable property tax: (1) an uprate by geographical unit (NUTS 2), based on uprating ratios of the commercial properties implemented in 2017; (2) an uprate by housing property type (apartment v. houses) and size (surface in m²), based on an experimentation by the French authorities in 5 departments in 2015([5]).

French banks are mostly exposed to risks common to other euro area banks. Overall, the 2018 EU-wide stress test revealed that French banks’ resilience is close to the European average. An abrupt increase in interest rates represents their most significant risk, together with possible international regulatory fragmentation (Banque de France, 2018). The remaining risks are country- specific. In particular, French banks are confronted with growing private indebtedness of both non- financial corporations (particularly large ones) and households (Graph 4.2.1) and to significant exposure to the Italian private sector via the large retail subsidiaries held in Italy. Fierce competition leads to low average interest rates on housing loans (1.49 % in December 2018). Should such limited profitability from new credit flows persist, the banks' bottom line could be more significantly affected. Finally, some distortions persist, such as the tax on financial transactions and the exoneration of the Livret A (equity and bonds), which tends to penalise capital market intermediation to the benefit of banking intermediation (loans); while the non-deductibility of banks' contributions to the Single Resolution Fund has an opposite effect.

In June 2018, the French government announced a series of measures to improve the integration of newly arrived migrants. The new measures will increase the hours of French classes for newcomers (from 200 to 400 hours, up to 600 hours for illiterate people) with an improved training framework. Access to employment is also expected to be promoted through the creation of specific vocational training pathways for 5000 refugees, 1000 pathways for skills recognition, and linguistic trainings with a vocational dimension. Specific measures for refugees will be implemented (housing, health, better support to claim rights after getting the refugee status). These measures will only start to have an impact from 2019 onwards.

The French Social protection system performs well in comparison to the rest of the world. Taxes and social transfers reduce the gap in mean equivalised disposable income between the top 10% richest and the bottom 10% to 6 times (v. 22 times before redistribution) in 2017. Between the top 20% richest and the bottom 20%, the gap is reduced to 4 times (v. 8 times before redistribution) (*Insee, 2018*). In 2017, the share of people at risk of poverty or social exclusion reached a historical low at 17.1%, significantly below the EU average of 22.4%. The impact of social transfers (excluding pensions) on poverty reduction, at 44.8%, is one of the highest in the EU. Income inequality remained slightly below the EU average but well above pre-crisis levels, with the Gini index at 29.3% in 2017 and the S80/S20 ratio at 4.4. However, in 2017, the rate of material deprivation of people at risk of poverty increased from 7.1% to 9.3% (EU level 2017 at 7.7%). Besides, fixed costs reduce disposable income for specific groups. This is particularly the case for households below the 60% of median income (DREES, 2018), which are already overburdened by housing costs (20.1 % against 4.7 on average in France). The increased taxation applied to fuel and tobacco products in 2018, aimed at influencing consumption behaviour, might have hampered the disposable income of specific groups (IPP 2018). In response to social protest, the government cancelled the increase in energy taxes in 2019.

Social housing supply is limited in certain areas. Despite recent positive developments (124 200 social rental units financed in 2016 and more than 100 000 renovated), shortages of affordable and social housing remain in certain regions. It is estimated that, in 2017, 2.1 million households were in the waiting list for social housing (*Union sociale pour l'habitat*). Overcrowding for more modest households is also increasing due to the lack of accommodation. Stronger investment in social housing, especially in areas with high demand, could reduce social distress and foster labour mobility.

The recently adopted ELAN law (‘*Évolution du logement, de l'aménagement et du numérique*’) aims at better allocating social housing to those most in need. The situation of existing social housing tenants living in tense areas will be now revised every 3 years to ensure that it benefits to the most urgent situations (see Section 4.1) Transparency in the allocation of social housing is also expected to be fostered by generalising a scoring system in large agglomerations. So far, only 2 large agglomerations (Paris and Rennes) have implemented this system. On the other hand, the easier conditions for selling out social houses to private actors could lead to the privatisation of up to 40 000 social housing units per year (compared to the current 8 000 units per year) with potential risks of shortage of social housing (*Fondation Abbé Pierre*). The law is also relaxing standards related to accessibility of people with disabilities, by reducing from 100 % to 20 % the share of new housings to be fully accessible. This change has been criticised by the French Ombudsman and the Council of Europe. An assessment of the changes introduced by the law is planned in 5 years.

Examples of EFSI-backed projects in France
Energy transition: Adestia energy-efficient social housing

- EFSI-backed financing: EUR 200 million, set to trigger total investment: EUR 330 million

The EIB is providing a EUR 200 million loan for modernisation and energy efficiency refurbishment work in 25 000 social housing units. The loan will help to increase the volume of operations by speeding up refurbishments that are more ambitious than originally planned, improving the quality of the housing units and reducing heating energy costs. In addition to the environmental and socio-economic impact, refurbishing these homes and bringing them up to standard will contribute to economic growth in their areas due to the scale of the work undertaken.

High investment needs and gap equally concern energy efficiency in buildings. The share of building stock reported to satisfy high energy efficiency standards is lower for firms in France (22 %) than the EU (37 %) (EIB, 2018). According to the plan for the retrofitting of buildings (‘*Plan de rénovation énergétique des bâtiments*’) adopted in 2017, 500 000 housing units should be retrofitted annually by 2020, of which 120 000 in social housing units, and 380 000 in private housing units. According to I4CE (2018), the investment gap reached 5 to 8 billion euros in 2018, accounting for 60 % of the total climate investment gap. Despite the multiplicity of existing public instruments to finance this segment (zero- interest “eco-loan”, Energy Transition Tax Credit program – *Crédit d’impôt pour la transition énergétique, CITE* – or White Certificates program- *Certificats d’économie d’énergie, CEE*, *Habiter Mieux, programme de l’Agence nationale pour l’Habitat*), France needs to unlock private financing into energy efficiency on the necessary scale in order to secure its energy transition with a 2020 perspective and beyond, through citizens awareness campaign, up-skilling of the workforce and one-stop shops with a strong territorial anchorage.

Germany:

Private investment has increased noticeably, but not across all asset types. Equipment investment has grown robustly in response to record-high capacity utilisation. Housing investment continues to boom, even if the construction sector reports capacity constraints and price increases. However, significant challenges loom. The manufacturing sector faces a slowdown in foreign demand dynamics, in tandem with a need to adapt to new consumer preferences and technological change (e.g. low-emission cars). Non- residential construction has been increasing sluggishly in real terms, suggesting that essential infrastructure may not have kept up with the economy's needs.

Private investment is expected to expand as a result of high capacity utilisation and replacement needs, but uncertainty has increased considerably. Above-average capacity utilisation and changing consumer preferences should spur the effort to renew and expand the capital stock, though economic sentiment in the manufacturing sector has cooled markedly during 2018. Housing investment posted strong growth in 2018 and is expected to continue increasing, although at a slower rate, given ample order book backlogs and a still-high level of new building permits.

House prices are set to rise further, owing to the inadequacy of the housing supply in large cities. This has implications for rent levels. Despite a pick-up in residential investment, the housing supply still lags behind demographic change, especially in conurbations and big cities. As a result, a housing shortage has built up over the past decade. This is probably one of the main factors pushing up house prices in large cities and the country as a whole. While house prices stagnated in the 2000s, the widening supply gap correlates with the 30 % nominal rise in house prices that took place between 2010 and 2017. ([4])

The construction sector is operating at full capacity, as reflected by the rising prices of construction services and rising profit margins. Inflation in construction investment rose from 1.4 % in early 2016 to 5.2 % in the third quarter of 2018. Inflation in the value added of the construction sector has tended to be significantly stronger, suggesting that the prices of construction output rise faster than input prices. At the same time, real unit labour costs (i.e. the labour share) are actually falling, implying that building firms are maintaining some degree of wage moderation and becoming more profitable (see Graph 1.2).

The completion of new dwellings has risen strongly since the crisis, yet remains considerably below potential demand. Numbers completed rose from 158 000 in 2011 to 285 000 in 2017, although owner-occupied dwellings rather than rental flats accounted for the lion's share of the increase (See Graph 1.3). New residential investment thus expanded from 1.5 % of GDP to 2.0 % of GDP during that period. Yet the number of dwellings completed remains below the annual target of 400 000 unit completions. ([5]) Moreover, stagnating building permits suggest that annual dwelling completions will plateau at 300 000 units over the coming years (Gornig and Michelsen, 2018). The weak supply response is likely to keep pressure on house prices and rents, especially in major and southern cities. Although demographic pressures have been building up since the late 2000s, weak building activity has resulted in a housing gap put by most estimates at one million units (GdW, 2017) or significantly higher (Holm et al., 2018), with a particular focus on big cities and conurbations.

Clearing the housing supply gap would raise investment significantly. Commission estimates based on regional data suggest that just reaching a target of 350 000-400 000 annual completions would require additional construction investment of 1.0-1.5 % of GDP, compared to 2017 levels.([6]) Conversely, had 400 000 units been completed annually since 2011, investment would have been 2.0 % higher over 2011-2014. Input-output tables suggest that the current account surplus would then have been 0.5 pps. of GDP lower during that period. Filling the housing supply gap could thus have a significant impact on the current account surplus. The deep dip in construction investment (as a share of GDP) from the late 1990s to 2015 was the most significant change in German investment during the emergence of the current account surplus.

The persistently subdued investment share of GDP continues to undermine Germany's future growth potential, and has implications for the euro area. Private investment is lagging behind infrastructure and housing needs. Additional construction investment to meet the targets for new dwellings could lower the current account surplus by 0.5 pps of GDP (cf. Section 1 on investment). Public investment has picked up, but a major investment backlog, with depreciation still exceeding new investment at municipal level, will take longer to make up. Stronger investment in innovation, quality education and skills, very high- speed broadband networks, sustainable transport and electricity infrastructures combined with structural reforms aimed at improving the investment-friendliness and efficiency of the tax system can raise potential growth in future. Structural reforms promoting better use of the labour market potential of so far under-represented groups could help address the already noticeable shortages of skilled labour. This would be of crucial importance especially as population ageing intensifies and immigration may slow down. Growth-enhancing policies could also have positive spillovers for the other EU countries.

Mortgage growth at the aggregate level has been moderate, but some recent acceleration can be observed. Although the overall outstanding stock of mortgages increased (Graph 4.2.1), it did so at a pace similar to nominal GDP growth. Consequently, aggregate mortgages have been hovering around 35 % of GDP over the past six years. More recently, some moderate acceleration can be observed, as the annual expansion of housing credits was 4.5 % in September 2018, compared to 3.9 % 12 months earlier.

House price increases are not leading to any macroeconomic or financial stability risks. Whereas increases in recent years could be seen as a price normalisation process, by now housing markets in Germany's seven biggest cities are estimated to have reached overvaluations of up to 30 % (see also Chapter 1). Still, a real estate price correction of 30 % and the related financial stress is not expected to bring banks below regulatory capital minimums (Bundesbank, 2018).

Although slowly improving, labour market participation of refugees is a challenge, requiring further investment. The employment rate of people from the countries from which most refugees came ([35]) was 32.7 % in November 2018, 7.8 pps. higher than in November 2017. Refugee women's employment rate is only 8 % (IAB, 2019). The main obstacles to refugees' integration into the labour market are the lack of German language proficiency, missing or non-transferable qualifications, caring responsibilities towards children and relatives, and lack of experience with informal rules on the German labour market (Dietz et al, 2018). Efficient cooperation between institutions at local level is crucial. The number of refugees among the applicants registered with the Federal Employment Agency and applying for training more than doubled in 2017 compared with the previous year (2016: 10 300; 2017: 26 400). (BMBF, 2018). Although inflows of asylum seekers have slowed, they have triggered considerable long-term investment needs for regions and local communities in different areas: integration in the labour market, education and training, and social inclusion and housing. Investment in making refugees more employable may help them integrate faster into society and the labour market and help meet current labour market demands.

Housing costs in large cities put older and poorer people at greater risk of poverty. Although the housing cost overburden rate for the population as a whole has been falling since 2012, it was above the EU average of 10.2 % in 2017, standing at 14.5 % ([42]). For old people (aged 65 and over), it was particularly high at 20 %. The situation of poorer people is particularly severe. Although their rate of housing cost overburden has been falling since 2014, it remained above the EU average of 34.3 % in 2017, at 44.5 % ([43]). There are substantial disparities in housing cost increases across the country. This is a major challenge, especially in big cities. Microcensus data show a provision gap of 880 000 affordable dwellings in 10 large cities ranging from Berlin to Bremen. ([44]).The stock of social housing could provide for only half of this provision gap (Holm et al., 2018).

The Federal Government's financial initiative to make 100 000 additional units of social housing available thus appears very timely. However, even this initiative will not cover supply gaps (see also Chapter 1 on housing shortages).

There has been a robust increase in private investment, though not across all asset types. Investment in equipment has grown strongly in recent quarters in response to record high capacity utilisation. Housing investment continues to boom, even though the construction sector reports capacity constraints. However, major challenges loom. The manufacturing sector is facing a slowdown in foreign trade, and, at the same time, the need to adapt to new consumer preferences and technological change (e.g. the automotive sector). Non-residential construction has been growing sluggishly, suggesting that essential infrastructure may not have kept up with the economy's needs.

Macroeconomic outlook

Investment is relatively low as a share of GDP, which undermines Germany's future growth potential, and has implications for the euro area (see Chapters 1 and 3). Private investment has responded only in part to capacity utilisation and housing needs. Public investment has picked up, but a major investment backlog will take longer to unwind. Stronger capital accumulation will be needed to sustain potential growth in the future, especially as population ageing intensifies as expected and immigration may slow down.

Germany is also stimulating investment through its national development bank, KfW, Europe's largest development bank, which committed a total financing volume of EUR 76.5 billion in 2017. KfW plays a major role in promoting energy-efficient housing, in financing municipal infrastructure such as public transport and sanitation, and in supporting individual entrepreneurs and start-ups through loans, equity and mezzanine financing. In addition to KfW, the Rentenbank is a national development bank active in financing agricultural projects, and the Länder have their local development banks (*Förderbank*), which are smaller, yet play an important role in financing municipal infrastructure and projects, including in housing.

Ireland:

Prioritising both public and private investment in infrastructure, decarbonisation, housing, innovation, skills and social inclusion is essential for sustainable and long-term inclusive growth. Investment in research and development, skills and digitalisation is needed to address the lagging productivity of domestic firms and reduce the increasing reliance on multinationals. Sustainable growth will also require an investment push in clean energy, transport, water, broadband and housing as well as to decarbonise sectors with high emissions. The resilience of the economy to international economic shocks could also be increased by diversifying maritime transport and energy connections with Europe. Other key issues are improving access to employment for all jobseekers, including by providing affordable childcare, as well as investing in social housing to address rising homelessness. Annex D identifies key priorities for support by the European Regional Development Fund and the European Social Fund over 2021-2027, building on the analysis of investment needs and challenges outlined in this report.

Ireland fares relatively well on most indicators of the Social Scoreboard supporting the European Pillar of Social Rights, although challenges remain. The effectiveness of the Irish tax and benefits system in reducing poverty and inequalities remains high. The labour market has recovered well from a very sharp economic downturn a decade ago on the back of successful employment policy choices. Real disposable income per person continues to grow but remains slightly below its 2008 level. While Ireland performs well in many education- and social- related indicators, the low percentage of the workforce with basic digital skills reflects the insufficient integration of digital skills in the education and training system. Finally, housing remains a very pressing issue, given increasing homelessness due to shortages of social housing.

The main findings of the in-depth review contained in this report and the related policy challenges are as follows:

- **Private debt levels continue to fall, improving the resilience of households and businesses.** A large part of the stock of private debt is attributed to multinational corporations. Debt of Irish companies, including debt of redomiciled public limited companies, and households, relative to GDP, fell below the indicative macroeconomic imbalance procedure threshold in 2017. However, relative to modified gross national income, domestic debt remains relatively high. Hence, total private debt levels continue to overstate this imbalance. Rising housing prices increased households' net worth and reduced the number of those in negative equity.

- **The government has implemented a broad range of measures to tackle the undersupply of housing, but results will take time.** Housing supply is rapidly recovering from very low levels but is still falling short of demand. As a result, house price inflation remains high, even if it has recently moderated. The system of rules intended to protect the stability of the financial system, known as the 'macro- prudential framework', remains crucial to ensure that new credit is extended under prudent conditions, preventing credit bubbles.

Rapidly rising rents, insufficient residential construction activity and a lack of affordable and social housing have driven up homelessness especially, in Dublin. The shortage of housing has led to a 23.4 % rent increase since 2015, the highest in the EU. Demand for social housing stands at circa 72 000 homes with just 10 000 planned for delivery in 2019. While a further 17 000 persons are to be assisted through Housing Assistance Payment or the Rental Accommodation Scheme, this risks exacerbating rent increases in the already supply-constrained private rental market. A large number of social homes are under- occupied, (notably in the Dublin area), in part due to current succession practices, thus further aggravating the situation (Melia, 2018).

Net inward migration has provided an important source of labour since it turned positive in 2015. The share of non-Irish nationals in the labour force has returned to its 2008 peak of 16.3 %. Further increases in the participation rate will likely be driven by immigration as skills and labour shortages emerge (see Section 4.3.1). In recent years, the overall participation rate has been sustained by the pick-up in non-Irish nationals' participation rate, which is much higher than that of the Irish (74.3% vs 60.3 % in 2018), and has been increasing since 2015 (+3 percentage points), while that of the Irish remains flat. While the employment rate of both Irish and non-Irish nationals has picked-up since 2015, the gap in favour of non-Irish nationals has widened to 10 percentage points. As migrants' qualifications have improved—49 % of immigrants had tertiary education in 2018— immigration may play an important role as a source of skilled labour in a tightening labour market. Hence, migration will likely play an increasing role in driving economic growth. Significant net inward migration in the future could also increase the strain on the already tight housing market in the short term. In particular, high-skilled migration will likely contribute to increasing price pressure on the more expensive rental and housing markets, such as Dublin.

The Irish economy has maintained its external competitiveness, but risks persist. In 2017, the real effective exchange rate based on unit labour costs remained unchanged from the previous year. The sterling depreciation in relation to the euro continued to negatively affect the competitiveness of the economy in 2017 but was partly offset by continued weak consumer price inflation. The underlying trade balance also shows that the external competitiveness of the country has been maintained (Section 4.4.1). As the labour market tightens, associated wage pressures and increasing activity in construction, non-tradable in nature, should be monitored in order to maintain competitiveness over the medium term. Also, supply constraints in the housing sector could negatively affect competitiveness by restrictingmobility of labour and by putting upward pressure on housing costs (Department of Finance, 2018a). Rising commercial and residential rents, along with higher electricity, legal and insurance costs could also affect competitiveness. The activities of multinationals continue to inflate overall productivity figures with significant productivity gaps between low-productivity domestic firms and high-productivity foreign companies (see Section 4.4.1. for more competitiveness challenges).

Investment and housing

Volatility in headline investment figures masks robust domestic activity. In the first nine months of 2018, headline investment increased by 2.8% year-on-year (y-o-y) driven largely by a fall in intellectual property investment in the first half of 2018, which then increased in the third quarter. However, these fluctuations were matched by similar swings in imports and therefore with a neutral impact on GDP. On the other hand, core investment, i.e. investment without aircraft and intangibles, grew by 22.0 % y-o-y. Construction activity increased by 17.9 % y-o-y and is expected to remain strong in the short term as housing supply is still catching up with demand, and supported by various government measures.

Public investment is on an upward path. Capital spending by the government declined considerably in the aftermath of the crisis in the context of fiscal consolidation, but has been growing gradually since 2014. It is now expected to reach 4 % of modified gross national income by 2024 (up from 2.7 % in 2017) and to remain around this level until 2027, according to the National Development Plan. This plan sets out an allocation of EUR 116 billion over the period 2018-2027 aimed at meeting the infrastructure and investment needs, focusing on housing, transport, education, health and water services (Section 4.4).

Housing price inflation continues to be high but has eased recently. Housing prices increased by 10.9 % in 2017, i.e. 4 percentage points (pps) above the macroeconomic imbalance procedure threshold. In 2018, after an increase to 13.3% in April 2018, annual housing price inflation fell 6.3 pps in the seven months to November 2018. Decline has initially been driven by Dublin but since June affected almost every county in Ireland. It is likely that more binding macro-prudential rules (Section 4.2.1) have contributed to dampening housing demand (European Commission, 2019). A more dynamic housing supply may have also helped curb housing price inflation.

Inflation in rents seems chiefly determined by the gap between housing supply and demand. In Ireland, annual rent inflation in December 2018 was 6.2 %. Since 2015, rents have increased by 23.4 %, the fastest pace of increase in the EU. National growth rate was highly influenced by Dublin which accounted for 37 % of tenancy

agreements. Rents appear to be chiefly determined by supply conditions and, to a lesser extent, by supportive macroeconomic conditions.

Private sector debt remains high, at 243.6 % of GDP at the end of 2017, despite continued efforts to reduce it. Overall indebtedness is heavily affected by multinational companies. While the debt of all non-financial corporations (NFCs) fell from 231 % to 196 % of GDP during 2017, debt of Irish NFCs, including debt of redomiciled public limited companies (PLCs), fell from 90.1 % of GDP in 2016 to 83.6 % in 2017. Relative to modified gross national income (GNI*), debt of domestic companies, including debt of redomiciled PLCs, amounted to 136 % in 2017. Total debt of households and domestic NFCs amounted to 131.3 % of GDP in 2017, slightly below the indicative MIP threshold of 133 % of GDP. Although rising housing prices are putting upward pressure on household debt, households have continued to reduce their debt-to-GDP ratio and brought it down to 47.7 % of GDP in 2017. Relative to disposable income, household debt declined to 135.7 %. This is relatively high compared to other EU countries and suggests that households remain relatively more vulnerable to interest rate and income shocks. Although an increasing share of new mortgages has interest rates fixed for more than one year, around 90 % of the stock of loans is with variable rates.

Annual house price inflation has moderated notably since April 2018 but remains high. The recent sharp pickup in construction coupled with more stringent macro-prudential rules appear to have eased pressure on house prices, notably in Dublin. However, despite the expansion in housing supply, a gap between demand and supply persists and continues to be the main driver of house price increases. Although there are not yet consistent signs of overvaluation, the price-to-income ratio is already above its fundamental value, indicating affordability issues (Graph3.1). In addition, the number of years of gross disposable income required by an average household in Ireland to buy a 100 square metres dwelling amounted to 16 in 2017. This period was above the prudential benchmark equal to 10 and one of the longest in Europe. (European Commission, 2018d).

The government has taken a range of measures to support housing supply, including the construction of social housing. The establishment of the Land Development Agency, the Serviced Site Fund and the Regeneration Development Fund may increase the availability of land serviced with the necessary infrastructure. The new planning rules for apartment design, the announced removal of blanket restrictions on building heights and the increase in the vacant site levy could further boost housing supply. However, there are concerns over the construction sector's capacity to deliver the required level of housing and infrastructure in a timely manner as well as regarding incentives for house ownership created by property taxes based on below-market house valuations. The Construction Sector Group (CSG), established by the government following the launch of Project Ireland 2040, may help assess the supply of necessary skills and measures enhancing this sector’s capacity.

OVERALL ASSESSMENT

Public and private debt, as well as rapidly rising housing prices, are a source of vulnerability for the economy. Debt of households and domestic companies, including redomiciled public limited companies, relative to GDP, fell below the indicative macroeconomic imbalance procedure threshold in 2017. However, relative to modified gross national income, debt of the domestic private sector remains elevated. Although new lending with interest rates fixed between one and five years is increasing, 90 % of household debt is on variable interest rates. Rising property prices should support banks' efforts to advance non-performing loans reduction plans, although the share of long-term arrears remains relatively high. The public debt-to-GDP ratio is on a firm downward trajectory and a balanced government position is expected by 2020. Some windfall gains are planned to reduce government debt. The activities of some large multinationals companies operating in Ireland and the markedly negative net position of the International Finance Service Centre complicate assessment of Ireland's highly negative net international investment position, even though there is strong evidence that neither constitute vulnerabilities of domestic sectors. The government has repeatedly intervened to tackle the undersupply of housing, but it will take time for the measures to have an effect. Insufficient capacity in the construction sector and housing ownership tax incentives remain a concern.

Conclusions from IDR analysis

- Large stocks of public and private debt make Ireland vulnerable to adverse shocks but the flow variables have continued to improve. While the stock of non-performing loans is falling, long-term mortgage arrears remain relatively high. Banks are well-capitalised, which makes them well placed to intensify restructuring efforts. Provisioning levels, however, remain low. Housing supply shortages persist and, together with increasing demand, translate into price increases.
- Following a recovery in credit demand in 2017, the stock of household credit have been broadly stabilised since the mid of 2018. Household debt fell to 47.7 % of GDP in 2017. Household debt relative to modified GNI however is elevated and among the highest in the EU. While the situation of non-financial corporations is more difficult to interpret given the weight of multinationals on total corporate debt, it is clear that most domestic companies keep reducing their deb relative to GDP. Public debt is on a firm downward trajectory and a balanced government position is expected by 2020. The pace at which non-performing loans are declining has picked up, supported by disposals. While the high negative net international investment position appears to be driven to a substantial extent by factors that are unrelated to the domestic economy, the external sustainability of the domestic sector is gradually improving due to current account surpluses. The marked increase of property prices and rents, on the back of a still insufficient supply response, makes it urgent to address any constraints limiting the construction sector and the supply of housing.
- Comprehensive policy measures have been taken in recent years to address all the vulnerabilities highlighted above. These include measures to reduce the amount of non-performing loans although those aimed at reducing long-term arrears have been subject to a slow start. Some windfall gains are planned to be used to reduce government debt. The government has repeatedly intervened to tackle the undersupply of housing, but it will take time for the measures to have an effect. Furthermore, macro-prudential policies have been tightened and help to ensure the resilience of households and banks. High uncertainty surrounds the final outcome of the negotiations between the UK and the EU.

Expenditure overruns in some departments are a cause for concern. The pace of fiscal consolidation has slowed in recent years, following several in-year expenditure increases. Expenditure ceilings have kept drifting up on the back of better- than-expected (but possibly temporary) revenue. In some departments, slippages of EUR 810 million in total emerged in 2018, driven by expenditure in healthcare and, to a lesser extent, the department of housing. This was offset mainly by lower than expected spending in other departments and debt interest payments. Overall, the purse strings have been loosened in 2018, with expenditure up by 7.2 % y-o-y. Within this, current primary expenditure increased by 6.5 %, while capital expenditure was up sharply, by 31.1 %

The rapidly rising number of homeless people as a result of rent increases and insufficient social housing merits urgent action. Insufficient levels of investment and construction over the last decade, including social housing, have led to a huge shortage of adequate accommodation for those most at risk. The bulk of the challenge is concentrated in the major urban areas and it is affecting different groups, notably single parents, single men, the elderly, people with disabilities and an increasing number of families and youth. Meeting social housing demand, in line with the Pillar principle on housing and homelessness, will take several years of sustained investment to address quantity, quality and variety of housing and to provide supporting services.

Recent reform efforts have tried to tackle the problem of weak work incentives for low- income groups, including partners who are out of work. Ireland has addressed those disincentives by tapering the withdrawal of benefits when returning to work and through the Housing Assistance Payment Scheme. The Housing Assistance Payment Scheme has increased financial work incentives for jobless households as recipients remain eligible when they are in full- time employment, in contrast with the Rent Supplement Scheme. However, disincentives seem to have increased for second earners in a couple, since household income is expected to rise above the maximum qualifying threshold when they move into work ([25]). The government also committed itself to bringing in a Working Family Payment to promote work by supplementing on a gradual basis the income of households, at the same time incentivising more working hours and full-time work. However, analyses previously undertaken cast some doubt on the likelihood of it being effective (European Commission, 2018).

Severe shortages in housing supply and social housing have created a very challengingsituation. The rapid increase in rents (see Section 1), combined with rising house prices, creates an affordability constraint for households which can increase poverty risk, in particular for women, and further exacerbate homelessness. ([29]) The 2019 budget has increased by 25 % the allocation to housing, bringing the total budget for 2019 to EUR 2.4 billion (European Commission, 2019). Whilst expenditure is envisaged to facilitate the delivery of 27 000 new social homes, this falls very short of the actual demand which in July 2018 stood at 71 858 homes (Housing Agency, 2018). The social housing needs of 27 400 households are expected to be met in 2019. Much work and investment remains to be done in order to provide a varied range of social housing that caters for different users and age groups. A large number of social homes are under-occupied (notably in the Dublin area), in part due to current succession practices, thus further aggravating the situation (Melia, 2018). Expenditure levels on housing and social housing, though growing, still stand at a level just below the 2008 peak, thus further contributing to the critical situation.

Policy measures are being taken to tackle homelessness but their effectiveness remains uncertain. As of November 2018, over 20 000 new homes have been made available within the Rebuilding Ireland Action Plan for Housing and Homelessness adopted in 2016 (Rebuilding Ireland, 2018). In addition, at the end of the third quarter of 2018, just under 64 000 housing solutions have been provided under Rebuilding Ireland programmes. A key focus of 2019 activity will be on prevention and the delivery of services for homelessness. An allocation of EUR 146 million (+ EUR 30 million on 2018) is expected to provide emergency homeless services and provide homeless households with long-term and sustainable housing solutions to 5 000 adults, including by extending the services provided by local centres coordinating family-related support. Further dedicated investments may be needed to help the 6 000 people estimated as homeless in Ireland and their children and to prevent further increases in the number.

INVESTMENT NEEDS

Increased investment in skills, education and training as well as social inclusion are essential for improving Ireland's productivity and long- term inclusive growth. Emerging skills shortages and mismatches in certain sectors require investments in under-tapped human capital, as well as better alignment of education curricula to labour market needs. Using the full labour market potential requires investing in access to quality childcare facilities to further promote women's labour market participation, support for jobseekers and people with disabilities, and the activation of those living in jobless households. Investments in social housing infrastructure and social services are crucial to address the severe social housing shortages and rising homelessness and reducing the number of children at risk of poverty and social exclusion.

The public sector has contributed most to the reversal of the current account balance in recent years. Before the crisis, households had been driving downwards the current account balance, mostly due to the large take-up of mortgages linked to the housing boom (Graph 4.4.1). After 2008, households have reduced their investments and preferred saving and deleveraging. The financial corporations sector seems to have been running a moderate surplus for more than a decade. The balance of non-financial corporations has been rather volatile over the years. Since 2013, these fluctuations seem to have been driven mostly by large multinationals, while the position of the other non-financial corporations was positive. The impact of multinationals is even more relevant over the period 2015-2017 contributing largely to the shift in the current account balance. Over the crisis period and in the immediate aftermath, the government balance was highly negative, in line with efforts to counterbalance the negative pressures of the economic downturn. In recent years, the improvement in the current account balance has been mostly driven by the declining government deficit, supported by economic recovery.

Even though Ireland remains one of the most competitive EU economies, it faces important challenges. ([35]) In the short run, cost competitiveness may deteriorate due to skills shortages and rising housing, electricity, legal and insurance costs. In the long term, the growth potential could be limited by the availability of talent and skilled labour, infrastructure deficits, and regional imbalances. Uncertainties linked to the global environment are also impinging on economic activity. In addition, Ireland has so far failed to decouple its economic growth from the emissions of greenhouse gases and air pollutants. This raises health, climate and environmental concerns and means that Ireland may miss opportunities linked to the EU's ambitious decarbonisation objectives.

Investment needs

Investment challenges relate primarily to infrastructure, decarbonisation, housing supply, skills and innovation. Infrastructure deficits such as in transport, energy, water, digitalisation and housing supply, as well as skills shortages, are considered by business to be a major obstacle to investment (Box 4.4.1). Skills shortages, in particular digital and managerial skills (Section 4.3.1 and 4.4.1), and a low level of investment in R&D by domestic firms (see above) may hinder the overall productivity of the economy, in particular for the domestic sector, and further widen the productivity gap between multinationals and domestic companies.

Prioritising investments and policies to meet decarbonisation needs in sectors accounting for a high share of emissions would also contribute to environmentally sustainable development and reduce the cost of future action.

Targeted and timely capital infrastructure investment may enhance productivity and competitiveness (National Competitiveness Council, 2018a)**.** After years of low public and private capital investment following the crisis, infrastructure is inadequately maintained and unable to meet peak demand (Engineers Ireland, 2018) reducing the competitiveness of Irish firms (World Economic Forum, 2018). The National Development Plan (Department of Public Expenditure and Reform, 2018) addresses some of the infrastructure gaps by increasing the capital investment efforts to EUR 116 million over 2018-2027. ([44]) Although public expenditure is being front-loaded and planned to increase strongly, time is required for the investments to have sizeable effects. Additional policy measures may be required to incentivise private investments in areas such as clean energy and transport, housing and skills.

Main barriers to investment and priority actions underway:

1. The availability of housing and infrastructure remains the major barrier to investment. Although the adoption and launching of the National Development Plan have improved the outlook for the provision of some basic infrastructure, it will take time to reduce the current infrastructure deficits, in transport (including clean transport solutions) and other public infrastructure. The same applies to the availability of housing despite the increase in the annual rate of supply of new housing units. Delays in the delivery of digital infrastructure add to these deficits hampering plans to reduce congestion in the Dublin region and to spread economic activities across regions. Infrastructure investment is also encountering difficulties in areas such as energy, digitisation, environmental infrastructure and the fight against climate change. Infrastructure deficits hinder investment in other sectors in turn.

2. Current policies and incentive mechanisms seem to have been insufficient to cope with the pressing needs for skilled labour and firms claim that this is a major obstacle to investment. There seems to be a general shortage of skilled labour that the local supply cannot meet. The level of labour market mismatches is not sufficient to the shortage of skills across sectors. Some stakeholders emphasise the strong competition in the market for skilled labour between foreign and local firms, it being difficult for the latter to match the wages paid by multinationals. The shortage is particularly important for digital skills. However, other sectors such as construction and infrastructure also mention the availability of staff at all levels, from managers to intermediate skills, as an important long-term barrier to investment and growth.

3. Uncertainty is holding back private sector investments. Despite strong economic growth in recent years, many firms are reluctant to investment. They remain reluctant to borrow, trying to avoid the potential hardship familiar from the recession. Uncertainty prevails in all sectors but it seems to be particularly important in construction (European Investment Bank, 2018, Cargan et al., 2018). This negatively affects negatively the rate of the supply-side response to the demand for housing and infrastructure. In the case of manufacturing and services, this uncertainty may delay the diffusion of innovation. Uncertainty seems to affect both small and micro firms as well as medium and large firms, although the two groups of firms may be

concerned by different underlying reasons.

The Strategic Banking Corporation of Ireland, established by the Ministry of Finance, ensures access to flexible and lower cost borrowing for Irish small and medium-sized enterprises and supports market access for small and medium-sized enterprises entering the lending market. Enterprise Ireland is a government organisation responsible for the development of Irish enterprises in world markets (for recent measures initiated by Enterprise Ireland, see the 2018 Small Business Act Fact Sheet (European Commission (2018i). The Ireland Strategic Investment Fund is a sovereign development fund of EUR 8.9 billion managed and controlled by the National Treasury Management Agency, which invests on a commercial basis to support economic activity and employment in Ireland, with a long investment time horizon. Microfinance Ireland is a not-for-profit lender, established to deliver the Government's Microenterprise Loan Fund, and provides loans of EUR 2 000 to EUR 25 000 to start-ups, newly established and growing micro-enterprises.

The weak capacity of the construction sector may become an obstacle to deliver the infrastructure and housing required. The crisis has had a devastating impact on the construction sector. Many firms left the market and the workforce occupied in the sector during the boom years was dispersed. Since then, the entry of new firms has been sluggish. In 2016, the number of firms was just 6.7 % higher than in 2010. In the third quarter of 2018, employment in the sector was just 39 % below the level reached in the heydays of 2007. Labour productivity in construction has recovered but remains low in comparison to other sectors and countries (European Commission, 2018). The productivity of the sector can be increased by a more intensive use of information and communications technology and pre-fabricated solutions, the reskilling of the workforce and the entry of larger foreign producers (McKinsey Global Institute, 2017). The latter should be possible unless barriers hamper entry.

Housing supply

Residential construction is booming but housing completions still fall short of demand. Annual housing completions amounted to 17 161 in the third quarter of 2018, i.e. 33% more than on the same period last year. Despite this steep increase, housing supply is still short of the required level, estimated to increase from 23 000 in 2018 to 32 000 by 2024 (DAFT, 2018)

A significant increase of investments in deep renovation of buildings is required to achieve decarbonisation objectives. The Sustainable Energy Agency of Ireland estimates that investment of circa EUR 35 billion would be required to upgrade Ireland's housing stock to a minimum building energy rating of B3. Most of this investment would have to be made by home- owners themselves, though there is also room for limited government assistance.

The low level of residential development on sites sold by the National Asset Management Agency (NAMA) is a concern. In March 2018, only 11% of the 55 000 units sold by NAMA (National Asset Management Agency, 2017) in the last 7 years had been built up. The development of some of these sites may be inhibited by constraints related to commercial viability, infrastructure or suitable planning permission. In addition, land hoarding was also identified by NAMA as one potential cause meriting further analysis.

The Serviced Site Fund and the Regeneration Development Fund will support the delivery of infrastructure to unlock land development. Around 3.3 billion are planned over 2018-2027 to inter alia service land sites with the necessary infrastructures. By 2021, the Serviced Site Fund expects to have serviced sites with capacity for delivering 6 200 housing units for those with the greatest affordability challenges. The Regeneration Development Fund will have a broader focus and fund infrastructure to facilitate housing development as well as urban and rural regeneration interventions.

More construction on publicly-owned land could increase housing affordability. Publicly- owned land has capacity for the development of over 50 000 housing units. This land could be used to provide social and affordable housing in areas where demand for housing is strong. The sale or leasing of land to private promoters may be conditioned to its immediate development to avoid land hoarding.

The newly-created Land Development Agency may help accelerate the construction in publicly owned land and reduce the volatility of prices in the housing market. The Agency, launched in September 2018, is expected to facilitate the construction of 150 000 new homes over the next 20 years in a mix of private and public land, including by supporting urban regeneration initiatives. It will assemble strategic land banks making these available for housing in a controlled manner so as to counter the boom-bust cycle in land and house prices. The agency has been provided with compulsory purchase powers that may discourage land hoarding.

Property taxes based on below-market valuations result in an implicit subsidy on home ownership and create incentives for under- occupation. House price valuations serving as a base for property taxes have not been revised since 2013 when prices were around 42 % below the current level. Regular updates combined with the introduction of special arrangements for low- income groups would optimise resource allocation ([46]) and reduce housing purchase demand as well as increase the progressivity of the tax system (see Section 4.1.3). In addition, it would provide the government with additional resources to address housing and infrastructure challenges.

Severe social housing shortages remain and homelessness is rising. Although the poverty rate has slightly decreased in recent years, there is still a need for food aid to the most deprived. Investment needs have therefore been identified to **promote the social integration of people at risk of poverty or social exclusion and to address material deprivation**, and in particular to:

- prevent and reduce homelessness and housing exclusion, including through the provision of social housing, and improved accessibility of products and social services to vulnerable groups;
- promote the social integration of children at risk of poverty and social exclusion;
- ensure that housing actions are part of an integrated policy response;
- provide food and basic material assistance to the most deprived

Italy:

Social policies remain poorly integrated. The citizenship income scheme will replace the previous income support scheme, keeping an active inclusion approach subject to certain conditions. However, the scheme may prove difficult to implement and may put a considerable burden on the public administration. The actual impact on employment will depend on the effectiveness of activation policies and controls. Labour market conditions are improving but in-work poverty is high and rising, affecting in particular temporary workers and people with a migrant background. Access to affordable and adequate housing is also a challenge. Childcare and long-term care services remain underdeveloped. Measures to promote equal opportunities and a work-life balance are fragmented and limited in scope, negatively affecting women's participation in the labour market amid unfavourable demographic trends.

The current account surplus reflects saving and investment decisions by the different sectors of the economy. The corporate sector has assumed a net lending position since 2009, amounting to % of GDP in 2017. Households increased net lending until 2014 and reduced residential investment in line with the slowing housing market but net lending fell to 0.9 % of GDP in 2017. In addition, the reduction of the government deficit supported the shift to a net lending position of the Italian economy.

Access to affordable and adequate housing remains challenging. While only 4 % of the population have access to housing with a subsidised rent, 28.2 % of tenants who pay rents at market prices were overburdened by housing costs in 2017 (EU average: 25.2 %). The severe housing deprivation rate, albeit on a declining trend, stood at 11.1 % in 2016, compared with a EU average of 5.6 %. ([53]) The public and social housing stock in Italy is among the lowest in the EU (only 4 % of the housing stock is owned by the public sector). Dwellings are often in a precarious condition and declared unfit for habitation. Housing needs were exacerbated by the economic crisis. Since 2015, following the depletion of the National Fund to support low-income tenants, new funds were introduced, targeted to indebted households. ([54])

Italy faces challenges on many indicators of the Social Scoreboard supporting the European Pillar of Social Rights. Labour market conditions are only slowly improving and the persistently high unemployment had a strong impact on the social situation. Youth unemployment, as well as the NEET rate, remain among the highest in the EU. The gender gap is extremely high, but a comprehensive strategy to promote participation of women in the labour market is still missing. The impact of social transfers on poverty reduction is limited and the share of people at risk of poverty or social exclusion remains very high. To tackle this issue, an anti-poverty scheme was introduced in 2018 and will be strengthened in 2019.

In addition to these challenges, access to social housing is extremely limited. The social housing system is affected by limited funding, difficult coordination between different government levels and lack of strategic overview. Italy has one of the lowest stocks of social and public housing in Europe, in a context of growing housing needs. Only 4% of the population has access to subsidised rent and all available indicators reveal high and increasing housing related hardship. Access to social housing is almost precluded to younger generations, since occupants tend to remain in social housing for their entire lives. The situation is also worrying for children (9.4% live in a household with a housing cost overburden). Chronic homelessness is also on the rise.

Italy scores well with respect to the 2020 Climate and Energy targets. However, the decoupling between economic growth and energy consumption is still weak, and recent progress in both renewable energy and energy efficiency is modest. High priority investment needs have therefore been identified to **promote energy efficiency measures,** as well as **priority investments for renewable energy**, and in particular to:

promote energy efficiency through renovation of social housing and public buildings, giving priority to deep renovations, innovative technologies and most advanced standards and practices;

promote innovative and less mature renewable technologies, particularly for heating and cooling, in public buildings, social housing and industrial processes in small and medium sized enterprises;

promote technologies, such as energy storage, to integrate more renewable energy in the system and increase flexibility and smartening of the grid, also increasing the coupling of energy sectors.

The rate of people at risk of **poverty and social exclusion** and income inequality remain among the highest in the EU. High priority investment needs have therefore been therefore identified **to foster active inclusion, promote the socio-economic integration of people at risk of poverty or social exclusion**, **address material deprivation**, **improve accessibility, effectiveness and resilience of healthcare and long-term care with a view to reducing health inequalities,** and in particular to:

- foster integrated and personalised active inclusion measures to outreach people at risk of poverty or social exclusion, including children and working poor;
- enhance high quality, accessible and affordable social services and their infrastructure, including housing, childcare, healthcare and long-term care, taking into account regional disparities and the rural/urban divide, also in access to innovative technologies and new care models;
- improve accessibility and adequacy of social protection systems as well as independent living for all, including persons with disabilities, through the development of community-based services and the integration of health, social and long-term care services;
- ensure the re-skilling and upskilling of healthcare, long-term care and social service workforce;
- promote socio-economic integration of third-country nationals, while also ensuring their protection from violence and exploitation, and of marginalised communities, also through housing infrastructure;
- address material deprivation through food and basic material assistance to the most deprived.

Latvia:

The adequacy of social benefits remains low. Benefits rose only marginally and do not contribute a lot to alleviating the high levels of poverty and inequality. Ambitious government plans to raise the minimum income level have been shelved due to a lack of funding. The large share of low-wage earners and widespread under-reporting of wages mean that a sizeable part of the population has only minimal social coverage. Despite some increases in the lowest pensions, ensuring their adequacy remains a challenge, while the proportion of the elderly at risk of poverty and social exclusion are increasing. Moreover, the social protection of people with disabilities remains weak. Social housing is scarce and not always fit for living.

Better internal labour mobility is crucial to economic growth outside Riga. Moving for work to places outside the capital region is made difficult by a lack of rental housing. This has often led people who cannot find work where they live to move abroad rather than to move within Latvia. Despite the lack of adequate and affordable housing, investment in housing in places outside Riga has been low due to the population's low purchasing power and the lack of long-term financing. Investment in housing has also been hampered by lengthy construction processes and poor protection of landlords' interests in the case of rental housing.

Investment

The inflow of EU funds and office space construction are driving investment growth in Latvia. In 2018, investment is forecast to have grown by 11.2%, slightly down from 13.1% the year before. Office space and EU-funded non- residential construction were the biggest contributors to investment growth. At the same time, investment in intellectual property was stagnant in 2018. As inflows of EU-funds peak, infrastructure investment is set to slow but pent-up demand for office space and housing should ensure investment growth of around 2-3% over the forecast horizon (Graph 1.2).

Wealth inequality in Latvia is among the highest in the EU. With a Gini coefficient for distribution of wealth ([3]) of 78.5, the wealth inequality in Latvia is among the highest of Member States. Around half of the wealth reflects ownership of the main residence and a quarter reflects ownership of other real estate, which is similar to the EU average. Share of wealth as financial assets is somewhat lower in Latvia, but it is mostly owned by the richest households, as in the rest of the EU. The high wealth inequality in Latvia persists despite low levels of housing- related debt and a high rate of home ownership in the general population (81.5 %), including among the population who are at-risk-of-poverty (74.2%).

Property taxation is based on outdated values. Recurrent property tax accounts for 0.8% of GDP in 2018, below the EU average of 1.6% of GDP in 2017. Around 60% of property tax revenue comes from land, 10% from housing and 30% from other buildings (Graph 3.1.5). The real estate cadastral values used as a basis for taxation are set to follow the market values. However, updating of cadastral values has been postponed for several years and taxation still reflects market values of 2012/2013. The proposed, but not adopted, update of cadastral values for 2018 based on 2015 market values would have increased total cadastral values by 34%, corresponding to some 0.3% of GDP in property tax revenue. The largest differences between cadastral values and market values are for agricultural land and newly built apartments.

A highly integrated and concentrated Nordic- Baltic banking system warrants close collaboration among financial supervisors. Most large Latvian banks belong to Nordic banking groups, with Swedish lenders SEB and Swedbank the two leading names in Latvia. The creation of Luminor Bank AS ([10]) in 2017 put in place Latvia's second largest credit institution, with a market share of 15 % in deposits and 25 % in lending. Given the Nordic economies' financial openness and the relatively large size of their banking system, potential spill-overs from shocks originating in those countries could be significant. Risks mainly relate to the Nordic housing markets and — with the exception of Finland — to the high indebtedness of their households. Risks may materialise in the form of constrained lending activity, short-term deposit volatility and higher financing costs for Latvian banks given the relatively heavy dependence of some Nordic countries on wholesale funding. In this regard, cross-border supervisory cooperation is warranted, to maximise the effectiveness of national macro- prudential policy instruments, ensure a level playing field for all credit institutions and reduce the risk of regulatory arbitrage.

Housing market

House price growth has picked up over the past two years. The house price growth exceeded 8% in 2017 and continued at the same pace in the first half of 2018. By comparison, the average house price growth from 2010 to 2016 was 5.5%. Despite the rapid pace, house price growth has remained broadly in line with income growth. The price to income ratio is now only slightly higher than it was in 2010 and significantly lower than it was at the height of the real estate bubble in 2008 (Graph 3.2.2). The demand for housing has been boosted by a state guarantee programme helping families and young professionals to get a mortgage against lower down payment than banks would normally require. This has also helped the mortgage credit growth turn positive in 2017. The construction of dwellings has also increased slightly, but over a longer time frame it has been anaemic. In stark contrast with the other Baltic countries, the amount of newly constructed dwelling space in Latvia has not increased much since 2010 (Graph 3.2.3).

Undeclared wages, cumbersome construction regulations and weak protection of landlords hold back investment in housing. Since the financial crisis of 2009, banks in Latvia are taking a much more prudent approach to granting credit against undeclared incomes and they currently identify this as one of the main obstacles to higher mortgage credit growth. Furthermore, investors point to lengthy and cumbersome construction regulations making the process costly and leaving investors less agile to respond to growing demand. Finally, weak protection of landlords discourages more investment into rental housing (European Commission 2018a). The government has prepared a draft rental law that would significantly strengthen the protection of landlords' interests. However, there are concerns that the proposal would shift the balance of protection too much in favour of landlords.

Investment in housing is crucial to facilitating better internal mobility and access to quality jobs in the peripheral regions. A large share of owner-occupied buildings means there are few options for people who would like to move for jobs outside of the Riga metro area. Moreover, the population’s low purchasing power makes commercial residential development not viable. This in turn hinders regional growth and encourages emigration. The experience of the city of Valmiera ([16]) shows that there is a high demand for affordable rental housing and that it can be a powerful policy tool to attract people to the municipality, providing employees to local businesses. However, it also suggests that residential development is only viable if cheap long-term financing is available. Inspired by Valmiera’s example, the Ministry of the Economy has put forward a state support programme aimed at helping municipalities finance rental housing projects. However, this has yet to be approved by the government.

Employment conditions differ across regions and internal mobility remains a challenge. Uneven regional distribution of jobs and vacancies is one of the key challenges the country is facing (Ministry of Economics, 2018). The employment rate in Riga is higher (73.4%) than in other regions, in particular Latgale (62.2%). This encourages residents of Vidzeme and Zemgale to take advantage of those region’s proximity to the capital region, with the result that 10% and 15% respectively of their employed residents work in Riga. The regional mobility support programme provides commuting or relocation support, but the uptake remains low, as the amount of support (cumulatively EUR 400 for first 4 months) does not sufficiently compensate for relocation expenses and the support is temporary. Lack of affordable and quality rental housing is the key bottleneck for internal mobility in the country (Section 3.2).

The adequacy of social assistance benefits remains low and they contribute little to alleviating high poverty and inequality. From January 2018, the guaranteed minimum income tops up income to EUR 53 (some municipalities voluntarily provide higher benefits). The average housing benefit is less than EUR 15 per person per month, while the calculated poverty threshold for 2017 was EUR 367. The adequacy of the minimum income benefits is below the EU average ([18]). According to the national data, out of the first (lowest) income quintile, 68.3% report difficulties making ends meet; however, only 16.2% have received the status of 'poor person' giving them access to social assistance and only 6.7% receive guaranteed minimum income. People from quasi-jobless households at risk of poverty face more difficulty accessing certain services in Latvia compared to other EU Member States ([19]). The concept paper adopted in 2014 envisaging a significant increase in benefit adequacy has not been implemented and the plan to improve the minimum income support system has not been adopted, although revised and resubmitted to the government multiple times (latest version submitted in May 2018).

Access to adequate housing, particularly for low-income groups, is a challenge. 15.2% of the population experiences severe housing deprivation, significantly above the EU average of 4.5%. Half of those below the poverty risk threshold live in poor housing conditions ([21]). Inhabitants of rural areas, in particular in the Latgale region, live in worse housing conditions than the urban population. While the housing cost overburden rate in Latvia has been declining, still almost one-third (32.9 %) of households report that housing costs impose a heavy burden (CSB 2018a).

Social housing is scarce and often not fit for living. In 2016, social housing constituted only 0.4% of social housing stock compared to the EU average of 8%. This is insufficient to respond to demand and currently there are 7 000 people waiting for a home. Local governments, with few exceptions, invest little to improve the technical condition of social housing and as a result, one third of vacant premises are not fit for living. State-funded grants for social housing have not been available since 2009.

There is little data on homelessness and this phenomenon is not addressed at national level. There is no national strategic document addressing homelessness, and the scope of existing policy documents only addresses the provision of night shelter services. According to national data, in 2017, more than 6 800 people used municipal and private shelters. These service providers are mostly located in the largest cities of Latvia and data on homelessness nationwide is lacking. To address the issue of homelessness and improve the provision of social housing, investment would be needed, in particular at municipal level.

Investment needs

In order to continue converging with the EU average, investment in innovation, human capital and regional development is needed.

Despite its rapid convergence, Latvia needs to continue to transform the structure of its economy towards more sophisticated products and services. Given the small domestic market, Latvia's main prospects lie with exporting higher value-added goods and services and growing its export market shares. At the moment, Latvia does relatively well in exports of knowledge-intensive services, but the share of high-tech goods in its exports is low. In order to facilitate the economy's transformation, Latvia needs to invest in human capital, including skills and health (see section 3.3.4). It needs to invest more in research and development both in the private and public sectors, including by engaging the state-owned enterprises more closely in its innovation system. Finally, Latvia needs to invest in regional development - investment in infrastructure and housing would help to integrate the lagging regions with centres of economic activity and facilitate internal labour mobility. Additionally, investment in resource efficiency is also needed in order to speed up Latvia's energy transition.

Main barriers to investment and priority actions underway

Investment in housing is hindered by a lengthy and costly construction process, poor protection of landlords' interests in the rental law and a lack of long-term financing (of 30 years or more) for projects outside Riga. Housing investment outside Riga is crucial to regional development as it facilitates better employment opportunities through higher labour mobility within the country. Regional development is also an important ingredient in reducing emigration and thus slowing the rate of population decline.

Latvia's economy is still relatively energy intensive, well above the EU average. Although Latvia is on track to achieve its indicative energy efficiency target for 2020, further efforts are needed to achieve more ambitious energy and climate targets for 2030. High priority investment needs have therefore been identified for **energy efficiency and renewable energy**, in particular to:

- improve energy efficiency in public buildings in housing and in businesses;

- support further deployment of renewables, including in district heating;

deploy solutions for smart electricity distribution grids and storage.

Poverty and social exclusion remain high, especially for people with disabilities, the elderly and the unemployed; social housing is scarce and income inequality is a challenge. High priority investment needs have therefore been identified to **foster active inclusion, improve employability** and **address material deprivation through food and basic material assistance**, including accompanying measures, and in particular to:

support integrated active inclusion measures with involvement of local communities and civil society;
improve access to personalized and integrated social services for disadvantaged groups;
reduce homelessness and housing exclusion, improve access to social housing, including through infrastructure.

Latvia's principal cities, and Riga in particular, have played a dominant role in Latvia's speedy convergence, but there are large disparities in income and employment opportunities. In particular the lack of affordable housing has been an obstacle to regional development. Also, there is a strong urban- rural divide in economic and social development. High priority investments needs in tailor-made sustainable and integrated development of urban, rural and coastal areas and local interventions, addressing urban-rural linkages have therefore been identified in order to complement policies to **address the socio-economic disparities** and the demographic challenges, in particular to:

- improve the attractiveness of urban areas and business environment and create links with the functional urban areas;

- address the needs and potential of the areas that are lagging behind in economic and social development, by combining adaptation and quality of life measures with investments enhancing growth;

- invigorate the capacity of local authorities to develop sound integrated territorial strategies and to assess and select projects.

Netherlands:

While growth is moderating, the still favourable economic environment provides a window of opportunity to sustain the reform momentum. This includes tackling long-term challenges in the housing market, labour market and pensions([1]). Recent structural reforms have borne fruit in terms of a job-rich recovery. Although measures to reduce the debt bias for households have been adopted, incentives to incur debt remain. While the labour market continues to recover, challenges with respect to labour market segmentation and the pension system remain.

There has been **some progress** in the following areas:

- Taking measures to reduce the debt bias for households and the remaining distortions in the housing market, in particular by supporting the development of the private rental sector. The government accelerated the reduction in mortgage interest deductibility and submitted a law to Parliament to increase the supply of housing in the middle segment of the rental market.

Subsidies to owner occupied housing and social housing lead to an underdeveloped private rental market. The social housing and rent-controlled sector is large compared to other Member States. The private rental market is the only non-subsidised housing sector and remains underdeveloped. The lack of a well- functioning middle segment on the rental market encourages households to buy rather than rent, leading to high debt-to-income ratios and financial vulnerability.

High illiquid housing and pension assets combined with high mortgage debt make households vulnerable to shocks. While the pension system performs well on pension adequacy and fiscal sustainability, it has drawbacks in terms of intergenerational fairness, transparency on pension rights and flexibility. Moreover, occupational pension contributions are high and fluctuate depending on how pension funds perform. As such, it may affect household spending in a pro-cyclical way, with the balance of risks geared towards young age groups as lower indexation and higher pension contributions have been the primary means of adjustment. Households combine substantial housing and pension wealth with high mortgage debt. However, the former are highly illiquid and unevenly distributed across generations. Long household balance sheets make households vulnerable to economic shocks and accentuate the pro- cyclical dynamics of household finances.

The current account continues to show a marked surplus. The Netherlands has had a current account surplus of 7% of GDP on average over 1999-2017. All institutional sectors are currently in surplus, which led to the current account surplus rising to 10.5% of GDP in 2017. This high level is mostly accounted for by the non-financial corporation sector, and may be linked to the presence of multinationals' headquarters. A comparatively large non-financial corporation savings surplus is rooted in a relatively high operating surplus, together with high net property income and relatively low levels of domestic corporate investment. Resuming income growth combined with high compulsory savings, pressure on households to reduce their debt level and low residential investment has led to positive net lending for households. The government sector recorded stable headline surpluses following substantial fiscal consolidation in recent years. While corporations make the largest contribution to the surplus over time, the government and household sector are largely responsible for the post-crisis increase in the current account surplus. Housing market and pensions institutions affect consumption and the surplus in a pro-cyclical way.

Social developments

The Netherlands has a low level of income inequality. As a result of the highly redistributive tax and benefit system, the ratio of disposable household incomes between the richest and the poorest quintile of the Dutch population is 4.0, which is well below the EU average of 5.2. Wealth inequality is higher, although this is mainly driven by households with negative net housing equity following the decline in house prices during the crisis.

Housing market measures have helped to reduce the high household debt level, but challenges remain. At 105% of GDP and 211% of household disposable income in 2017, compared to 57% and 93% respectively for the euro area, household debt is high in the Netherlands. A high debt level makes households vulnerable to economic shocks. Household debt largely consists of mortgage debt, which is subsidised by mortgage interest deductibility in personal income taxes. Since 2012, recommendations have been issued on the need to reform the housing market, in particular to modify the favourable tax treatment of homeownership, refocus social housing and provide a more market-oriented price mechanism in the rental market. The Dutch government has acted upon those recommendations, in particular with a reduction of mortgage interest deductibility (including a requirement to repay mortgages within 30 years to qualify for mortgage interest deductibility). Policy measures have also been taken on the rental market, such as the the Housing Act (*Woningwet*) in 2015, but challenges in the housing market remain.

Some progress has been made on reducing remaining housing market distortions. The accelerated reduction in mortgage interest deductibility has been adopted and will be implemented between 2020 and 2023. However, as this fiscal subsidy will not be phased out completely and remains an important policy distortion, sustaining a debt bias for households and affecting the decision to buy or rent. The government also acknowledges the need to develop the private rental market, making it a genuine alternative for the owner occupied market. It has submitted a draft law to Parliament to increase supply in the mid-priced rental market (*Wet maatregelen middenhuur)* by easing requirements for housing corporations to build for this segment.

The Netherlands	Overall assessment of progress with 2018 CSRs : some progress
CSR 1: *While respecting the medium-term objective, use fiscal and structural policies to raise public and private investment in research, development and innovation Take measures to reduce the debt bias for households and the remaining distortions in the housing market, in particular by supporting the development of the private rental sector. (MIP relevant)*	The Netherlands has made **substantial progress** in addressing CSR 1: • **Substantial progress** has been made by implementing a fiscal stimulus, including additional spending on R&D in 2019. • **Some progress** has been made on the housing market, although the mortgage interest deductibility will remain generous after being reduced to a maximum applicable rate of 37% by 2023.

With the corporate sector making the largest contribution to net lending, all domestic sectors are in surplus. Both financial corporations and non-financial corporations are in surplus, with the latter being the main driver. Net lending by non- financial corporations amounted to 5.3% of GDP in 2017. Compared to the rest of the euro area, profitability and net property income are relatively high for Dutch firms, whereas investments are lower. The presence of multinational enterprises is likely to influence aggregate corporate sector net lending, although available macro-economic data do not allow for a straightforward identification of their statistical impact (see Section 4.2.6). Households have been recording surpluses since the crisis, amounting to 2.3% in 2017. The dip in the housing market during the crisis led to a decrease in residential investment, while at the same time private consumption stagnated. Pension funds are also an important driver of household net lending. Pension contributions and investment income are much higher than payouts, with pension funds mainly investing in assets abroad (European Commission, 2018e). The government sector recorded a headline surplus of 1.2%, driven by past consolidation measures and increasing tax revenues.

Household debt largely consists of mortgage debt. The tax deductibility of mortgage interest payments incentivises households to take on mortgage debt. The household debt ratio declined to 105% of GDP in 2017 on the back of strong GDP growth, although nominal household debt is increasing again. However, growth is much slower than before the crisis, at around 1% annually in recent years. Growing mortgage debt can be linked to the strong recovery of the housing market. House prices accelerated in 2017, increasing by 6% in real terms therefore reaching the macro- economic imbalance procedure threshold. Overall, house price developments suggest a lagged supply response rather than overvaluation at national level (see Section 4.2).

Private debt is expected to remain elevated. Solid nominal GDP growth is projected to support the trend of passive deleveraging. The acceleration of the maximum applicable rate of mortgage interest deductibility from 49% in 2019 to 37% in 2023 has been adopted by Parliament. While this decreases the debt bias for households, a substantial subsidy remains. The government has also launched initiatives to support the private rental segment, which would provide households with an alternative to taking on mortgage debt. However, with a share of 13% of the total housing stock in 2017 the private rental sector remains underdeveloped. For firms, a limitation on the deductibility of interest payments has been introduced in 2019, which may reduce the incentive to take on debt for tax optimisation purposes.

OVERALL ASSESSMENT

The Netherlands has recorded persistently large current account surpluses. The net lending position is largely driven by non-financial corporations, with both relatively high savings and low investments. Corporate net lending is also likely influenced by the presence of large multinationals. Households also make a positive contribution, among other things due to high mandatory pension contributions. Household debt as a share of GDP is around 50 pps higher than the euro area average as tax incentives encourage households to take on mortgage debt. While household debt is coupled with substantial housing and pensions assets, these assets are often illiquid, leaving households vulnerable to shocks.

The external surplus and the high private debt level are both expected to unwind only gradually. The current account balance is set to moderate slowly on the back of domestic demand and rising wages, also supported by the fiscal stimulus package. However, the level is expected to remain well above the threshold. While household debt is decreasing as a share of GDP, it is increasing in nominal terms as the housing market has recovered. Despite measures taken, strong incentives to take on mortgage debt remain, also against the background of an underdeveloped private rental market.

HOUSING MARKET

The housing market moved from recovery into a phase of buoyancy. Nominal house prices increased by 9% in 2018, up from annual growth of 7.6% in 2017. Nationwide, house prices exceeded their 2008 nominal pre-crisis level in mid-2018, although they are still well below the pre-crisis level in real terms. Real house prices increased by 6% in 2017, thereby reaching the MIP scoreboard threshold, and accelerated further in 2018.

Price-to-income and price-to-rent ratios were broadly in line with historical averages in 2017. A model-based assessment also does not suggest that house prices exceeded their fundamental value (Graph 4.2.5). These indicators suggest that house prices were overvalued before the crisis, followed by a strong correction during the crisis, and recovery in recent years. Overall, current housing market developments point to a lagging supply response rather than overvaluation. However, a continuation of price increases at this rapid rate could lead to a risk of overvaluation in the future. The ratio of average prices to income has already returned to a level that is higher than in most euro area economies.

Behind national trends, substantial regional differences exist. The housing market recovery was led by the larger cities, where house prices have increased at a faster pace than the rest of the country. In the four largest cities, house prices increased by 11% to 13% per year on average in 2016-2018. In most provinces outside the *Randstad* region, house prices increased at a more modest rate of around 5-7% in the same period. This difference may be explained by the attractiveness of urban areas (PBL, 2015) and more restrictive supply constraints in those areas. A recent study by the Dutch central bank suggests that house prices react stronger to income increases in municipalities where a larger share of available land has already been developed (Öztürk et al., 2018).

While demographic trends and economic developments increase demand for housing, available housing supply has decreased substantially. While population growth was just below 0.5% per year over the last 10 years, the number of households increased at a substantially faster rate due to the increasing share of one-person households. Nominal disposable income per household, after stagnating during the crisis, has been increasing again and was almost 8% higher in 2017 than in 2008. Financing costs have started to pick-up recently, but are still below pre- 2008 levels due to low mortgage interest rates (De Nederlandsche Bank, 2018d). However, on the supply side of the market, the number of existing dwellings for sale has decreased by more than 70% between 2012 and 2018([18]). The number of transactions peaked at a historic high of 242 000 in 2017, but decreased by almost 10% in 2018. The slowdown is most pronounced in the larger cities, where supply shortages are largest, but is occurring in all provinces.

Building more homes could help ease current housing market pressures. Housing supply in the Netherlands has historically been relatively inelastic, although it has increased since the crisis according to a recent Centraal Plan Bureau--study (Michielsen et al., 2018). The development of new dwellings has declined drastically since 2009 and started to recover in 2015 (Graph 4.2.6). The government has stated an annual construction target of 75 000 dwellings until 2025 to address housing shortages and meet demographic trends (Ministry of the Interior, 2018a). In 2018 66 000 new dwellings were built and the number of new building permits, which reached 70 000 in 2017, remained roughly stable at that level.

Household saving is to a large extent driven by institutional features of the housing market and the pension system. Following a housing market boom, the crisis led to a considerable dip in new construction. Residential investment as a share of GDP, declined from over 6% in 2008 to 3% in 2013, leading to an increase in household net lending. The decrease in house prices also resulted in a negative net housing equity position for many households. This wealth shock could have contributed to the strong fall in private consumption during the crisis([25]), further boosting household saving. Policy factors like the introduction of mandatory mortgage repayment within 30 years to qualify for mortgage interest deductibility in 2013 also require homeowners to increase their savings. On the pension side, high pension contributions and investment income that exceed pension benefits also fuel the household surplus (see Section 4.2.5)

POLICY PERSPECTIVE ON HOUSEHOLD BALANCE SHEETS*

Long household balance sheets make households vulnerable to financial shocks, with pro-cyclical effects. Pension entitlements as a share of GDP have been on an upward trend between 2007 and 2017 reaching almost 200% of GDP (Graph 4.2.12 and Section 4.2.5). Housing wealth decreased during the crisis, but has been increasing over a longer time horizon. However, both housing and pension wealth are typically illiquid. At the same time, almost half of all households own less than EUR 10 000 in liquid financial assets (Smid and Luginbuhl, 2018). High debt and low liquid savings make households vulnerable to financial shocks, and limit consumption smoothing over time. Low liquid assets are also associated with a higher volatility of consumption at the macro-level (Lukkezen and Elbourne, 2015).

Pension savings come with a large compulsory payment wedge on labour and low liquid savings. While high mandatory pension contributions lead to good pension adequacy, they make up a large part of the relatively large tax and non-tax compulsory payment wedge in the Netherlands (European Commission, 2018e). At EUR 33 billion in 2017, contributions amounted to almost 10% of total employee compensation just for the second pillar. The high pension assets that households build up over their lifetime are among the largest in the euro area, but are generally not accessible until retirement.

Mortgage interest deductibility is an important driver of household debt. This fiscal subsidy encourages households to enter the owner- occupied market and take on mortgage debt. Given housing supply-constraints, it also leads to higher house prices. The announced acceleration of the reduction in mortgage interest deductibility between 2020 and 2023, reducing the maximum applicable rate from 49% to 37%, has been turned into legislation (Belastingplan 2019). Nevertheless, the fiscal subsidy on home-ownership remains substantial.

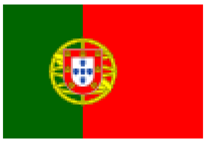
Further developing the private rental market can contribute to reducing household debt. Implicit and explicit subsidies lead to a relatively large and highly regulated social housing sector (a share of 29% of the total housing market). The private rental market, as the only non-subsidised segment, remains underdeveloped with a share of 13% in total dwellings. It is often not affordable for middle-income households, while at the same time they are not eligible for social housing (Middelkoop and Schilder, 2017). In 2018, the government presented draft legislation to ease the requirements for housing corporations to build for the middle income rental segment (*Wet maatregelen middenhuur*). Municipalities also play an important role in increasing private rental supply, but may not be fully incentivised to do so. Since 2017, they can include minimum shares for the affordable private rental segment in their zoning plans. However, they can generate higher revenues by developing and selling land for new construction in the owner occupied segment market as mortgage interest deductability pushes up prices in this segment (De Nederlandsche Bank, 2017). At the same time, according to a recent survey the percentage of municipalities that had some form of policy aimed at increasing supply in this segment rose from 40% in 2016 to 53% in 2018 (Stec groep, 2018). Supply-side measures in the rental segment can provide an alternative for middle incomes to taking on mortgage debt, but the debt bias for households continues to exist as long as homeownership is fiscally subsidised.

Taken together, current pension and housing institutions may lead to a sub-optimal pattern of saving and consumption over the lifetime. Households are encouraged to take on high mortgage debt. The introduction of mandatory mortgage repayment to qualify for interest deductibility in 2013 improves the incentive for households to repay their mortgage. However, higher monthly mortgage payment and high pension contributions both require substantial savings, which puts consumption under pressure. At the same time, replacement rates at retirement exceed 100% for many households, particularly in the case of homeowners (Studiegroep Duurzame Groei, 2016). This suggests potential welfare losses due to a lack of consumption smoothing over the lifecycle.

Poland:

Labour market outcomes and employment challenges differ between regions. There remain substantial differences in unemployment rates between and within regions. This in part reflects differences in human capital and in regions' economic structures but also limitations on geographical mobility. Barriers include underdeveloped transport infrastructure and services (see Section 3.4), insufficient access to affordable housing in locations with high demand for labour (especially larger cities), disincentives in the benefit system and features of the unreformed special pension regime for farmers (European Commission, 2017a).

A comprehensive strategy for the socio- economic integration, including independent living of persons with disabilities and mental health problems is lacking. The support system is fragmented, lacks coordination and consistency between different forms of support and does not take full account of individual needs of the people with disabilities and their families (Badania Społeczne MSK, 2017). The availability of community-based services addressing individual needs, in particular assistant services and supported housing, is not sufficient and requires investments. The support system discourages persons with disabilities and carers from taking up jobs.



Portugal:

Risks linked to the increase in house prices appear to be contained for the time being. The rebound in house prices since 2016 is seen as a correction from previously low levels of valuation and construction activity and is currently not considered an imbalance. Moreover, the stock of housing loans relative to GDP is declining and new housing loans are substantially below the rates reached before the crisis in 2008. Nevertheless, it warrants closer monitoring if the current rapid pace of real house price growth is sustained over the medium term. The increase in house prices also risks having a negative impact on the affordability of housing for socially vulnerable groups (see Section 4.3.2).

Consumer loans are growing rapidly, while gross mortgage lending remains subdued. Overall, loans to households increased by only 0.6 % between June 2017 and June 2018, but consumer loans grew by 11.3 %. Monthly new consumer loans amounted to less than EUR 200 million in 2012-2013, but are now at around EUR 400 million (see Graph 4.2.1). New mortgages were on average below EUR 175 million per month in 2012-2013, having fallen from EUR 1.5 billion per month in 2004-2007. Since summer 2017, they have been consistently above EUR 700 million. But despite double-digit growth in new mortgage attribution, redemptions still outweigh new housing loans. Consequently, the stock of outstanding mortgages fell by 1 %. Loans for other purposes fell by 2.4 %.

HOUSING MARKET

House prices continued accelerating in 2017 and the first quarter of 2018. In annualised terms, the growth in house prices peaked to 12.2 % in Q1-2018 but moderated somewhat afterwards to 11.2 % in Q2-2018 and 8.5 % in Q3-2018. This compares to a year-average growth rate of 9.2 % in 2017. The recent statistics on construction volumes and newly issued construction permits show substantial growth. Along with the slowdown in tourism, these developments indicate that supply of real estate properties is likely to gradually catch up with demand. Therefore, the increase in house prices is set to slow down over the medium run. However, a more significant rebalancing effect from the recent growth in construction is likely to be seen as of 2019, as many projects are still in the pipeline and will not have an immediate impact on the market.

The increase in the deflated house price index is expected to exceed again the 6 % indicative threshold in the macroeconomic imbalance procedure scoreboard in 2018. This would mark the third consecutive breach of the threshold after 8.0 % in 2017 and 6.1 % in 2016. However, the rebound in house prices is seen as a correction from previously low levels of valuation and construction activity and the stock of mortgage loans is still on a downward trend relative to GDP. The market was mainly driven by tourism and foreign capital inflows, particularly in the main cities of Lisbon and Porto where the price hikes are well above the average. This is moving prices not only in popular tourist areas but affects also residential quarters. This is thus having implications on housing affordability, particularly for socially vulnerable groups (see Section 4.3.2).

The impact of foreign capital flows is linked to purchases of properties by both non-residents and non-habitual residents[30]. It is estimated that about 20 000 non-habitual residents, including about 7 000 directly attributable to targeted regulation and financial incentives, have been attracted between 2012 and 2018. These incentives have drawn over EUR 4 billion in additional investment, mostly concentrated on real estate acquisitions.

Property valuations appear broadly in line with fundamentals. The estimated price-to-income and price-to-rent ratios in 2017 are still below the long- term average (see Graph 4.2.3). The gap based on deviation from equilibrium values based on demand and supply fundamentals shows an overvaluation of 7.5 % in 2017 but the estimated overall house price gap is close to zero. House prices are therefore not considered a source of imbalances for the moment given also the non-debt nature of factors behind the recent price drivers. However, these developments warrant a closer monitoring under the macroeconomic imbalances procedure.

The risk of poverty remains high in rural areas. The proportion of people at risk of poverty is significantly larger in rural areas than in cities, with a larger gap than EU average (see Graph 4.3.2). Recent data show that, taking the national poverty threshold as the benchmark (EUR 5 610 in 2017), the Greater Lisbon area (Área Metropolitana de Lisboa) was the region with the lowest at-risk-of poverty rate (12.3 %) while the Autonomous Regions were the most affected by the risk of poverty (31.5 % in Azores and 27.4 % in Madeira). Nonetheless, pockets of poverty persist also in urban areas, notably in the capital region when computing the poverty threshold at regional level (see further details in Section 4.4.3

Recent increases in house prices (see Section 4.2.2) can put housing affordability at risk in urban areas. Overall, indicators of housing cost overburden ([37]) do not signal a challenge for Portugal compared to the EU average. However, the share of tenants experiencing housing cost overburden, at 28.2 % in 2017, is above the EU average of 26.2 %. Moreover, the rate of severe housing deprivation in cities, though decreasing, is above the EU average (5.3 % vs. 3.8 %). The recent rise in housing prices is likely to worsen the situation for people who have low incomes particularly in the country's two largest cities. The government launched a 'New Generation of Housing Policies' strategy in May 2018 which acknowledges the problem, notably for lone-parent households and young people. The strategy aims at promoting universal access to adequate housing, for instance by increasing the share of public supported housing and lowering the housing overburden within the rental regime.

Box 4.3.2: **The 2018 Tripartite Agreement**

A tripartite agreement was signed in June 2018 to tackle precarious employment, reduce labour market segmentation and promote more dynamism in collective bargaining. The measures proposed in the agreement, subject to parliamentary approval (expected in 2019), seek to introduce changes in the labour code, the code of contributory schemes, the legal framework for the protection of employees, the framework of active labour market policies and other complementary legislation.

The approved action plan consists of three main strands of action. The first one tackles precariousness and seeks to reduce labour market segmentation, namely by limiting the scope for legal use of fixed-term contracts (e.g. reducing the maximum duration of fixed-term contracts) and reducing the safeguard period to access social unemployment benefits when unemployment is due to the expiry of fixed-term contracts. Other proposals aim to reduce the excessive use of fixed-term contracts, promote open-ended hiring (by increasing the length of the probationary period and by means of incentives) and to increase contract duration for seasonal activities.

The second strand of the proposal focuses on fostering collective bargaining as a shared effort to involve stakeholders with a view to improve labour market outcomes. This includes reducing individualisation of labour relations, preventing gaps from occurring due to the expiration of collective agreements and promoting the collective dimension for instruments of labour regulation.

The third strand is policy-driven and envisages the reinforcement of public means and instruments to regulate labour relations. It implies upgrading the capacity of the Labour Conditions Authority, reinforcing the mediation role of the Labour Administration and simplifying communication procedures regarding employment contracts.

Romania:

Housing market

The growth rate of house prices is slowing down, but developments vary at sub-national level. Housing demand has been adversely affected by higher lending costs and overall higher prices. House prices increased by 5.7 % in Q3-2018, less than the same period of the previous year (6.2 %). The deceleration continued in the first quarters of 2018 on the back of volatile demand, especially in the residential segment, due to the tightening of both public (the *Prima Casă* programme) and private credit conditions. Substantial regional differences persist. House prices advanced by less than 6 % in Bucharest in Q3-2018, but some counties saw double-digit increases.

Household indebtedness has increased in recent years, although from low levels. Due to the sustained increase in housing loans since 2015, household indebtedness has increased in absolute terms. Whereas household debt-to GDP stood at just below 17 % in 2017, well below the EU average, the indebtedness level of low-income borrowers constitutes a matter of concern as they are the most exposed segment to an increase in interest rates. To curb the risks from the high indebtedness of individuals with low income, the National Bank of Romania introduced as of January 2019 maximum levels of indebtedness for both RON and foreign currency denominated loans (40 % and respectively 20 % of net income). These levels can be increased by 5 pps for borrowers taking out a mortgage loan for the first time to buy an own occupied dwelling.

The high level of housing deprivation hampers social inclusion. One in seven households faces a serious housing problem (e.g. humidity, lack of sanitary facilities) ([33]). Overall housing deprivation is the highest in the EU. Romania's housing stock is low quality, energy inefficient and deteriorating because of lack of maintenance (Housing Europe, 2017). Post-institutionalised children, the victims of domestic violence and the mentally ill are particularly in need of housing. Social housing policies are being decentralised without a strategic framework, which makes poverty worse in areas that are already poor. Through measures co- financed under the European Social Fund approximately 260 vulnerable communities are currently supported, but not all vulnerable groups are covered.

Roma community, to enhance access to quality services and address material deprivation, and invest in housing, health care and long-term care infrastructure and in particular to:

- develop and consolidate individualised integrated services, in particular in marginalised areas; initiate targeted measures to support children at risk of poverty and social exclusion;
- increase quality and availability of social services and develop tailored family-based approach;
- improve access of Roma community to integrated support and mainstream services.
- support the upskilling of social, health-care and long-term care workers and tackle territorial disparities;
- support deinstitutionalisation of children and of adults with disabilities, including relevant training, services, and infrastructure;
- develop social housing services and infrastructure for vulnerable groups, in a comprehensive way, to reduce spatial segregation, including by urban regeneration projects;
- address material deprivation through food and basic material assistance to the most deprived;
- increase access to primary health services and prevention; develop outpatient care and e-health solutions, in particular at community level and for vulnerable groups; support health infrastructure with emphasis on primary/ambulatory care and intermediate care facilities;
- develop home care, long-term care and community-based services and infrastructure, in particular for the elderly and people with disabilities; support effective national active ageing measures

Slovakia:

Growth in house prices appears to have peaked, as macroprudential policy measures help to contain credit growth. Low interest rates and limited housing supply still support house prices, but a range of indicators suggest no signs of significant housing market overvaluation. Budgetary consolidation is set to continue, supported by a favourable economic environment.

Addressing the various investment needs in Slovakia — including those in education, innovation, infrastructure and energy technology — will help secure future growth and prosperity. Strategic investments in education and training and in research and development can help to bring out the best in young and future workers and researchers. Making the economy more knowledge-based will require investments in digital connectivity and the digital transformation of enterprises. Inadequate road and rail transport networks hinder smooth and efficient transport and transit. Sustainable and green investment can improve the energy efficiency of industries and buildings and support climate change adaptation, waste and water management, biodiversity and improved air quality. Shortages of skilled labour and future economic and social trends will require investment in improving people's skills and in social infrastructure. This includes more accessible social housing, better healthcare, long-term care and childcare, with appropriate attention being paid to regional disparities. Annex D identifies key priorities for support by the European Regional Development Fund, the European Social Fund Plus and the Cohesion Fund over 2021-2027, building on the analysis of investment needs and challenges outlined in this report.

A stronger labour market is reducing poverty levels but some regions lag behind significantly. The situation is particularly critical in the south-eastern parts of the country, where high poverty and social exclusion levels are acute in the marginalised Roma communities. The effectiveness of policies to improve the social inclusion of disadvantaged groups is hampered by insufficient social housing, inefficient governance structures and the low attractiveness of social work.

Credit growth

The buoyant economy is set to support credit growth for both households and non-financial corporations. Record-low interest rates and favourable labour market outcomes have and will continue to stimulate credit growth to households, even if it may have peaked in the first half of 2017. Since then its annual growth has eased, but it remains above 10 %. Slower mortgage lending growth appears to be the major factor underpinning the slowdown in total credit to households. Furthermore, macro-prudential policy measures effective from July 2018 (NBS, May 2018) are likely to relax demand pressures in the housing market by restricting credit supply. Credit flows to non-financial corporations remain strong. Loans for investment purposes kept growing solidly at a rate of 8 % year-on year, while growth in loans to small and medium-sized enterprises slowed to below 5 %.

Housing market

Despite fast price rises, the housing market does not show major signs of overvaluation yet. Although property prices keep increasing, developments so far have been broadly in line with the strong economic and financial fundamentals. Property price growth reached a peak at the turn of 2017 and has eased since. Strong demand that pulled property prices out of their post-crisis slump reflects favourable affordability backed by record- low credit costs (NBS 2017) and gains in real disposable income by households. The increase in building permits and residential investment have also mitigated demand pressures on prices. Envisaged slower employment growth and the tightening of credit standards by the National Bank of Slovakia are likely to restrain demand and shield the housing market from overheating.

Banking sector

Slovakia's small banking sector performs well but fast-growing private indebtedness may threaten future

prospects. There are 25 banks operating in the country and together they control close to 70 % of the total financial assets. Half of these are controlled by 3 major players. Retail loans (consumer and housing) continue to dominate the credit market, and have been growing faster than corporate loans in the first half of 2018 (11.2 % year-on-year vs 5.4 % year-on-year). In the same period, Slovakia recorded one of the fastest credit growth rates in the non-financial private sector in the EU. The rapid growth of household indebtedness in particular was also identified by the National Bank of Slovakia as a potential risk to the stability of the financial sector.

Housing market

Similar to other Central and East European countries, housing prices continue to rise. In Q3 2018, residential property prices (on average EUR 1433/ m2) surpassed their previous peak of Q2 2008. In 2018 house price inflation moderated from 4.8 % year-on-year in Q1 to just 4.0 % in Q3, a virtually unchanged level from the previous quarter. Prices are heavily skewed towards the Bratislava area where the average price / m2 is EUR 2000, almost double compared to the next most expensive regions, Trnava and Košice.

The estimated valuation gap for housing prices in Slovakia is close to zero. According to Commission calculations, the alternative valuation metrics suggest no significant overvaluation imbalances and the growth rates recorded in the past years appear sustainable. In particular, price- to-income measures do not point to an overheating housing market. Affordability remained stretched in 2017, with an average of 9.5 years of income needed for the acquisition of 100 m2, which is broadly in line with the long-term average.

Demand for housing is fuelled by a positive economic climate, but also a lack of alternative housing options. Slovakia ranks very high in EU in the share of young people (aged 25-34) still living with their parents (57 % v the EU average of 28 %; Eurostat, 2019) and in the high number of persons sharing rooms. Slovaks also leave their parents' house at the age of 31 on average, putting them among the latest in the EU. The thin rental market means that young people often struggle to move to rented accommodation as an intermediate step towards home ownership (see chapter 3.3). Less than 9 % of the population rents at market prices, usually in Bratislava and a few other cities. The lack of property for rent keeps the cost of renting high (in some cases even higher than the cost of ownership), while also limiting labour mobility. Lower income groups are particularly hard-hit, being priced out of the rental and ownership market, while also suffering from a shortage of social housing in major cities. Housing infrastructure available for social housing is a prerequisite for effective roll-out of social policies.

Household debt

Household debt continues to rise and poses a potential risk to the stability of the banking sector. A favourable economic outlook, historically low interest rates, high employment and rising wages have encouraged households to take on increasing amounts of debt. However, households' disposable income did not rise as fast as GDP or wages over the past 10 years (2008- 2017 average GDP growth 2.5 %, wages 3.1 %, disposable income 1.6 %). Slovakia recorded the highest growth in terms of household debt to GDP in 2017 and the first half of 2018 in the EU. This debt mostly consists of mortgage loans, associated with a culture of home ownership. Slovakia ranks very high in the EU in t erms of people living in owned dwellings (90.1 % versus 70 % and 66 % and euro area averages). All these were major contributing factors to the accumulation of debt.

Intermediaries such as mortgage brokers play a major part in keeping the flow of new mortgages high. Around 60 % of new mortgages are arranged via brokers, whose earnings consist of commissions earned upon the signing of a new borrowing agreement. While brokerage activities have helped to create more liquid mortgage markets, they have also contributed to households regularly re-financing their mortgages at lower rates while leaving debt service costs typically unchanged. This in turn has eroded financial buffers for households in the event of interest rate increases, and the reliance of banks on brokers has driven down banks' lending margins.

Higher household savings can create financial buffers to cope with rising debt service costs. Looking ahead, potential rising interest rates will pose a double risk to households. First, the debt service effort will increase and squeeze household finances. Second, some households may no longer qualify for mortgage loans on the basis of the macro-prudential rules in force, which may cause them to substitute mortgage financing with more expensive consumer loans. The impact of rising interest rates is enhanced by the generally long terms of existing mortgage and consumer loans (more than 26 years on average for housing and seven years for consumer loans). Households appear to have responded to rising house prices by extending mortgage maturities, as during 2017 63 % of mortgages were issued at 30-year maturities (the permitted maximum), up from 54 % in 2016.

The social economy sector remains underdeveloped but measures have been taken to stimulate its growth. In 2017, only 2.1 % of the working population was employed in the social economy sector, well below the EU average of 6.8 %. Important persisting barriers include: a) lack of financial capital and of entrepreneurial skills in the population; b) weak coordination of the policy with the public employment service; c) insufficient inclusion of social aspects in public procurement procedures; and d) limited access to decent housing. In the disadvantaged regions, social enterprises also struggle with the low purchasing power of the local population (Škobla, D. et al.2018). The March 2018 Social Economy and Social Entrepreneurship Act laid down a new legal framework, which should allow for more investment in this sector.

Weaknesses in social safety nets and social protection persist. The adequacy of the minimum income benefits is below the EU average. ([26]) The overall improvement of the labour market has also contributed to a decline in the number of minimum income support recipients. In 2017, the number of recipients of minimum income support further decreased to a monthly average of 87 727 (by 16.9 % compared to 2016) of which 57 725 were registered with the Labour Office, receiving an average monthly benefit of EUR 134.62. Around 70 % of people at risk of poverty did not have access to the minimum income benefit in 2017 (Ministry of Finance et al. 2018f). Housing support benefit is particularly low (EUR 89 for two or more family members), and covers only marginal part of real housing costs in the tight Slovak housing market.. In addition, the eligibility criteria for receiving unemployment benefits remain strict, despite some loosening in 2018. ([27]) This translates into relatively low coverage of the short-term unemployed by unemployment benefits.

Social housing remains underdeveloped. The low availability of rental/social housing negatively affects the effectiveness of social policies aimed at socially disadvantaged or excluded persons and persons with disabilities, and will require significant investment. For certain groups, the provision of social housing support would bring economies to public budgets. This is in particular the case of families or single mothers with children in institutional care, where re-unification of the family by providing adequate social housing would be less costly than keeping children in care (G. Csomor, 2017). In addition to the lack of infrastructure, there is no strategy at the government level to reduce and prevent homelessness, and the responsibilities stay mostly with the municipalities. The lack of a coordinated approach even leads to cases of facilities allowing 24-hour stay being turned into night shelters, just because the latter have more stable access to finance through the Ministry of Labour. The concepts of homelessness or inadequate housing situation are also very vaguely defined in the legislation.

The living conditions in marginalised Roma communities are often hampered by the lack of access to services. There remains a need for investment and support for Roma marginalised communities([28]) to ensure access to essential services, including water, sanitation, energy, transport and other facilities. The Atlas of Roma Communities (UNDP, 2014) is under revision, mapping the existing infrastructure and facilities and developing a statistical survey of living conditions, with data expected in 2019. Large- scale systematic progress is hampered by the lack of social housing. While some improvement is expected in response to the non-governmental sector projects based on micro-credits and self- construction, and to a newly launched EU-funded call, further investment in non-segregated social housing is crucial.

Experiencing an increasing inflow of immigrants since 2011, Slovakia faces challenges to integrate them well. Foreigners concentrate mostly in the regions with the highest level of labour shortages. Approximately three-fourth of immigrants reside in Slovakia for more than three years (Ministry of Finance 2018c), accentuating the need for effective investment in long-term integration measures. Challenges persist regarding effective access to social and healthcare services, discrimination in the housing market, availability of affordable Slovak language classes and lack of coordination among central and local levels (Plavnická, J. and D. Šlosár, 2017).

New legislation aims to improve quality in higher education. A new law on quality assurance in higher education introduces a new independent accreditation system and aims at rationalising the number of universities and university degrees. It creates a new 'interdisciplinary studies' bachelor's programme. Students will also have an option to extend their fee-free study period by one year if they take part in an internship abroad or in the Erasmus+ programme (Eurydice, 2018). Measures may contribute to improving quality and the internationalisation of higher education if supported by better accreditation and quality assurance measures, an increased focus on strategic planning, and better governance of Slovak higher education. To improve studying conditions, the government announced new investments in student housing (EUR 50 million over two years) in May 2018.

Investment needs

More investment in skills, education, training and social inclusion can improve Slovakia's productivity and generate inclusive growth. Shortages of skilled labour and changing industrial production patterns require investment in human capital development and adapting the labour force to new job opportunities, including through fostering digital and entrepreneurial skills and activating the unemployed, particularly the long- term unemployed. Investment can raise the performance of the education and training system, and improve competitiveness and social cohesion. Using the full labour potential requires investment in social inclusion policies and social infrastructures, in particular accessible social housing, healthcare, long-term care and childcare, with due attention to regional disparities. Investment is also necessary to ensure universal access to public utilities and services, notably for segregated Roma communities.

While the coverage and quality of transport infrastructure has improved, progress is uneven and some regions lag behind. Weaknesses in the transport network could be tackled by enhancing the interconnectivity, multimodality and inter- operability of the existing public and urban transport network, and by promoting sustainable modes of transport. Slovakia ranks slightly above the average in the 2016 EU Transport scoreboard, with low scores on road and air transport infrastructure and road safety. It scores poorly as regards the completion of both the Trans-European Transport Network core road and railway network, such as in the Rhine-Danube corridor (European Commission, 2016). When complete, the projects could connect the less developed regions of Prešov, as well as Banská Bystrica and Košice, to growth centres in other parts of the country. Better connections and easier access to social housing could also improve the low internal mobility of workers and narrow the wage differential, while reducing labour shortages in prosperous regions and reducing unemployment in less developed ones (see section 3.3).

healthcare services, **including through infrastructure,** and in particular to: • ensure access to healthcare systems across the country, particularly for vulnerable groups, notably in prevention and primary care, with a view to reducing health inequalities; • improve accessibility of long-term care services for the elderly and promote active and healthy ageing; • address shortages in the number of medical occupations, taking regional disparities into account; • support integrated active inclusion measures, including through outreach and personalised services, to disadvantaged people, including providing food and basic material assistance to the most deprived; • support the transition from institutional care to community- or family-based services for persons with disabilities, as well as for children in state institutional care; • prevent and reduce homelessness and housing exclusion, including through social housing; • ensure the necessary support to and attractiveness of social worker professions.
Poverty, social exclusion and limited provision of essential services are particularly prominent in south-eastern Slovakia, strongly affecting the marginalised Roma communities. Priority investment needs are identified to **promote socio-economic integration, including through infrastructure,** in particular to: • increase the access to mainstream public utilities and inclusive social housing; • address the barriers in access to education, employability, health and housing, with a view of inclusion of marginalised citizens.

Slovenia:

Housing market

Increases in the prices of real estate reflect the recovery of the Slovenian economy. The robust GDP growth is being supported by employment, private consumption, consumer confidence, and bank loans to households, which are all co- dependent factors. The favourable economic situation led to increasing demand for real estate but supply has not responded. House prices have therefore been increasing strongly since summer 2016, reaching 13.4 % growth in the first half of 2018. While the prices of existing dwellings grew at 11.7 %, those of new dwellings rocketed in price by 26.8 %. Slovenia has now the highest growth in house prices of all EU Member States.

Despite the strong increase in house prices, there is no indication of a new real estate bubble. House price growth seems mainly linked to the current limited supply of new residential real estate that is pushing up prices up. It is expected that with an increase in construction activity residential real estate price dynamics could moderate substantially in the near future. Low household debt, moderate growth of housing loans and a low stock of loans to the construction sector indicate that there is no sign of increased risk to the banking system.

Although the aggregate valuation gap indicates that prices were undervalued in 2017, the recovery pace should be carefully monitored. Risks could increase in the event of excessive optimism about further growth in real estate prices. The Bank of Slovenia already issued two macro- prudential recommendations for the housing loans sector at the end of 2016 and has extended them in late 2018. Up to now, both of these recommendations seem to be effective. However, it is important that banks continue to maintain high credit standards in their housing loans.

Strong consumer lending growth raises credit risk, and has led the Bank of Slovenia to issue specific recommendations. Consumer lending grew by 11.6 % year-on-year in September 2018, partly driven by the pushy behaviour of some medium-sized banks underwriting non-purpose- specific consumer loans of longer maturities. To prevent the relaxation of credit standards and to improve banks' resilience, the Bank of Slovenia decided on 22 October 2018 to expand the existing macroprudential recommendation for housing loans to all consumer loans. Concretely, banks are invited to cap the loan-to-value ratio at 80 %, the debt service-to-income ratio at between 50 % and 67 % and the loan maturity at 120 months. In the event of increased risks to financial stability, the Bank of Slovenia stands ready to introduce binding macroprudential instruments if necessary.

The decrease of social benefits when taking up employment could reduce work incentives. According to a benchmarking exercise in the area of minimum income schemes conducted within the Social Protection Committee, Slovenia performs around the EU average for the indicators related to adequacy of the minimum income benefits (see draft Joint Employment Report 2018), which was increased by EUR 95,22 in the last year. However, inactivity traps in Slovenia are relatively large, especially for single parents and one-earner married couples with children. The major part of the inactivity trap is attributable to the withdrawal or reduction of social assistance, family and housing benefits when taking up employment, and only a minor share results from increased income tax and social security contributions. Reducing the inactivity trap is particularly important given the ageing of the population in Slovenia (OECD, 2018).

Spain:

After the sharp adjustment that followed the crisis, the housing market and construction sector are recovering. Despite sustained increases in recent years, housing prices remain far from the pre-crisis maximum levels both in nominal and real terms. House price developments vary greatly across regions, with larger increases in areas where the stock of unsold houses is lower. Despite the pickup in housing investment in recent years, its volume in 2018-Q3 was still at less than half of the pre-crisis peak (see Section 4.2).

Deleveraging needs remain for both corporations and households, but the stock of loans to households has started to increase again. According to prudential and fundamentals- based benchmarks, both household and non- financial corporations' debt remains high and deleveraging needs persist (see Section 4.2.3). The continued reduction of private sector debt is driven by non-financial corporations (NFCs), whereas the stock of total household debt stabilized in 2018 after being on a downward trend since 2010. Significant growth in new credit to finance durable consumer spending, as well as growth in lending for house purchases and a reduction in the repayment of mortgages (due to a reduction in housing debt) explain this change of trend. Even though consumer credit has contributed to the economic recovery in recent years by supporting domestic demand, its rapid increase increases agents' vulnerability to adverse shocks, especially if it goes to the most vulnerable households. On the corporate side, the debt reduction process has continued despite new credit flowing towards the less indebted and most productive firms, supporting investment (European Commission 2018a).

Amid rising house prices, the construction sector has started to grow, but houses are still undervalued for the country as a whole. House prices have risen for almost five years in a row, although there is a high degree of heterogeneity across regions, partly reflecting a still large stock of unsold houses in some areas and a buoyant rental housing market in others. On average for the whole of Spain, house prices remain below pre-crisis levels, and their recovery does not seem to imply potentially harmful dynamics, but price developments in some regions deserve attention. According to standard price valuation indicators, overall house prices are still undervalued in Spain, although some indicators suggest this gap is closing (see Section 4.2). Investment in residential construction has been increasing since the last quarter of 2015, but remains below pre-crisis levels (5 % of GDP in 2017, compared to about 12 % of GDP in 2006).

The housing market has consolidated its recovery, supporting the clean-up of banks' legacy assets. The housing market and construction sector continued to recover from the sharp adjustment that followed the crisis. Unsubsidised house prices increased by 7.2 % year-on-year in the third quarter of 2018. Prices of new dwellings went up by 6.1 % and those of used dwellings by 7.3 %. Despite this increase, house prices remain below the pre-crisis peaks, in both nominal and real terms (by around 22 % and 32 %, respectively). According to standard price valuation indicators, house prices are still undervalued in Spain, but some indicators suggest the gap is closing (see Graph 4.2.1).

Affordable housing is a challenge for tenants, low-income households with children, and non- EU-born people. The housing costs overburden rate ([56]) is above the EU level for low-income households (38.4 % vs 34.3 %), households with children (11.4 % vs 8.1 %), including those with a lone-parent (30.6 % vs 18.4 %). Tenant eviction orders increased by 4.3 % in 2017 and a further 7.9 % year-on-year in Q3-2018 (General Council for the Judiciary, 2018), in a context of increasing rents. The new State Housing Plan (2018 – 2021) includes rent subsidies targeted at vulnerable groups, promotion of public housing and housing renovation. The most recent survey on homelessness shows that between 2014 and 2016 the number of people hosted in a shelter increased by 20.5 % (INE, 2017a).

Investment needs

Increased investment in education and training, employment services and social inclusion policies is important for improving Spain's productivity and long-term inclusive growth. Promoting better access to quality and inclusive education is key to employability and social mobility. Investment in modern public employment services is a driver of quality jobs and smoother labour market transitions. High at-risk- of-poverty or social exclusion rates, in particular for children, call for investment in active inclusion policies and social infrastructure (e.g. social housing). Actions promoting labour mobility, entrepreneurship and the social economy can respond to depopulation in some inland regions. Integrating the different strands of healthcare services, while strengthening primary care may help adapt care delivery to population ageing, disability and chronic conditions. Investment should respond to regional needs and disparities in the availability and effectiveness of public services.

Poverty remains high, in particular for children and non-EU-born, as well as in-work poverty. Coverage and adequacy of benefits (different from pensions) are limited and some groups face barriers to access services. Care delivery is not adapted to population ageing, disability and chronic conditions. High priority investment needs are therefore identified to **foster active inclusion**, **promote the social integration of people at risk of poverty or social exclusion, including children, third country nationals and marginalised communities such as the Roma** and **enhance equal and timely access to quality services and social protection**; and in particular to:

- develop active inclusion policies, including a twin-track approach for persons with disabilities; adapt social protection to societal and labour market changes.
- promote social integration for people at risk of poverty and social exclusion, particularly children.
- fight discrimination, especially in access to education, labour market and social services. Support social housing infrastructure, jointly with education, employment and health interventions.
- strengthen primary care and integrated care, including through investments in infrastructure and e- health, in particular in regions lagging behind and with a view to reducing health inequalities.

Sweden:

Sweden's overall economic performance remains healthy, but mounting risks highlight the importance of addressing structural weaknesses. The housing shortage, long a key challenge, is the result of insufficient new housing construction compounded by demographic developments. Boosting construction in appropriate locations and market segments could help alleviate this. A more market-oriented rental housing sector could also help, and would underpin mobility and flexibility in the labour market. Tax incentives for property ownership and mortgage debt are aggravating the problems of growing household debt and overvalued house prices. Addressing these issues would make the Swedish economy more resilient and reduce risks posed by imbalances.

Investment growth is slowing as residential investment adjusts to lower levels. A fall in housing prices in the second half of 2017 is expected to reduce the construction of new housing, dampening growth in investment. In addition, investment in equipment is set to lose speed as trade-related uncertainty weighs on external demand and adds to already lacklustre business sentiment.

Strengthening investment ([2]) in new housing, education and skills could further enhance Sweden's long-term growth potential. It would also be beneficial to maintain investment in transport infrastructure and innovation. The investment rate in Sweden has stood well above the EU average for the last decade; nevertheless, some parts of the economy could benefit from more investment. A structural undersupply remains in the housing market, despite a significant increase in new construction over the past 5 years. In the education system, demographic developments will lead to an increase in the number of pupils, while the country already faces a teacher shortage. Investment in education and skills will also be crucial to help boost productivity growth and address the skills mismatch in some parts of the labour market. Finally, there is a need to maintain investment in transport infrastructure and Research and Development at high levels to support long-term productivity growth and to fully exploit business potential. Annex D identifies key priorities for support by the European Regional Development Fund and the European Social Fund Plus over 2021-2027, building on the analysis of investment needs and challenges outlined in this report.

Sweden has made limited ([3]) progress in addressing the 2018 country-specific recommendation.

There has been some progress in the following area:

Sweden is moving forward with policy steps to stimulate residential construction. This includes the gradual implementation of the '22-point plan' for the housing sector, as well as measures to boost foreign competition in the construction sector (see Section 4.2.2).

While banks are healthy, some vulnerabilities are linked to their growing exposure to the real estate market. Banks remain profitable. The regulatory capital adequacy ratios are healthy, though they decreased at end 2018 due to changes in the calculation of banks' risk-weighted assets. The major Swedish banks showed resilience in the 2018 stress test conducted by the European Banking Authority. The banks' high level of lending to the real estate market remains a key risk and households remain vulnerable to an adjustment in the housing market and an increase in interest rates. Moreover, since Swedish banking groups are of systemic importance for all countries in the Nordic- Baltic financial market, any shock to the banking sector could have a wider impact on neighbouring countries.

While house prices declined in late 2017 and have since been broadly stable, this follows a long period of strong price rises, and valuations remain well above fundamentals. Key issues include tax incentives favouring home ownership and mortgage debt, and accommodative credit conditions coupled with still relatively low mortgage repayment rates. Despite a sharp rise in new construction, a shortage remains, particularly of affordable homes around major cities. This shortage is linked to structural inefficiencies, such as limited competition in the construction sector. The housing stock is not used efficiently. In the rental market, below-market rents create lock- in and 'insider/outsider' effects. In the owner- occupancy market, capital gains taxes reduce homeowner mobility. The housing shortage makes it harder for people to change jobs and can contribute to intergenerational inequality.

The continued increase in household debt and bank residential mortgages are a growing risk to macroeconomic stability. Despite gradual policy action, mortgage debt continues to grow. With the housing market still appearing overvalued, even after the declines in autumn 2017, rising indebtedness means there is a growing risk of a disorderly correction. This could have an adverse impact on the economy and potentially the banking sector.

Residential investment, a key growth driver, is expected to adjust to lower levels. After a peak in mid-2017 house prices declined in the second half of the year and have remained largely unchanged. The decline had a negative impact on sentiment in the construction sector and new housing starts are expected to fall holding back investment growth. In addition, investment in equipment is set to lose speed as trade-related uncertainty weighs on external demand and adds to already lackluster business sentiment. Overall, investment growth is forecast to slow markedly until 2020.

Since the start of the European Semester in 2011, 84 % of all country-specific recommendations addressed to Sweden have recorded at least 'some progress'.([6]) 16 % of these CSRs recorded 'limited' or 'no progress' (Graph 2.1). Substantial progress and full implementation have been achieved in several policy areas, in particular fiscal governance and research and innovation. Limited progress has been achieved in implementing housing market and household debt related CSRs.

The focus has mainly been on macro-prudential measures and steps to tackle housing supply bottlenecks. Macro-prudential measures include a loan-to-value ceiling of 85 % for mortgages in 2010, raising banks' risk weight floors for mortgages in 2013 and 2014, introducing a formal mortgage amortisation requirement in June 2016, followed by a strengthened amortisation rule for high-debt-to-income borrowers in March 2018 (see Section 4.2.3). Sweden also strengthened the legal mandate of the macro-prudential authority in February 2018. These steps have improved the resilience of the banking sector (see Section 4.2.1), but have not been able to rein in household debt growth (see Section 4.2.3). The authorities have also introduced measures to streamline building and planning regulations and have provided some budgetary support to municipalities to encourage more construction. While this has resulted in a significant pick-up in construction, the current level is still below anticipated demand, particularly in major cities (see Section 4.2.2).

Sweden has made limited ([7]) progress in addressing its 2018 country-specific recommendation (CSR). Some policy steps have been taken in response to the recommendation (which is relevant for the macroeconomic imbalance procedure (MIP), see Section 3). However, implementation has been uneven and key areas are left unaddressed. For the housing market, Sweden is moving forward with policy steps to promote more construction, including the gradual implementation of the '22-point plan' for the housing sector, as well as measures to boost foreign competition in the construction sector (see Section 4.2.3). Additionally, in January 2019, the new government announced that reforms will be prepared to make the rent-setting system more flexible. There are also plans to make deferred capital gains taxes on sold properties in the owner- occupancy market interest-free. However, no progress has been made on reforming mortgage interest deductibility or recalibrating recurrent property taxes.

Growing household debt coupled with elevated house prices makes the Swedish economy vulnerable to shocks. Swedish house prices have risen steadily for almost two decades, although in autumn 2017 the market experienced a gradual decline followed by stabilisation over the course of 2018. Strong fundamentals, in particular robust disposable income and population growth, can explain part of Sweden's historical house price growth, but several indicators such as price-to- income (affordability) and price-to-rent (dividend) ratios suggest that house prices are above their historical trend. Distortive taxation and structural supply-side inefficiencies in the housing market contribute to this overvaluation (see Section 4.2.2).

The banking sector is solid, but it could be vulnerable in the event of a potential abrupt fall in real estate prices. Banks' assets have performed well so far and the sector has high profitability compared to its peers in other EU countries. However, banks rely to a large extent on international wholesale funding, giving rise to some degree of maturity mismatch. Risk weights generated by their internal models are low and might not fully reflect the underlying risks in banks' exposure to household mortgages. Banks also have significant exposure to the commercial real estate sector. Consequently, in a severe housing market or commercial property slump, these vulnerabilities could have repercussions for the wider economy and the financial system. Due to the importance of Swedish banks in the region, other Nordic economies might also be affected (see Section 4.2.1)

So far, however, these measures have had a limited impact on household debt growth, and key policy gaps remain. Sweden has one of the highest tax incentives for home ownership in the EU, due to relatively low property taxes and high mortgage interest rate deductibility, while the design of capital gains tax limits a more efficient use of the housing stock. These tax incentives contribute to the problem of persistent household debt growth.

Swedish banking groups have a substantial and growing exposure to household mortgages, while being supported by sufficient capital buffers. The near-term risks of household debt service problems seem limited, given low debt service costs and sizeable household budget margins. However, stretched housing market valuations combined with high debt levels make the household sector vulnerable to shocks. If, for instance, mortgage interest rates were to rise significantly, or if incomes were hit due to an external shock to the economy, households could be forced to rapidly reduce consumption levels. Moreover, as Swedish banks are reliant on wholesale funding, a downturn in the housing market could result in a sudden rise in bank funding costs, thus amplifying the impact of any domestic housing market adjustment. Supervisors are mindful of such risks.

Policy action focused on curbing housing demand via macro-prudential measures, combined with steps to stimulate new construction. Since 2010, Sweden has gradually introduced a number of macroprudential measures (see above), aimed at containing mortgage growth and thus housing demand. The authorities have also proceeded with the gradual implementation of the '22-point plan' for the housing market and similar measures to stimulate more construction.

Some key structural distortions in the housing market have not yet been addressed. In particular, no policy action has been taken to reform the tax incentives for home ownership and mortgage debt (see above). Similarly, so far there have been no concrete policy steps to liberalise tight rental market regulations and revise the capital tax on owner-occupied homes, although in January 2019 the new government announced plans to introduce reforms in these areas, subject to preparatory inquiry work (see 'Policy developments' in Section 4.2.2). In addition, there remains scope to further tackle the lack of land available for development, complex planning and building regulations, limited incentives for municipalities to support new construction and limited competition in the construction sector (see 'Supply-side issues' in Section 4.2.2).

Sweden faces sources of imbalances in the form of high private debt and overvalued house prices. The elevated private indebtedness, in particular of households, makes the economy vulnerable to macroeconomic shocks (see 'Risks and policy response' in Section 4.2.3). Such a shock could trigger deleveraging, potentially leading to harmful adjustment, with lower consumption and investment. Although house prices have stabilised well below their 2017 peak, they continue to appear overvalued. In the event of a large, disorderly downturn in the housing market, there is a risk of negative spillover effects acting on other Nordic countries through the financial system.

Policy measures to address these imbalances have so far been insufficient. The authorities have gradually taken some policy action to curb household debt growth in recent years, but this appears to have had limited impact on indebtedness growth. In addition, some key structural issues in the housing market have not been addressed. Overall, policy gaps remain for housing-related taxation, the functioning of housing supply and of the rental market.

Conclusions from IDR analysis
• Sweden is characterised by important sources of stock imbalances in the form of high household debt associated with elevated house prices, which represents a risk as it exposes Sweden to potential adverse shocks and a possible disorderly correction with harmful implications for the real economy and the banking sector and possible spillovers to countries with a strong presence of Swedish banks.
• Household indebtedness keeps growing. House prices have experienced a correction in the autumn 2017, followed by gradual stabilisation in 2018, but remain at levels that appear out of line with fundamentals.
• Some measures have been taken in recent years to address rising household debt, especially in the area of macro- prudential policy. However, these measures have had limited impact so far in addressing underlying imbalances. Overall, policy gaps remain in the area of housing-related taxation and the functioning of housing supply and the rental market.

Key risks and policy responses

Banks' high exposure to the housing market is a key risk. Households remain vulnerable to an adjustment in the housing market and an increase in interest rates. Since about 70 % of household mortgages have been taken at variable interest rates, an increase would result in higher payments, lower consumption and potentially substantial repercussions for the overall economy and the financial system (see Section 4.2.3). This was also highlighted by the Riksbank (Sveriges Riksbank, 2018a) and the Financial Supervisory Authority (Finansinspektionen, 2018c).

HOUSING MARKET (*) Housing market developments

Following a sharp adjustment in late 2017, house prices have broadly stabilised. After two decades of largely uninterrupted price growth, the housing market slowed notably in 2017, culminating in a nominal price fall in the autumn of close to 10 % on average. This decline was probably triggered by a sharp rise in new-built supply in specific market segments, notably high- end apartments in Stockholm (Sveriges Riksbank, 2018a; European Commission, 2018a). Since 2018, prices have broadly held steady (Graph 4.2.1). As of December 2018, they stood at about 7 % below their 2017 highs. Transaction volumes have overall remained weak compared to 2016 and early 2017, and have fallen somewhat over the course of 2018. The recent stabilisation and structural factors supporting house prices (see below) point to broadly steady prices in the near- term. However, the continued supply overhang in higher-priced Stockholm apartments represents a significant downside risk.

While house prices remain below their peak, valuation indicators still suggest that they are overvalued. Fundamental drivers, in particular strong population and income growth and increasing urbanisation, supported house price growth in previous years (European Commission, 2016a), but cannot fully explain the current high levels. Fundamental-model-based estimates suggest that the housing market is overvalued by around 12 % ([18]) as of end-2017 (Graph 4.2.2). Other valuation indicators like price-to-income and price-to-rent ratios (measures of affordability and return-on-investment of owner-occupied houses) point to a sizeable valuation gap of about 45 % and 65 % respectively above their long-term averages. These estimated valuation gaps are among the highest in the EU. While such indicators are inevitably subject to some modelling uncertainty, they do underscore that the Swedish housing market is vulnerable.

The recent housing market weakness has only made a modest dent in a long-standing upwards house price

trend. After bottoming out following the banking crisis in the early 1990s, house prices have grown steeply and persistently. In real terms, they have more than tripled, significantly outpacing income growth as well as house price rises in other EU countries (European Commission, 2018a). While the 2017 price declines were significant in absolute terms, real house prices have only moved back to roughly their end-2016 level. Thus, the recent market weakness should not detract from the broader concerns that Sweden's elevated high house prices contribute to macroeconomic stability risks (see Sections 3, 4.2.1 and 4.2.3) and also have implications for social equality (see 'Inequality' in Section 1).

Demand-side issues

Not only low mortgage rates, but several structural features of the Swedish mortgage market have boosted housing demand. Monetary policy in Sweden has been highly accommodative. Although the Riksbank has raised the benchmark interest rate in December 2018, it remains negative, as it has been for over 3 years now (see Section 1). While low interest rates naturally act as a tailwind for the property market, in Sweden this effect has been magnified by a high share of variable-rate mortgages, long contract maturities and still generally low amortisation rates (see Section 4.2.3 for details). As a result, debt service costs relative to incomes have remained low, even as house prices and debt levels have continued to climb.

The Swedish tax system favours owner- occupied housing over other investments, particularly when financed by mortgage debt. Under the dual income tax system, returns from financial investments are normally taxed at a flat capital income rate of 30 %. However, imputed rents (the effective return to homeowners on their housing investment) are not taxed. Instead, property owners pay a local property fee (*kommunal fastighetsavgift*). This fee is capped at a low ceiling([19]), resulting in a highly favourable tax treatment of owner-occupied housing compared to other investments, and low overall tax revenues from property by international standards (Graph 4.2.3). Additionally, interest paid on mortgages is generally deductible at the 30 % capital income rate ([20]), providing an effective subsidy for mortgage debt. This further favours (debt-financed) home ownership, both over other investment opportunities and over rental housing, for which the overall tax burden is considerably higher (Statens Offentliga Utredningar (SOU), 2014).

Reforming the tax incentives for home ownership and mortgage debt could contribute to reducing inequality and benefit job creation. The impact of such tax reforms would be broadly progressive, as households benefiting the most from low recurrent property taxes and generous mortgage interest deductibility tend to be the higher-income ones (Finanspolitiska rådet, 2016). Moreover, the fiscal room created by such reforms could be used to ease the labour tax burden in an appropriately targeted way, thus facilitating job creation and further supporting social equality (European Commission, 2018a).

Supply-side issues

One of the key drivers of Sweden's elevated house price level is a structural undersupply of dwellings. Following the early-1990s banking crisis, residential construction activity in Sweden was muted for a prolonged period, in spite of strong population growth and rapid house price rises (European Commission, 2018a). More recently, new housing construction has accelerated notably and annual housing starts more than tripled from their 2012 low to a recent peak of about 64 000 in 2017 (Graph 4.2.4). However, even after this strong upswing, new housing supply failed to reach projected near-term needs, estimated at about 90 000 new homes per year for 2018-2020. Additionally, some of the new construction appears to attract limited demand (Katinic, G., 2018), and may thus have little immediate effect on the broader housing shortage.

New housing construction slowed significantly in 2018, and appears set for further near-term falls. The late-2017 house price declines combined with an ongoing overhang of unsold new-built Stockholm apartments have had a notable impact on sentiment in the construction sector and expectations for future building activity (Graph 4.2.5). New housing starts fell significantly in 2018 — by an estimated 20 % across Sweden as a whole, and about 35 % in Stockholm — with further declines projected in 2019 (Graph 4.2.4). As a result, the recent housing market weakness may exacerbate the long-standing supply shortage even further. This underscores the importance of tackling remaining barriers to new housing construction.

Structural bottlenecks are constraining housing supply and raising construction costs. There is a lack of developable land, partly driven by the fact that a large share of buildable land is owned by municipalities, which can have financial incentives for making it available in a piecemeal fashion over time rather than when it is needed most (European Commission, 2015)([21]). Despite some recent reforms, zoning and building regulations overall remain relatively cumbersome and complex. In particular, the interpretation of building rules continues to vary between some municipalities ( ), creating a fragmented market that reduces efficiency and increases uncertainty for construction companies (European Commission, 2016). Additionally, the total time required to complete land acquisition and planning processes can be considerably longer than in other countries (Emanuelsson, 2015). This raises financial risks for construction projects and causes delays in new supply. Rigidities in the construction sector have weighed on productivity growth and restricted competition ([23]), raising construction costs in Sweden to among the highest in the EU (European Commission, 2018a).

Barriers to efficient usage of the housing stock

Sweden's tightly regulated rental market can create lock-in and 'insider-outsider' effects. Sweden's rental market has some of the strongest tenant protection rules in the EU (European Commission, 2017a). Rents are mostly set in collective-bargaining-style negotiations ([24]), which tend to result in below-market rent levels in urban areas (European Commission, 2018a). This creates large demand/supply imbalances and long waiting lists to obtain rental accommodation (Graph 4.2.7). As a result, sitting tenants can have a strong financial incentive not to move, even if their accommodation is no longer fully suited to their needs ([25]) (Katinic, 2018). Conversely, new entrants, such as students, young households and recent immigrants, face difficulties in getting a foothold on the rental market, thus creating an insider/outsider effect. Indirectly, the latter also contributes to high house prices in the owner- occupier market, as no access to rental housing can push households to purchase their own home.

The gap between negotiated rents and market rents has impaired rental housing supply, particularly in major cities. Below-market rent levels combined with high land prices create financial incentives to favour construction of owner-occupancy housing over rental apartments ([26]). This situation also encourages conversion of rental units into owner-occupied homes, thus further aggravating the rental housing shortage. Historically, this has been particularly pronounced in major urban areas: for example, in Stockholm, for every new rental apartment built, three were converted into owner-occupied units over the 1990s and 2000s (Emanuelsson, 2015).

In addition, there are negative knock-on effects on labour mobility and social equality. The lock- in and insider/outsider effects in the rental market can prevent workers from moving to locations with the best job opportunities, thus hampering labour market dynamism. Furthermore, tight rental regulations combined with a shortage of affordable rental housing can exacerbate inequality and social problems. This particularly affects lower-income households, and can contribute to a relatively high degree of overcrowding among socially vulnerable groups (OECD, 2017b). While reform of Sweden's rental market may also have significant redistributive and social consequences, this could be managed by a combination of tax measures and targeted subsidies (Donner et al., 2017).

The role of 'social contracts' in public housing policy is gradually growing. The need for affordable rental housing is linked to broader questions concerning optimal use of the available housing stock. Sweden does not have a designated social housing sector. Public housing companies ([27]) own around 20 % of the housing stock. Additionally, municipalities can offer 'social contracts' ([28]) to assist the most vulnerable groups in society. Although numbers are still low (roughly 30 500), such social contracts are gaining in importance, especially in urban areas.

Capital gains taxes on housing transactions can create lock-in effects in the owner-occupier market. Sweden applies a 22 % capital gains tax on property sales, even when a homeowner is selling to buy another property of similar value elsewhere (meaning no actual economic gain is realised). As house prices have increased significantly in Sweden, this means that households which have owned their home for a long time can face prohibitively high moving costs ([29]). In practice, this tends to particularly affect elderly households living in large single- family houses and looking to relocate to a conveniently-located apartment. Reforming capital gains taxation to eliminate this lock-in effect could help free up underused family dwellings from the existing housing stock and improve overall supply- demand matching in the owner-occupier market.

Policy developments

Demand-side policy action in the housing market has been focused on using macro- prudential measures to curb mortgage lending. Since 2010, Sweden has gradually introduced a number of measures, including loan-to-value limits, adjusting banks' risk-weight floors, and introducing a binding mortgage amortisation requirement in June 2016 (see Section 4.2.3 for details) to contain mortgage debt growth (and thus housing demand). A more stringent amortisation rule for borrowers with high debt-to-income ratios came in force in March 2018 (also discussed in Section 4.2.3).

The implementation of the '22-point plan' for the housing market continues. The plan, originally proposed in June 2016, contains a range of measures — mostly rather incremental in nature — which aim to increase the land available for development, reduce construction costs, shorten planning process lead times and address some specific inefficiencies in the rental market. Some parts of the plan, particularly those which concern reducing costs and lead times for new construction, have been broadly completed. For other elements, including a review of building and planning regulations and measures to make more developable land available, public inquiries and other preparatory steps are still ongoing. More time is required before these proposals can be finalised, therefore, and it remains uncertain whether they will result in actionable conclusions and ultimately successful implementation.

Sweden is taking steps to boost participation of foreign companies in the construction industry. In June 2018, the National Board of Housing, Building and Planning (*Boverket*) finalised the first phase of an effort to facilitate entry of foreign construction firms in the Swedish market in order to promote competition and lower residential construction costs. It set up an online portal ([30]) with detailed English-language guidance for foreign developers, including translations of building regulations and practical information on the Swedish construction sector. The web portal will gradually be expanded further, and Boverket will also investigate additional obstacles encountered by foreign operators and which could be addressed by targeted policy measures

The Swedish authorities intend to initiate inquiries into possible reforms to improve mobility in the housing market. As part of its policy statement in January 2019, the new government announced plans to introduce a more flexible rent-setting system for newly constructed housing, and to allow location to play a larger role in adjusting rents within the negotiation-based system for existing housing. Additionally, deferred capital gains taxes on sold properties in the owner- occupancy market could be made interest-free. Such reforms can potentially help address some of the barriers to efficient usage of Sweden's housing stock (see above), and incentivise more rental housing construction. However, these plans are subject to significant preparatory inquiry work to assess feasibility and develop detailed implementation proposals. It therefore remains unclear what form these measures will ultimately take and how impactful they will be.

Drivers of household debt growth

Mortgage lending growth is linked to the long period of steep house price growth in Sweden.

House price rises (see Section 4.2.1) and mortgage debt growth are mutually reinforcing: a strong housing market enables larger mortgage loans, as it increases the value of the underlying collateral, and growing mortgage debt levels raise demand for houses while supply is limited, thus putting upwards pressure on prices. Even when house prices remain broadly stable at a high level (as in 2018), overall mortgage debt still tends to increase (albeit at a slower rate). This is due to natural turnover in the housing market ([32]) and growth of the overall housing stock (Emanuelsson et al., 2018).

In Sweden, this dynamic is exacerbated by structural factors that lower debt service costs. A discussed in Section 4.2.2, there are strong tax incentives for purchasing owner-occupied housing, especially when financed with a mortgage. In addition, due to a combination of borrower preferences and institutional conditions([33]), mortgages are mostly variable-rate in Sweden. This reduces current debt service costs, but also shifts risks related to future rate rises to the household sector. Finally, Swedish mortgage contracts have long maturities compared to other EU countries, generally accompanied by low amortisation (i.e. capital repayment) requirements (Graph 4.2.10). This further amplifies the impact of low interest rates on debt service costs (European Commission, 2017a)

Risks and policy response

Growing household debt coupled with elevated house prices makes the Swedish economy vulnerable to shocks. If incomes were to fall due to an external shock to the economy, or if there was a sharp rise in mortgage risk premiums — triggered, for instance, by a renewed housing market downturn or by higher bank funding costs as perceptions about their riskiness worsen — highly-leveraged households may need to rapidly reduce consumption to meet their mortgage payments. This would reduce demand and increase uncertainty, potentially weighing on growth and employment and thus further impairing households' debt service ability. At the same time, overall credit availability may shrink, as falling collateral values make banks more cautious about new lending. Ultimately, this could lead to a self- reinforcing deleveraging process with a significant broader macroeconomic impact, in line with historical developments in other countries facing similar imbalances (OECD, 2017a; Crowe et al., 2011).

Risks are partly mitigated by households' robust payment ability and financial wealth. Households have relatively high income surpluses after mortgage service costs and day-to-day expenses, of roughly 40 % of disposable income on average (Finansinspektionen, 2018b). Households' strong payment ability is also reflected in a very low share of non-performing household loans (see Section 4.2.1). Additionally, households have a high savings rate and significant financial wealth, estimated at roughly three times their liabilities.

However, this strong overall financial position would likely provide only limited cushioning in a disorderly deleveraging scenario. Income surpluses are high on average, but they are heavily skewed towards higher-income households (European Commission, 2018a). Moreover, they assume that households are able to reduce their spending to near-subsistence levels. Thus, although most households may be able to continue servicing their debt even in a downturn, this would likely require a very considerable consumption reduction with major macroeconomic knock-on effects. As for financial wealth, close to 50 % of non-housing assets owned by Swedish households are invested in pension fund or life insurance instruments, and can therefore only be accessed upon retirement. Moreover, most non-housing assets are exposed to market risks (Graph 4.2.12), and would likely fall in value in an economic downturn. Thus, rather than cushioning the impact of a housing market fall, this could further amplify it, by weighing on consumption via wealth effects.

Sweden has mainly relied on macro-prudential measures to address the risks related to household debt growth. These include the introduction of a loan-to-value (LTV) ceiling of 85 % for mortgages in 2010, gradual increases in banks' risk-weight floors for mortgages in 2013 and 2014, a formal mortgage amortisation requirement in 2016, and an enhanced overall macro-prudential framework in February 2018. Additionally, in September 2018, the macro- prudential authority decided to further raise the countercyclical capital buffer for banks from September 2019, as a broad measure to improve financial sector resilience (see Section 4.2.1). While welcome steps forward, these measures have not meaningfully curbed the continued growth in household debt (European Commission, 2018a).

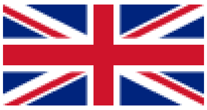
In March 2018, a strengthened amortisation rule for new mortgage borrowers with high debt-to-income levels came into force (see Section 4.2.1)**.** While there is insufficient data for a detailed impact assessment at this stage, the initial effect of this new measure seems to be rather muted, in line with *ex ante* analysis (European Commission, 2018a). There have likely been some changes in individual borrower behaviour, particularly in higher-priced segments of the housing market, but there appears to have been little immediate impact on overall house prices and household debt developments. Nevertheless, if house price growth resumes, this additional macro- prudential policy step is likely to become increasingly binding over time, and can thus help contain mortgage borrowing at excessive DTI levels.

Boosting investment in new housing, education and skills, and maintaining investment in transport infrastructure and R&D can further enhance the Swedish economy. Regarding housing investment, a structural undersupply of dwellings remains despite a significant increase in new construction (see Section 4.2). Moreover, building activity is set to slow in the wake of the late-2017 house price falls. Concerning the educational system, demographic developments will lead to an increase of the numbers of pupils, exacerbating the present shortage of teachers. Investing in education and skills will thus be key to help boost productivity growth and to address the skills mismatch experienced in some parts of the labour market (see Section 4.3). In addition, there is a need to maintain investment in transport infrastructure and R&D at high levels, as discussed below.

Macroeconomic perspective

Total investment as a % of GDP was above the EU average over the last decade. Both private and public investment have grown faster than GDP and the EU average. Private investment is set to grow at a lower but still robust pace, as residential investment adjusts to lower levels due to lagged effects of 2017 housing market weakness. Public investment in housing, healthcare and education infrastructure is set to remain overall robust in 2019.

The expansion of the high-speed rail network could support labour market connectivity and new residential developments. The national plan for infrastructure for 2018-2029 contains three routes for high-speed trains. The objective is to better connect Stockholm, Gothenburg and Malmö. Expansion is envisaged to take place at a pace allowed by the economy and in a cost- effective manner. In parallel, the National Negotiation on Housing and Infrastructure has agreed a framework with municipalities of the three metropolitan regions about central government co-financing of investments in public transport and cycling. In total, municipalities have committed to building 193 130 housing units, in particular between Uppsala and the county border with Stockholm.



United Kingdom:

The United Kingdom could boost its low, stagnant productivity by raising investment. Employment is high and the UK business environment has many positive aspects, including relatively free and efficient product, labour and capital markets. However, labour productivity and investment are low. The UK faces a broad-based need to invest more in equipment, infrastructure and housing, at the same time as bringing down project costs. There are weaknesses in basic and technical skills. Tight regulation of the land market can also prevent capital and labour from moving to where it is most needed ([1]).

Household debt remains high, having stabilised at 86 % of GDP in 2017. Growth in lending to households continued to ease in 2018, in a context of subdued house price growth and housing market activity. The banking system has continued to improve its capital position. UK banks became more profitable in 2017 and 2018.

There has been some progress in the following areas:

- Housing investment. Annual net housing supply has increased significantly from post-crisis lows. However, the recovery in house building has lost momentum since mid-2017 and it is now flattening off at a level below the estimated growth in demand. Many obstacles to higher house building remain, including extensive 'no-build' zones. Real house prices are high, but have stabilised in the context of economic uncertainty. The government has recently extended and revised a number of housing policies, including updating spatial planning rules. It is now easier for local authorities to borrow in order to build public housing, but wholly new initiatives have otherwise been limited.

Key structural issues analysed in this report, which point to particular challenges for the UK economy, are the following:

- **The availability and affordability of housing remains a major challenge.** House prices and rents remain high, especially in areas of high demand, and there are signs of overvaluation. Significantly fewer young adults now own their own homes and this contributes to inequality between generations. The amount and location of land available for new housing is limited by tight regulation of the land market, particularly around big towns and cities. This has prevented housing supply from responding adequately to shifts in demand, and inflated the price of building land and existing houses. The government recognises the problem and is implementing a range of measures to boost housing supply, but house building remains below what is required to meet estimated demand.

Homelessness is increasing and shows no signs of abating. According to recent research by the housing and homeless charity Shelter, there were around 320 000 homeless people in the UK in Q1-2018. This is a 4 % increase on the same period a year earlier (Shelter, 2018). The increase was largely driven by rises in homeless people in temporary accommodation and people without a shelter of any kind. Worryingly, homelessness is also surging among children. A calculated 131 000 children were homeless in March 2018. This is 3 % higher than last year and 59 % higher than five years ago. Wales and Scotland have seen bigger proportionate increases in homelessness than England over the last year (*ibid*.).

Since the start of the European Semester in 2011, the UK has recorded at least 'some progress' on 94 % of CSRs addressed to it. This includes 15 %, covering access to finance and fiscal policy, where it achieved 'substantial' progress. On the other 6 % of CSRs, it has recorded only 'limited' progress (see Graph 2.1). On labour market, housing and infrastructure CSRs, it has tended to record 'some' progress. While the government has put in place a range of relevant policies, these are all deep-rooted and long-standing policy challenges still requiring sustained reform efforts. There has been more variation in the assessment of fiscal CSRs over time as the pace of ongoing fiscal consolidation has fluctuated, as have trends in public investment.

The UK has announced a range of policy measures to increase housing supply. Residential construction and net additions to the housing stock have risen since the start of the decade, due both to an ongoing cyclical recovery from a post-crisis trough and to policy action, including major reforms to the planning system. Housing has become less affordable, despite a recent slowdown in house price rises. The high cost of housing, which is particularly acute in major urban centres, underlines the long-term and structural challenges in the housing market. The government recognises these challenges and has set itself the ambitious goal of increasing annual housing supply in England to 300 000 units by the mid-2020s. Household debt remains high but household balance sheets are strong on aggregate, while households and the broader economy appear resilient to short-term shocks.

The UK has made some ([6]) progress in addressing the 2018 country-specific recommendations (CSRs). The UK currently has three CSRs. CSR 1 on fiscal issues is not assessed in this country report. There has been some progress on CSR 2, which relates to housing supply. Annual net housing supply has increased significantly from post-crisis lows. However, the recovery in house building has lost momentum since mid-2017, and it is now stabilising at a level below what would be necessary to meet estimated demand. Real house prices are stabilising and real rents are now falling slightly, but the cost of housing remains high. The government has recently extended and revised a number of existing housing policies. The rules on local authority borrowing to build public housing have been relaxed, but wholly new initiatives have otherwise been relatively limited. The UK has made some progress in addressing CSR 3 on skills and apprenticeships. Skills mismatches persist and shortages are starting to become acute as the labour market tightens and vacancies reach record levels. The implementation of the apprenticeship reform is facing difficulties, with low registration rates and employers facing a considerable administrative burden and confusion with regard to the functioning of the Apprenticeship Levy.

HOUSING SECTOR

The availability and affordability of housing in the UK remains a major challenge. Annual net housing supply has increased significantly from post-crisis lows, but it is now stabilising at a level below what would be necessary to meet estimated demand. Regulation of the land market is strict and complex. Shortages of housing and high housing costs are particular issues in areas of high and growing demand, such as in and around urban centres. The government recognises the problem and has put in place a range of policy initiatives and set ambitious objectives to increase supply in the coming years. At the same time, it has reaffirmed its commitment to limiting development in the green Belt around urban centres. Home ownership has fallen for younger people, contributing to intergenerational inequality.

Housing affordability and demand

House prices are high, especially in areas of high demand. Valuation metrics continue to suggest significant overvaluation in the housing market. The average UK house price was GBP 231 000 (EUR 261 000) in November 2018 (ONS, 2018a). The ratio of median house prices to median annual earnings rose to a new record high of 7.8 in 2017 (ONS, 2018c) and the Commission estimates that, nationally, UK housing is around 20 % overvalued. In London, the average price of properties bought by first-time buyers (smaller and cheaper than average properties) is 13 times average earnings (ONS, 2018d).

Young adults have largely been priced out of home ownership. Housing transactions remain well below pre-crisis levels. A third of house purchases are now made without a mortgage, much higher than before the crisis. This reflects stretched affordability and intergenerational inequality (Resolution Foundation, 2017). Home ownership has declined overall in recent years, especially among younger adults on middle incomes. In 1995-1996, 65 % of those aged 25-34 with incomes in the middle 20 % for their age owned their home, but by 2015-2016 the proportion had fallen to only 27 % (IFS, 2018a). The likelihood if young adults owning a house has become much more dependent on their parents' level of property wealth, with negative implications for social mobility (Resolution Foundation, 2018).

The housing market has cooled, particularly in the most expensive areas. Real house prices rose quite rapidly from 2014 to 2016, before easing in 2017 (Graph 3.2.1). Indicators of housing market activity (both supply and demand) were quite flat through 2018. Nominal national house price growth (year-on-year) fell to 2.8 % in November 2018 (ONS, 2018a), only marginally above consumer price inflation. The growth in the price of buying and renting property has slowed most in the most expensive regions. In London, nominal house prices declined by 0.7 % in the year to November 2018. Private housing rent growth has also fallen gradually steadily, to 1.0 % year-on-year in December 2018 (ONS, 2018b). With high economic uncertainty, fragile consumer confidence, and weak surveyor expectations of near-term price movements and transaction volumes, housing activity and prices appear set to remain subdued in the short term (RICS, 2018).

Housing supply and constraints

The post-crisis recovery in house building has lost momentum. As shown in Graph 3.2.2, new housing starts have been on a slight downward trend since peaking in early 2017. Completions also seem to have plateaued. The number of net additional dwellings rose by 2 % to 222 190 in 2017-2018, a much smaller annual increase than the 14 % rise in the previous year (MHCLG, 2018a). While new build completions are still rising, office-to-residential conversions fell by a third from their 2016-2017 peak. The official level of annual demolitions is very low (one in 3 000 dwellings), which has implications for the pace at which the housing stock modernises and becomes more energy-efficient.

Tight, inflexible regulation of the land market limits the scope for residential development. As discussed in previous country reports, the process of obtaining planning permission is complex and costly. The 'green belt' policy was put in place to contain urban sprawl and keep broad swathes of land around existing conurbations permanently open. After growing through the post-war period, the amount of land designated as green belt has remained broadly fixed in recent years. This restricts the scope for the expansion of major urban centres. For example, London's green belt now covers over half a million hectares, and is about three times larger than London itself. The government has committed to maintaining the green belt in its current form, which does not directly distinguish between areas of high environmental amenity value and other areas.

This has prevented housing supply from responding adequately to shifts in demand and inflated the price of land used for housing. The tight regulation of the land market affects the efficiency of the labour market and wider economy, with distributional consequences. On average, 70 % of the price paid for a home is now accounted for by the value of the land, and only 30 % by that of the property itself (IPPR, 2018), though this average masks significant variation. The planning system and high cost of building land has contributed to increasing concentration in the residential construction sector and created barriers to entry for smaller firms. Builders' profitability is heavily dependent on land-price dynamics and it can make commercial sense for them to focus on maximising margins rather than volume (Bentley, 2017).

Housing demand is set to continue to outstrip supply although estimates of household formation have been revised down. The Office for National Statistics (ONS) now expects the number of households in England (about 85 % of the UK population) to increase by an average of 159 000 a year over the next 25 years (ONS, 2018e). This is much less than the 210 000 projected previously. To keep up with demand, gross residential construction will need to be significantly higher than this, to replace demolitions and accommodate geographical shifts in the population. High housing costs may also have suppressed household formation, for example by forcing young adults to live at home or cohabit as renters for longer. Average household sizes have stagnated in England, while continuing to fall in most of the rest of the developed world.

The government's policy response

The government is implementing a range of policy initiatives to boost housing supply. Its 2017 white paper, *Fixing Our Broken Housing Market* (DCLG, 2017), set out four broad policy objectives for housing. These are: (i) increasing the supply of land available for house building; (ii) accelerating the rate of house completions; (iii) encouraging more diversity in the building industry; and (iv) providing support to homebuyers. A revised National Planning Policy Framework (NPPF) is in place. Further updates to the NPPF in 2018 included a standardised methodology to determine minimum housing need in each local authority area. There has been progress in issuing more residential planning permissions, with permission for 359 500 housing units granted in the year to September 2018 (MHCLG, 2018b). The government is increasingly focusing direct public support for house building on areas with the highest housing demand and prices.

Recent measures have largely involved extending and revising existing policies. The Housing Infrastructure Fund supports the funding and planning of infrastructure linked to housing developments. In the 2018 Autumn Budget, it was increased by GBP 500 million (EUR 566 million) to GBP 5.5 billion (EUR 6.22 billion), to be used by 2022-2023. The British Business Bank (see Box 3.4.1) will deliver a new scheme that will provide guarantees supporting up to GBP 1 billion (EUR 1.13 billion) of lending to SME house builders. The government has consulted on proposals to allow housing to be more easily built above commercial premises, or in their place (MHCLG, 2018c). The 'help to buy' equity loan scheme will be extended by a further two years, to 2023. By increasing the amount buyers can borrow, it may have contributed to more rapid price growth in new-build properties.

The government has relaxed rules on local authority borrowing to build public housing. In its 2018 Autumn Budget, it removed the caps on the amount that local authorities can borrow through 'housing revenue accounts'. This is a much more significant measure than the limited increase in the caps announced in 2017. Since 2010, local authorities have been constructing an average of only around 1 500 homes a year (1 % of total building). The scope for increased borrowing will allow them to build more homes, but it is not yet clear on what scale and the possible financial risks are still unclear. The government estimates that it could eventually enable local authorities to build up to 10 000 homes a year. However, not all local authorities have the necessary experience and skills to be able to make use of this new freedom in the short term.

A review was carried out to address a growing gap between planning permissions and house building volumes. Planning permission for 359 500 homes was given in 2017-2018, but only 195 290 new homes were built. This gap has been getting wider. The *Independent Review of Build Out*, published alongside the 2018 Autumn Budget (HM Government, 2018), found no evidence that speculative land banking by major house builders is a driver of slow build-out rates. It concluded that the binding constraint on build-out rates by profit- maximising house builders is the rate at which the market would absorb new homes of a particular type on a large site. Greater differentiation in the types and tenures of housing delivered on large sites could therefore help to accelerate construction. The government welcomed the review and will formally respond to its recommendations shortly.

Homelessness figures are on the rise and show no sign of abating. A shortage of housing supply and low levels of construction by local councils have driven up rents and limited access to affordable and social housing. According to research by the housing charity Shelter, at least 320 000 people are homeless in the UK (Shelter, 2018). This year-on-year increase of 13 000 (4 %) comes despite pledges to tackle the crisis. The Homeless Reduction Act, which came into force in April 2018, provides a new legislative framework for local authorities to refocus their work on preventing homelessness. The government has committed to maintaining Housing Benefit for all supported housing and halving rough sleeping ([17]) by 2022, and eliminating the phenomenon by 2027, in line with the Rough Sleeping Strategy

CSR 2: Boost housing supply, particularly in areas of highest demand, including through additional reforms to the planning system.	The UK has made **some progress** in addressing CSR 2: Annual net housing supply has increased significantly from post-crisis lows. However, since mid-2017, the recovery in house building has lost momentum, and it is now stabilising at a level below what would be necessary to meet estimated demand. Real house prices are stabilising, and real rents are now falling slightly, but the cost of housing remains high. The government has recently extended and revised a number of existing housing policies, including updating spatial planning rules. The rules on local authority borrowing to build public housing have been relaxed, but wholly new initiatives have otherwise been limited.