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PARLIAMENT, THE COUNCIL AND THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE**

Alert Mechanism Report 2024

{SWD(2023) 901 final} - {SWD(2023) 902 final}

ALERT MECHANISM REPORT COMMUNICATION

The Alert Mechanism Report (AMR) identifies Member States that the Commission considers may be affected by, or may be at risk of being affected by, imbalances, based on an economic reading of the Macroeconomic Imbalance Procedure scoreboard⁽¹⁾. The reading considers the outturn data for 2022, which are interpreted in a forward-looking manner, taking into account the development of possible risks based on 2023 in-year economic developments and longer-term forecasts from the Commission 2023 autumn forecast, where relevant. A full analysis and an annex containing the values of the scoreboard are included in the staff working document accompanying this Communication⁽²⁾.

The 2024 Alert Mechanism Report considers the evolution of macroeconomic imbalances at a time of still high but declining inflation and weak economic growth. By early 2023, the peak in headline inflation appeared to have been reached in most EU economies, as energy prices have fallen and continuing reductions in food inflation are easing price pressures. Despite substantial falls, as reflected in the most recent data, a stickiness in core items may make it difficult for inflation to ease to a more desirable level in the immediate future. A protracted period of elevated inflation exacerbates the risk of continued divergence as national economies adjust and redistribute the impact of the energy price shock in different ways. Growth has stuttered in real terms in many countries, particularly around the turn of the year, with muted consumption stemming from reduced real household purchasing power and monetary tightening dampening demand. The current outlook is for further, albeit slower, reductions in inflation rates and a gradual pick-up in real GDP growth. Risks to the outlook are driven by the global context: the new conflict in the Middle East, Russia's continued war against Ukraine, and a generally changing geopolitical context, which may impinge on global trade and make external conditions difficult. Across the globe, inflation and central banks' responses to tackling inflationary pressures, in combination with the appreciation of the US dollar, have led to some financial stress outside the EU.

Sector-specific thematic reading

- In 2022, **current account balances declined in almost all Member States**, but are increasing in most cases in 2023. The impact of soaring energy prices **reduced surpluses and widened deficits**. Both energy and non-energy balances declined, reflecting worsening terms of trade as well as still strong, albeit weakening, domestic demand and exchange rate depreciations in some countries. High current account surpluses narrowed somewhat in 2022. The current account balances of most large net-debtor countries remained below the levels conducive for their swift correction. The large **net external stock positions**, both positive and negative, generally narrowed but remained substantial. Throughout 2023, external balances have been making a partial return to their previous levels, owing mainly to lower energy prices and weakening demand. While many moderate current account deficits are closing, a small number of countries continue to have much higher deficits than before either 2022 or the COVID-19 crisis. Moreover, these deficits remain higher than what fundamentals would suggest or what an improvement in their external stock position towards more prudent levels would call

⁽¹⁾ Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances.

⁽²⁾ Commission staff working document, Alert Mechanism Report 2024, SWD(2023) 901

for. The current accounts of most large net-debtor countries are increasing as the impact of energy prices wanes.

- In 2022, the **euro area current account** balance fell significantly, turning negative for the first time in more than a decade as a result of the much higher energy prices, but has been increasing ever since. With the deterioration in the terms of trade, the nominal trade balance fell sharply as imports values grew much faster than exports, while the trade balance remained broadly stable in real terms. With an improvement in the terms of trade underway and muted real demand, the euro area current account started to strengthen in late 2022 and returned to a surplus in the second quarter of 2023. It is forecast to continue improving this year and next, with a strengthening trade balance. Overall, the narrowing of the net international investment positions has led to some rebalancing of **external positions within the euro area**; the changes in these positions have been greater for net-debtor countries despite some sizeable reductions in their current accounts.
- Growth in **unit labour costs** picked up markedly overall and diverged considerably between countries in 2022 and into 2023 – including within the euro area, where divergence poses higher competitiveness risks. Very strong growth in some Member States marks a sharp acceleration relative to recent years. Wage increases were substantial in most countries, but were still below the increases in the cost of living. This resulted in pressure on household budgets, especially for low-income earners. In 2023, wages have been accelerating. As a result, unit labour costs are forecast to rise even faster in 2023 than in 2022 in most countries, and even where they moderate, they are still expected to grow at a strong pace. Cumulatively, wages are forecast to fall in real terms over 2022 and 2023. For 2024, the forecast is for a significant slowdown in unit labour costs growth rates, but uncertainty remains high as wages are dependent on negotiations that have not yet taken place in many countries. The expected stronger growth in unit labour costs in some net-creditor countries should support further symmetric rebalancing of the external positions within the euro area in 2023 and 2024.
- The nominal depreciation of the euro against other major currencies in 2022 – as Europe was more directly affected by the energy crisis and monetary conditions remained looser – resulted in an overall depreciation of the euro area’s **real effective exchange rate**. The euro gained strength in the first half of 2023. Within the euro area, high inflation countries have shown a continued appreciation of their real effective exchange rates, mainly driven by differentials in core inflation. Outside the euro area, changes in the nominal exchange rate have been a significant factor affecting real effective exchange rates, and in most countries a nominal depreciation in 2022 was followed by some appreciation in the course of 2023, even relative to the euro. Overall, the monetary stance tightened more and earlier in non-euro area countries, particularly at the very beginning of the inflationary period. However, in those countries, and despite the clear reduction in headline inflation since the turn of this year, price pressures remain high.
- **Corporate debt-to-GDP** ratios decreased in 2022, reflecting strong nominal GDP growth. Loan flows were strong for most of 2022, but started to decelerate sharply towards the end of the year. Profits increased overall as firms benefited from higher pricing power. However, unit profit growth recently decelerated, with industry particularly affected. By 2023, active deleveraging was present in some countries as loan flows turned negative. However, debt stocks remain sizeable in many Member States and above pre-pandemic levels in some cases and represent a risk factor. As corporate loans are typically taken out with flexible conditions and short maturities, rising interest burdens increase pressures in some sectors, including commercial real estate. In some countries, non-performing loans and business bankruptcies have started to increase and are clustered in high-risk sectors, including accommodation and food and transport. In the near future, rising interest rate burdens, declining profits, potential cost

competitiveness pressures and limited access to financing are likely to increase corporate vulnerabilities. The reduced recourse to new loans will also likely hamper corporate investment, affecting growth prospects in the future.

- **House prices** continued to accelerate in most Member States in the early months of 2022, before reaching a turning point. A combination of higher mortgage rates and lower real disposable incomes led to a slowing of house price increases, with house prices falling on a quarterly or even annual basis in the most affected countries, leading to a reduction in overvaluations. House prices are expected to continue adjusting to higher interest rates. In a handful of countries, however, where mortgage rates have not increased substantially or where financing is flowing in from abroad, house prices continue to experience strong growth and construction activity is strong.
- **Household debt ratios** continued to fall in 2022, despite buoyant mortgage flows over the early months of the year. Household debt is decreasing further in 2023 due to reduced mortgage flows, and there is a weaker denominator effect than in 2022 as real GDP growth is slowing and inflation easing. Despite these continued reductions in debt ratios, the interest burden on some households has increased and will continue to do so in many countries as higher interest rates gradually feed through into monthly mortgage payments. The extent and speed of this depends on how long mortgage rates are fixed for and the share of interest payments in monthly payments. Across the EU, mortgage rates increased significantly over the course of 2022, exceeding levels observed over the last decade. In a few countries, they have peaked recently, but in most, the cost of borrowing was still rising in September 2023.
- **Government debt** fell as a share of GDP in 2022, with nominal growth having a strong denominator effect, and further reductions are underway. Nominal growth also contributed to buoyant tax revenues with government deficits falling. While support measures to mitigate the impact of higher energy prices weighed on the deficit, they typically replaced the sizeable pandemic support packages. Government debt-to-GDP ratios remain higher than prior to the COVID-19 crisis in most countries, with the exceptions being primarily some very high debt countries marked by very strong real GDP growth. Over 2023 and 2024, debt levels are forecast to fall more slowly in most cases or to stall in others. The interest burden of government debt has been rising, and gross financing needs remain significant in many countries, with high inflation expected to gradually feed into higher government expenditure.
- Higher inflation and rising interest rates changed the environment for the **banking sector**, enabling it to become more profitable as interest margins increase. Overall, the banking sector is well capitalised and liquidity is sufficient. Despite the pressures on borrowers, the low level of non-performing loans has remained stable so far. The euro area banking sector has seen a temporary reduction in its valuations following bank bankruptcies in the US and Switzerland in March, but has otherwise not shown an increase in related vulnerabilities. However, the weak short-term economic outlook may affect assets and credit risks, and certain sectors such as commercial real estate are a source of potential stress. There is also uncertainty about possible hidden vulnerabilities in the financial sector, including in the non-bank financial sector. The results of the 2023 stress test conducted by the European Banking Authority and the European Central Bank point to the ability of European banks to withstand adverse outcomes and become more resilient relative to previous exercises.

Outlook for economic imbalances

Strong nominal growth has facilitated the debt deleveraging, easing some long-standing imbalances, but pressures stemming from tighter financing conditions have grown. The inflationary environment facilitated faster passive deleveraging, reducing indebtedness as long as

no new stresses emerge. For countries on a deleveraging path, the current climate has favoured and should continue to favour an easing of vulnerabilities. A continued gradual reduction in debt can continue in countries with long-standing vulnerabilities provided there are no additional financing needs, but it may be more difficult where private sector loans have been taken out by overstretched households in recent years and where government financing needs are the result of short durations. In countries where debt servicing requires large rollovers of debt, and where the private sector faces fast increases in mortgage payments, increased debt servicing costs are a risk to the economy. Non-financial corporations with large debts may struggle to meet their increased financing obligations if they face additional pressures from changing economic conditions, including to their competitiveness. In some cases, the interest rates exceed or approach nominal GDP growth rates, raising the prospect of a snowball effect on government debt, which requires larger primary surpluses to be contained.

The entrenchment of deteriorations in cost competitiveness is becoming a more concrete risk as price and cost pressures continue to diverge. Cost competitiveness concerns were highlighted in last year's Alert Mechanism Report, as differentiated price and cost increases raised the prospect of real appreciation and subsequent risks of competitiveness losses in countries with strong price increases. These concerns remain, although they have abated in some cases. Some high inflation countries display signs of core inflation stickiness at a high level, and are marked by continued high increases in unit labour costs, as other countries' core rates reduce, increasing the differences in price levels. Persistent competitiveness losses could spill over into other economic developments if vulnerabilities such as pre-existing debt or stress in particularly indebted sectors are present. For euro area countries, a re-alignment of domestic costs and prices via changes in the nominal exchange rate is not an option. In addition, divergent inflationary effects make the task of the monetary authority more difficult as the uniform transmission of changes in monetary stance to all parts of the monetary union may be hampered by differences in real interest rates across the euro area, which in some cases may drive further divergence. Across the EU, countries may struggle to address strong inflation and subdued growth while remaining in sync with their peers.

The adjustment of external balances following the price shock may be challenging, particularly for countries with external deficits. A number of countries face the prospect of large current account deficits continuing into the near future either due to their high energy import dependency or to resilient domestic demand, which is often associated with loose fiscal policies. Persistently high energy prices may require an acceleration of costly structural adjustments away from high import dependency to avoid the build-up of external debt or a reduction of potential growth. Over time, external weaknesses and a rise in external indebtedness could lead to economic stress if there is an erosion of cost competitiveness and an absence of internal demand restriction. Most countries at risk of sustained competitiveness losses stemming from high inflation have some margin on the external side as their underlying starting external positions are strong. Current account surpluses that fell in 2022 are increasing again. Higher long-term energy prices would affect these countries' output. The extent to which they will affect the current accounts will depend on how demand responds. The return of euro area rebalancing depends on the relative adjustments of surplus and deficit countries as economic conditions normalise, and rebalancing is forecast to continue.

In most cases the reversal in house price dynamics reflects a soft adjustment to higher interest rates, but in other cases dynamics are more worrying, with possible spillovers into other sectors. In most cases, the modulation or reduction in house prices that is underway can be expected to be limited to a level adjustment that reflects the higher interest rate environment, before resuming their long-term upward trajectory driven by limited housing supply. However, feedback loops into the economy are possible. These are evident in particular in some countries where higher mortgage rates have reduced household consumption when households are highly indebted. In addition, differences in the translation of interest rates into loan payments can

also lead to frictions in the transmissions of monetary policy. In countries where house prices are contracting, falling prices could put pressure on banks, with reductions in their collateral eroding asset quality and affecting capitalisation as well as the credit supply to the rest of the economy. Non-financial corporations that are very active in the commercial real estate sector may be particularly affected, and the same holds for banks very exposed to the commercial real estate sector. In some countries, on the other hand, prices continue to experience strong growth, possibly tied to interest rates being too low or external funds flowing in, and a continued build-up of risks in the real estate sector could result in higher vulnerabilities and a potential sharp correction in future.

Country-specific conclusions

In 2024, In-Depth Reviews will be prepared for the 11 Member States that were identified as experiencing imbalances or excessive imbalances in 2023⁽³⁾. The Alert Mechanism Report presents an overview of the evolution of key data underlying these imbalances. An economic assessment of whether these imbalances are aggravating, are under correction, or have been corrected, with the view to updating existing assessments and assessing possible remaining policy needs will be undertaken in the 2024 In-Depth Reviews to be published in the first half of 2024. This will be the case for **Cyprus, France, Germany, Greece, Italy, Hungary, the Netherlands, Portugal, Romania, Spain, and Sweden.**

In addition, the economic reading of the scoreboard leads to the conclusion that an In-Depth Review will be undertaken for Slovakia, as it presents particular risks of newly emerging imbalances. In **Slovakia**, concerns related to cost competitiveness, external accounts, government finances, house prices and household debt, persist. These concerns were analysed in an In-Depth Review in spring 2023, and were found to be overall contained in the near future, with the expectation that they would ease as economic conditions normalise, leading to a conclusion that no imbalances were present⁽⁴⁾. The current scoreboard reading for Slovakia shows that in 2022 four indicators were beyond their indicative thresholds, namely the net international investment position, the export market share, unit labour costs, and the youth unemployment rate. The economic reading of the scoreboard points to risks of imbalances as the abatement of these risks does not appear to be clearly underway. After several years of significant increases, nominal unit labour costs are set to accelerate further, growing faster than in the euro area overall. Headline and core inflation remain well above euro area peers, and the differential is not reducing sufficiently, to undo accumulated increases in price levels. The current account deficit remains sizeable, even if declining recently owing to lower energy prices. The clearly negative net international investment position is expected to remain stable this year and slightly worsen next year; excluding non-defaultable instruments, it is now at its lowest level in two decades. The fiscal deficit is set to widen, while the government debt is expected to increase going forward as nominal GDP growth moderates and the deficit increases. Nominal house price growth turned negative recently, but prices still show signs of overvaluation. The household debt-to-GDP ratio, which had been on an upward trend over the last two decades, is expected to decline this year on the back of high inflation, while credit flows remain resilient.

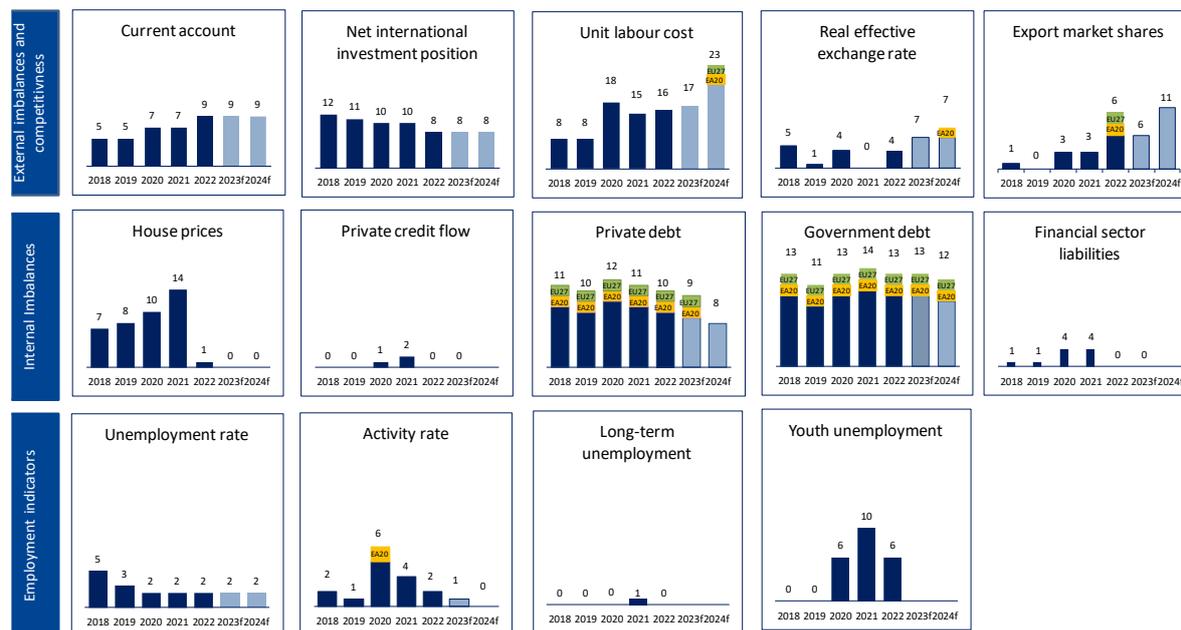
For the remaining Member States, there is no need to carry out In-Depth Reviews at this juncture. For those Member States that were subject to an IDR in spring 2023 but were not identified as experiencing imbalances or excessive imbalances (**Czechia, Estonia, Latvia, Lithuania, and Luxembourg**), this Alert Mechanism Report concludes that while some developments may be of concern, associated risks of imbalances are reducing with the normalisation of economic conditions.

⁽³⁾ Communication from the Commission 2023 European Semester - Spring Package, COM(2023) 600.

⁽⁴⁾ See previous footnote; see also 'In-depth review for Slovakia', 24 May 2023, SWD(2023) 643 final.

For **four** other Member States, the economic reading of the scoreboard leads to the conclusion that while they are not as affected by, or at risk of being affected by, imbalances, a number of developments or concerns merit attention. In **Bulgaria**, developments related to cost competitiveness, dynamic household borrowing and strong house price growth are of relevance. Nominal unit labour costs are expected to continue growing sharply, while core inflation has been well above the euro area average. Nominal house price growth has moderated recently but remains high, and household borrowing is sustained while household debt is contained. A strong underlying external position and the ongoing nominal convergence process mitigate risks. In **Croatia**, cost competitiveness pressures have recently increased and house prices have grown strongly. While nominal unit labour costs have increased visibly substantial differentials with respect to the euro area are very recent, mitigating risks. Government debt, while high, is continuing to decline and is forecast to come in below 60% of GDP by the end of next year. Nominal house price growth remains high as prices continue to rise strongly. In **Denmark**, the large current account surplus has increased further and non-financial corporations and household debts are very high. The current account surplus is the highest in the EU and has increased over the last decade and jumped further in 2022. While moderating, the surplus is forecast to remain very high, but there are limited spillover risks and Denmark's economic fundamentals remain strong. In **Poland**, developments related to unit labour costs and the widening high fiscal deficit are of increasing relevance. Nominal unit labour costs increased visibly last year, and are expected to grow more markedly this year, and both headline and core inflation have been above euro area and EU averages. The fiscal deficit widened last year and is forecast to further increase substantially in 2023, but the external position continues to strengthen and is no longer past the scoreboard threshold, mitigating risks.

Graph 1: Number of Member States, and euro area and EU aggregates, recording scoreboard variables beyond thresholds



The number of Member States recording scoreboard variables beyond relevant thresholds in a certain year is based on the vintage of the scoreboard published with the respective annual Alert Mechanism Report. EU27 and EA20 aggregates added where beyond threshold. Possible ex-post data revisions may imply a difference in the number of values beyond thresholds computed using the latest figures for the scoreboard variables compared with the number reported in the graph above; for instance, the increase in the number of Member States with current account readings outside the thresholds between 2019 and 2020 data observed in the graph above is mostly due to data revisions. Forecasts for financial sector liabilities are performed for 2022 only; no forecasts are performed for long-term unemployment and youth unemployment.

Source: Eurostat and Commission calculations

