1. Advanced Europe: Reversing the Slide

The euro area crisis has entered into a new stage in the context of a marked global slowdown. Tensions have moved from the euro area periphery to some core economies, prompting new policy interventions, but a definite solution remains elusive. As a result, confidence has eroded more widely and downside risks have intensified again throughout the advanced economies of Europe. Both conventional and unconventional policy stances will need to be adapted to reflect the weakening and tense outlook and a durable resolution to the euro area's sovereign debt problems needs to be found. Fiscal and monetary policies will have to be as supportive as possible within credible medium-term frameworks; financial systems need to be strengthened further; and a consistent, cohesive, and cooperative approach to monetary union needs to be adopted by all euro area stakeholders.

Divergent Recoveries, but a Synchronized Slowdown?

Idiosyncratic vulnerabilities mattered a great deal…

In the wake of the global financial crisis, advanced European economies have recovered at very different speeds. Some experienced tepid growth, hindered by high private indebtedness (Figure 1.1), a burst in asset prices, weak credit owing to banks' funding difficulties and private-sector deleveraging, and lost competitiveness. Meanwhile, many others—such as Germany and Sweden—free from major imbalances, took advantage of their strong initial competitiveness positions to ride the global recovery wave in 2010, barely affected by the turmoil in the euro area periphery (Figure 1.2) (Jaumotte and others, forthcoming).

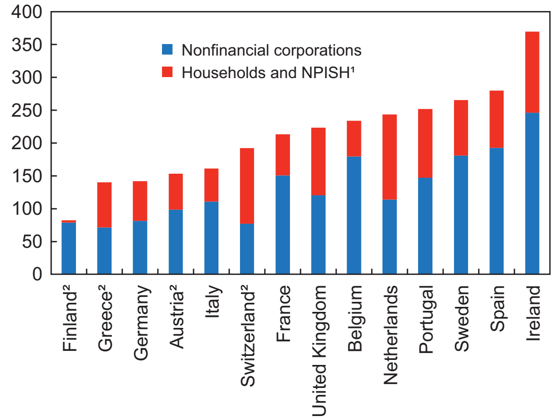
This tiering is now fading. Sweden, Switzerland, and many northern euro area countries, powered by Germany, continued cruising in the first quarter, with investment particularly buoyant (Figure 1.3). By contrast, Spain, Italy, and the United Kingdom registered lackluster performance, as they struggled, respectively, with high unemployment, weak structural fundamentals and meager real income prospects. The three program countries (Greece, Ireland, and Portugal) either remained mired in or

Note: The main author of this chapter is Céline Allard.

Figure 1.1

Selected Advanced European Countries: Sectoral Debt Levels, 2010

(Percent of GDP)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

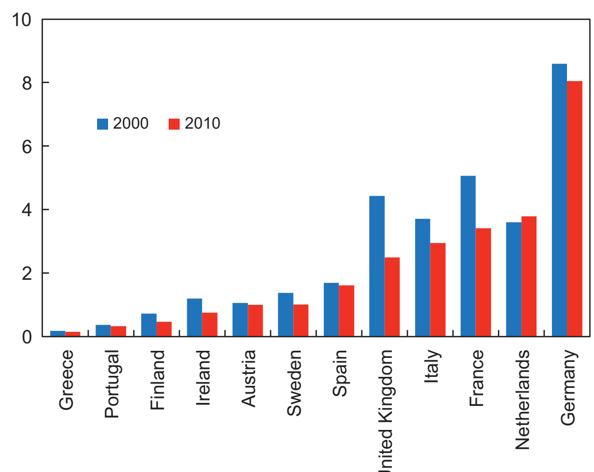
[1]NPISH: Nonprofit institutions serving households.

[2]Based on 2010:Q3–Austria, Greece, France (households); 2009–Finland (households); 2011:Q1–Belgium, Netherlands, and Sweden; 2008–Switzerland.

Figure 1.2

Selected Advanced European Countries: Export Market Share, 2000 and 2010[1]

(Percent)



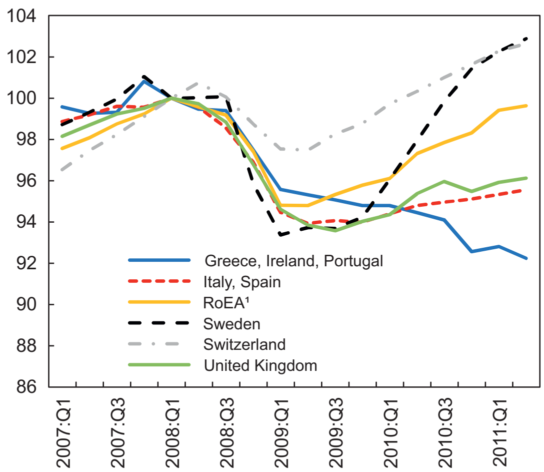
Source: IMF, *Direction of Trade*.

[1]For each country, exports of goods to the rest of the world as a share of total world exports.

Figure 1.3

Selected Advanced European Countries: Real GDP, 2007:Q1–2011:Q2

(2008:Q1 = 100)

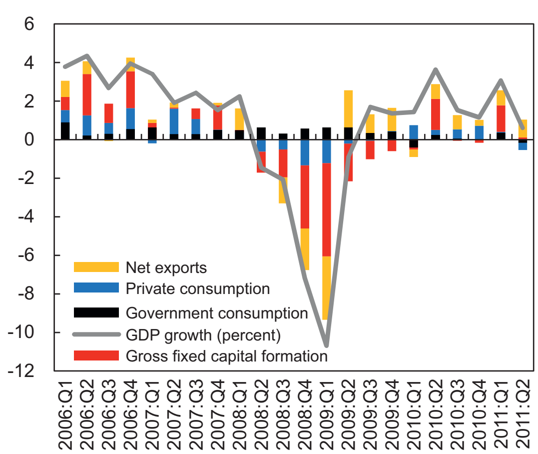


Source: IMF, *World Economic Outlook*.
¹Rest of euro area: excludes Greece, Ireland, Italy, Portugal, and Spain.

Figure 1.4

Euro Area: Contributions to GDP Growth, 2006:Q1–2011:Q2

(Quarter-over-quarter annualized growth rate, percentage points; seasonally adjusted)

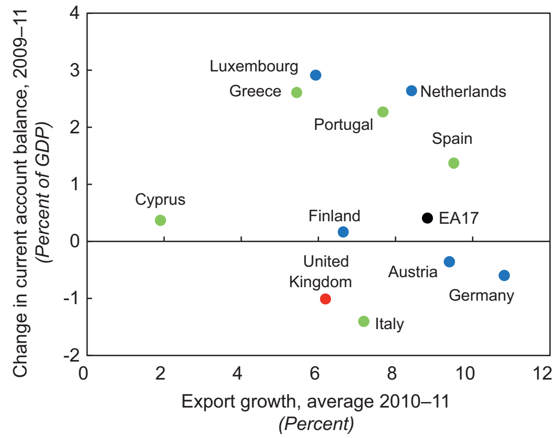


Sources: Eurostat; and IMF staff calculations.
Note: Contributions from inventories and statistical discrepancy not shown.

were barely exiting from recession on the back of large front-loaded fiscal adjustments. The most recent indicators, however, point to a general convergence toward low growth, as evidenced by the acute loss in momentum in the second quarter, even after taking into account some exceptional factors that dampened growth (Figure 1.4). The deceleration

Figure 1.5

Euro Area Countries and United Kingdom: External Imbalances, 2009–11



Source: IMF, *World Economic Outlook*.
Note: Green dots: large deficit countries with 2010 deficit above 2.5 percent of GDP; blue dots: large surplus countries with 2010 surplus above 2.5 percent of GDP; black dot: EA17; and red dot: United Kingdom.

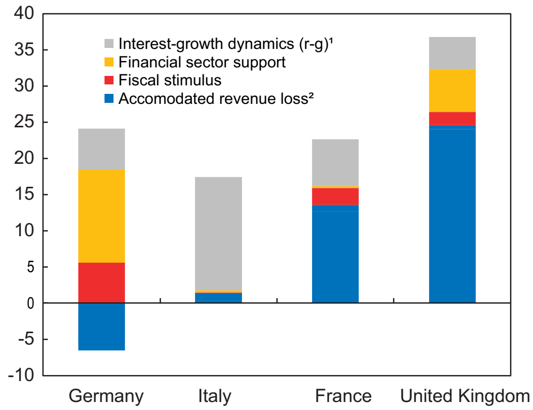
of activity at the global level, combined with lagged effects of higher commodity prices and the supply disruptions that followed the Japanese earthquake, have affected mostly those countries that had benefitted so far from the strong global recovery. Yet the escalation of the euro area crisis is having a more wide-spread effect on domestic demand, as the confidence shock has spread beyond the periphery to core countries' consumers, bankers and investors.

One consequence has been that external imbalances, especially within the euro area, have declined, although questions remain about the sustainability of that trend. Apart from Italy, all euro area countries that had a negative external balance exceeding 2½ percent of GDP in 2010 have seen their current-account deficit decline since the crisis; yet, with the exception of Spain, this correction has not come as a result of particularly buoyant exports, but mainly as a result of cyclically weak domestic demand (Figure 1.5). As further elaborated in the September 2011 *World Economic Outlook* (IMF, 2011g), the significant efforts currently under way to strengthen public finances in the peripheral countries will also contribute to reducing external imbalances, but given the absence of the nominal exchange rate tool, the adjustment is likely to be protracted.

Figure 1.6

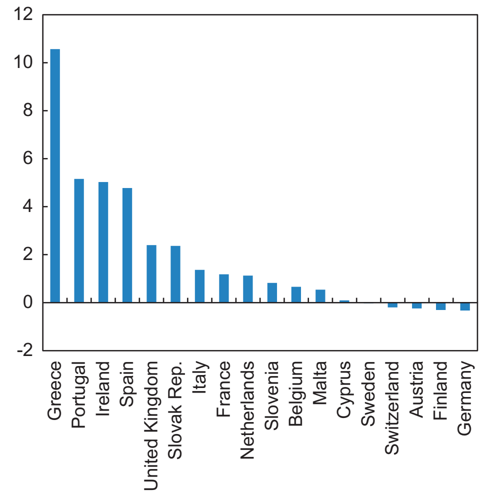
Selected European Countries: Drivers of Public Debt Increase, 2007–2011

(Percent of GDP)



Selected European Countries: Change in Structural Fiscal Balance, 2011 vs. 2009

(Percent of GDP)



Sources: IMF, *Fiscal Monitor*; and IMF, *World Economic Outlook*.

[1]Contribution of the interest expenditure (in percent of GDP) adjusted for growth (see Appendix 1, IMF, 2010a).

[2]Revenue loss associated with output losses from the financial crisis. This is computed as a residual. If the sum of identified drivers of debt is larger than the overall increase in debt, revenue losses from lower output were minimal and/or compensated for by fiscal measures (see Box 1, IMF, 2010c).

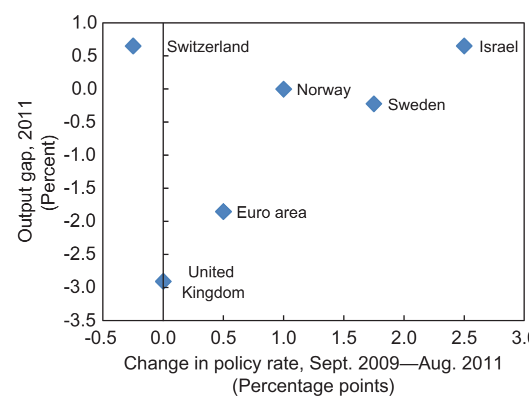
…as did differentiated policy responses

Different policy mixes

Countries adopted very different policy mixes, both inside and outside the euro area. In the wake of the crisis, the general poor state of public finances in advanced Europe became apparent, as bank recapitalization programs, recession-related revenue losses and fiscal stimulus packages boosted public debt by up to 15–20 percentage points of GDP in the largest euro area countries and by as much as 40 percentage points of GDP in the United Kingdom (Figure 1.6). Countries with relatively better starting positions pursued fiscal consolidation strategies spread over several years, to minimize the short-term contractionary effect on activity. In contrast, countries under severe market pressures, including the three program countries, but also Spain and more recently Italy, had no choice but to front-load their efforts to avoid confidence from spiraling downward. The United Kingdom, faced with serious fiscal risks, deliberately chose to tighten its fiscal stance early on—an approach that has been successful at buttressing market sentiment but has created headwinds for near-term growth.

Figure 1.7

Euro Area and Selected Countries: Monetary Policy Stance, 2009–11



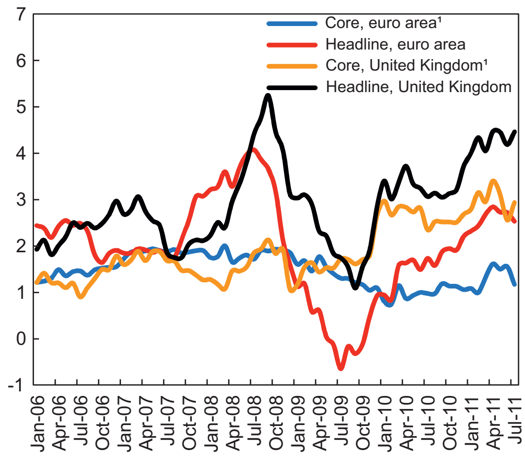
Sources: Haver Analytics; and IMF, *World Economic Outlook.*

Accordingly, the monetary stance varied too (Figure 1.7). Countries most advanced in the recovery cycle (Israel, Norway, and Sweden) clearly had to withdraw monetary support, while Switzerland kept its accommodative stance, as safe-haven behaviors triggered a strong

Figure 1.8

Euro Area and United Kingdom: Headline and Core Inflation, January 2006–July 2011

(Percent; year-over-year change)

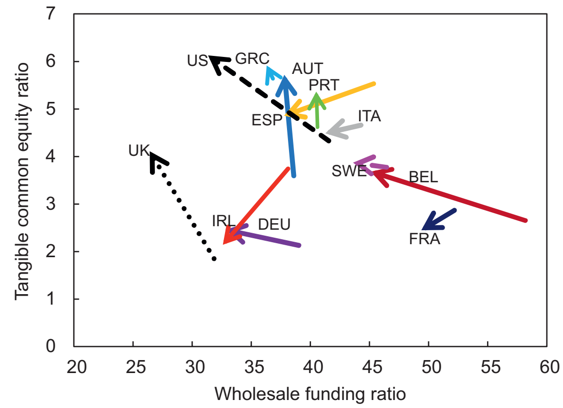


Sources: Eurostat; Haver Analytics; national authorities; and IMF staff calculations.

[1]Harmonized index of consumer price inflation (excluding energy, food, alcohol, and tobacco).

Figure 1.9

Selected European Countries: Tangible Common Equity and Wholesale Funding Ratio, 2007–10



Sources: Bloomberg, L.P.; and IMF staff calculations.

appreciation of the Swiss franc, with a dampening effect on prices. The European Central Bank (ECB) increased its interest rates by 50 basis points between April 2011 and July 2011, reflecting rising headline inflation following the rally in commodity prices and the prospect of a steadily closing output gap (Figure 1.8). By contrast, the Bank of England kept the scale of monetary stimulus unchanged, on account of the strong fiscal consolidation, greater slack in the economy (which has kept wage growth subdued) and an inflation overshoot that is largely seen as driven by temporary factors, including indirect tax increases.

Uneven approaches to financial system reform

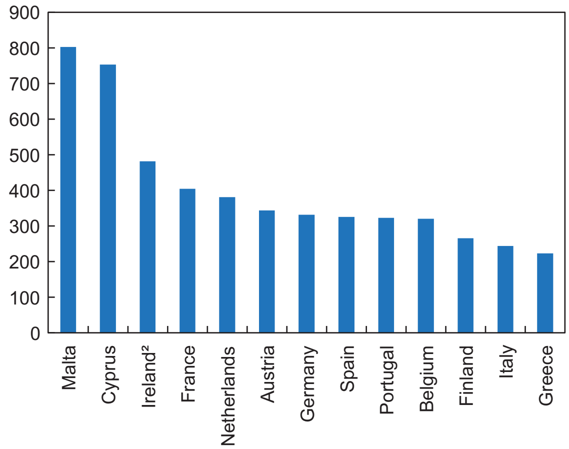
Progress toward putting banks on a sounder footing has been uneven. Having been among the institutions most heavily reliant on wholesale funding before the crisis, euro area banks have also been slower than their Anglo-Saxon counterparts to reduce this reliance since then (Figure 1.9). While substantial efforts were made to raise capital ahead of this summer's stress tests, buffers remain thin in a significant number of financial institutions. In addition, large exposures to the sovereign debt of program countries and continuous low profitability—on the back of rising non-performing loans in some countries—call into question their ability to rely on retained earnings to build capital buffers in the future. By contrast, with core tier 1 ratios above 10 percent, major U.K. banks are taking a proactive approach in their transition to Basel III rules. Similarly, Swedish banks have raised capital to well above the minimum regulatory requirements and their loan losses in the Baltic countries—their main foreign exposure—have fallen.

Regulatory approaches to tackling banking sectors that still remain large (Figure 1.10) have also differed. Having suffered severely from the crisis through financial channels, regulators in the United Kingdom, Sweden, and Switzerland have all expressed their preference for going further than the Basel III minimum requirements to reinforce capital as a way to strengthen their banking system and reduce associated fiscal risks. Similarly, in Ireland, in the context of the adjustment program, institutions are unwinding noncore assets while nonviable banks are being resolved—ultimately leading to a much leaner banking sector. Meanwhile, other euro area regulators are pushing to soften somewhat the capital quality standards and see no need to go beyond Basel III.

Figure 1.10

Selected European Countries: Financial Sector Assets Relative to Size of Economy, 2010[1]

(Percent of GDP)



Source: European Central Bank.

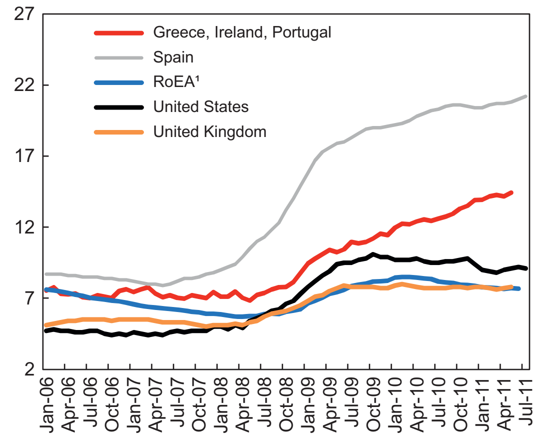
[1]Excluding the Eurosystem.

[2]International financial service centers are excluded because they do not actively provide credits to the domestic economy.

Figure 1.11

Selected European Countries and the United States: Unemployment Rate, January 2006–July 2011

(Percent)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

[1]Rest of euro area: excludes Greece, Ireland, Portugal, and Spain.

Insufficient structural reforms

Countries that suffered the most from the global crisis as the result of past imbalances have also been most prone to embark on needed structural reforms. As the sharp decline in the nontradable sector led to dramatic increases in unemployment rates in a number of countries, authorities were confronted with long preexisting weaknesses in their labor market, which the boom years had somehow masked (Figure 1.11). Greece, Portugal, and Spain have started overhauling their dismissal and employment protection regulations as well as their wage bargaining systems to tackle dual labor markets and facilitate job reallocation. Meanwhile, countries that had done so prior to the crisis, such as Germany through the mid-2000 Hartz reforms, reaped the benefits in the form of fewer job losses during the recession, and are already enjoying unemployment rates lower than their pre-crisis levels.

Where recoveries have been stronger, however, there has also been less urgency to tackle impediments to growth, despite the risk that higher unemployment inherited from the crisis could become entrenched. In many countries, labor utilization remains excessively low (Allard and Everaert, 2010). Disincentives to take a job (for instance, in France) and entry barriers in some services (for example, in Germany and Italy) are still holding growth and employment back, although here again countries under adjustment programs are starting to address these issues. In addition, uneven positions on the structural map are also at the root of some of the persistent inflation differentials within the euro area, with detrimental consequences for the efficiency of the common monetary policy (Box 1.1).

These divergent paths threaten to reverse past successes at cross-border integration, especially within the euro area, with banks and policymakers alike turning more inward. Capital markets are being segmented, with the periphery relying on ECB and official financing. Cross-border banking mergers and acquisitions within the euro area, which were already lackluster, have further diminished in the wake of the crisis—although preliminary signs suggest a modest revival (Figure 1.12). And needed progress on euro area crisis management and burden sharing arrangement has

Box 1.1

Labor Reforms in the Euro Area: Still Too Little?[1]

Efficient labor market institutions and policies are key to raise employment growth and reduce inequities. Employment rates are higher and unemployment lower in economies with lower labor taxes, moderate unemployment benefits, and collective bargaining systems that are more favorable to employment than wage increases (typically full coordination or full decentralization as opposed to intermediate coordination of collective bargaining) (Bassanini and Duval, 2006; Annett, 2007). Lower employment protection legislation (EPL) facilitates entry into the labor market of groups that tend to be marginalized in dual markets, such as women and youth, and reduces the incentives to resort to flexible but precarious temporary contracts (Jaumotte, 2011). It also increases labor productivity by fostering reallocation to the most productive sectors. Pension reforms that increase the legal retirement age, curb early retirement schemes, and reduce the implicit tax on continued work at old-age can boost the employment of older workers.

Adequate institutions are even more essential to the good functioning of the euro area. In the pre-crisis period, wage indexation practices, high employment protection and to some extent intermediate structures of collective bargaining contributed substantially to large and persistent intra-euro inflation differentials, the deterioration in competitiveness and the emergence of imbalances in many peripheral countries (Jaumotte and Morsy, forthcoming). Indeed, these institutions give workers more market power to negotiate wage increases to compensate for high inflation and therefore tend to increase inflation persistence.[2] This feature is harmful in a monetary union, where the individual real effective exchange rate can be adjusted only through relative price changes (Jaumotte and others, forthcoming).

Labor market institutions and policies still have room to improve substantially in advanced Europe, with different priorities across countries (Allard and Everaert, 2010). Lower labor utilization in the euro area accounts for a GDP per capita differential with the United States of about 15 percentage points.[3] Although this may in part reflect different preferences for labor and leisure, cross-country indicators of labor market institutions point to less efficient set-ups in euro area countries, relative not only to the US but also to the OECD average. The largest sources of inefficiencies differ across countries, with a (not fully clear-cut) divide between northern and southern euro area countries (see figure). In southern euro area countries, the intermediate coordination of collective bargaining (Greece, Portugal, and Spain) and high EPL (Greece, Portugal, and Spain before recent reforms) constitute the main impediments. But these features are not unique to the southern euro area, as France also has an intermediate collective bargaining system and high EPL. In northern euro area countries, labor tax wedges are particularly high (France and Germany, but also Greece and Italy) and unemployment benefits generous (Germany and Ireland). Disincentives to labor market participation of older workers are a problem in most countries.

Crisis countries have been under more pressure to reform their labor markets for various reasons. First, with the Great Recession and the euro area sovereign debt crisis, their unemployment rates have increased drastically,

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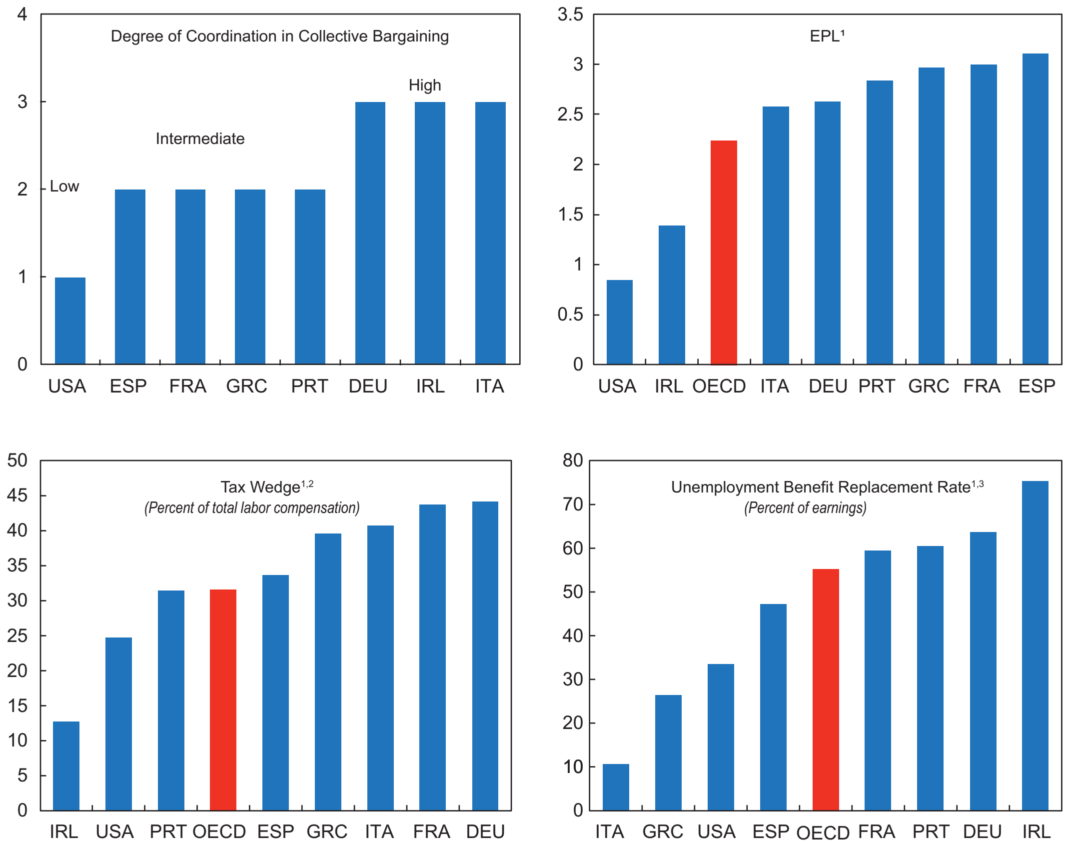
Note: The main author of this box is Florence Jaumotte.

[1] The box focuses on the four large euro area countries (France, Germany, Italy, and Spain) and the three program countries (Greece, Ireland, and Portugal). But many of the issues specific to Germany and France also apply to other northern euro area countries.

[2] The relationship with the coordination in bargaining is non-linear, in the sense that both low and high coordination would lead to less inflation persistence than intermediate coordination. In the case of low coordination, workers have little market power, whereas in the case of very high coordination, the unions recognize their market power and take into account the effect of their wage demands on inflation and unemployment (Calmfors and Driffill, 1988).

[3] Mourre (2009), updated by the European Commission using the Lisbon Assessment Framework Database (LAF), developed by DG-ECFIN, European Commission.

Labor Market Set-Ups in Selected Advanced Countries, 2008–09[1]



Source: Organization for Economic Cooperation and Development.
[1]2008 for EPL and tax wedge; 2009 for unemployment benefit replacement rate. These indicators do not incorporate the impact of reforms taken after 2008 (or 2009) in program countries and Spain.
[2]Average tax wedge on labor; average of two income situations (67 percent and 100 percent of average worker earnings).
[3]Average of net replacement rates over 60 months of unemployment for four family types and two earning levels (67 percent and 100 percent of average worker earnings), including social assistance. Ireland's replacement rate at one-year duration is relatively low, but benefits are stable over time, making them higher on average over a five-year period.

and young people have been especially affected by joblessness (reaching 40 percent and above in Greece and Spain). To a large extent, this reflected the collapse in output and the difficulty in reallocating resources from non-tradable to tradable sectors. However, wage rigidities resulting from inefficient labor market set-ups and, in some cases, the high share of temporary workers, have strongly amplified the unemployment increase and hindered the needed process of internal devaluation. Second, as mentioned above, the significant deterioration in competitiveness in the run-up to the crisis also resulted in part from those flawed institutions. Finally, over the longer term, they contribute to higher structural unemployment and lower potential growth—all features that need to be remedied for these countries to grow out of the crisis.

Although labor market reforms are thus progressing in countries under market pressure, little is being done in countries with stronger recoveries. Some crisis countries are doing so in the context of EU/IMF programs; others, such as Spain and to a lesser extent Italy, are doing so independently—in all, reforms seem appropriately targeted, although in some cases they should be bolder. Greece and Portugal have begun to reduce *EPL* significantly, including by reducing the protection of regular contracts and further steps are in the offing; Spain has also made some progress in this direction. Greece passed a law to introduce more *wage flexibility* by allowing agreements at the

Box 1.1 *(concluded)*

firm level to reduce wages below sectoral minimums;[4] Spain facilitated opt-outs from collective agreements and more recently adopted legislation to allow firm-level agreements; in Italy, rules were modified to allow greater use of firm-level agreements. Other measures taken to stimulate employment include limiting increases in minimum wages (France, Portugal), and introducing special work contracts for youth (with sub-minimum wages and/or lower social security contributions). *Unemployment benefits* will be reformed in Portugal (to reduce overly generous benefits but increase coverage), and Ireland is reducing the generosity of its unemployment benefits, especially for young unemployed and where activation measures are refused, to generate a labor supply response. Finally, efforts at restoring long-term fiscal sustainability through *pension reforms* will have a positive impact on labor utilization, by increasing old-age workers' participation. France, Greece, Ireland, Italy, and Spain have reformed their pension systems.

The relatively good unemployment performance of countries with stronger recoveries should not lead to a let-up in their reform momentum. Unemployment rates have performed much better during the crisis in these countries, and in some cases they are already below pre-crisis levels (for example, Germany). Although this performance could be interpreted as a benefit from earlier labor market reforms (for instance, the Hartz reforms in Germany in the mid-2000s), labor market set-ups remain relatively inefficient in these countries by international comparisons. Given the large potential benefits for employment and living standards, there can thus be no let up in the reform momentum of these countries. In Germany, the tax wedge should be reduced in a manner targeted at groups that are at the margin of the labor market and whose labor participation is more sensitive to taxes (married women, elderly workers, and low-income workers). This would help increase labor force participation and offset population aging, while reducing further the unemployment rate. Unemployment benefits could also be revisited to increase work-incentives. In France, the priority is to tackle the dualism of the labor market, easing further the hiring and firing process, while improving prospects for finding jobs through a strengthening of the activation policies and job placement agencies. It is also necessary to address the high unemployment rate of low-skilled and young workers, including by letting the minimum wage fall further relative to the median wage, and to continue improving work-incentives for seniors.

[4] However, these have been little used so far, as firms have resorted to individual and part-time and irregular contracts instead.

been protracted—on the back of strong domestic opposition in some countries.

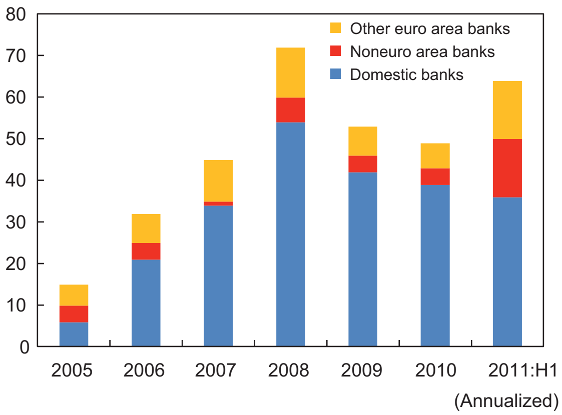
New Headwinds from an Escalating Euro Area Sovereign Crisis

No reprieve from financial markets

Repeated bouts of storms in euro area sovereign debt markets since May 2010 have formed a rip current of doubt about debt sustainability. These doubts are fed by concerns that excessive demand compression in program countries will undermine their adjustment efforts and that high debt countries face poor long-term growth prospects. These concerns have also surfaced outside the euro area, with a similar debate about the pace of adjustment in the United Kingdom, and recent rating action on Japan and the United States.

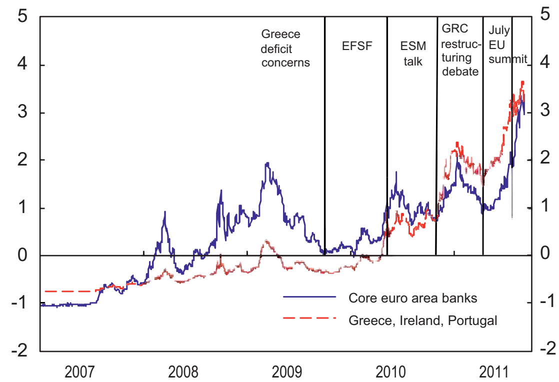
The euro area sovereign debt crisis took another turn for the worse in the summer of 2011. Initially, it was the continued lack of cohesion among European policymakers—especially in the debate on private sector involvement—which unnerved markets. Negative sentiment was further exacerbated when growth outturns disappointed, triggering a general reassessment of world growth expectations. In the euro area, the spiral of credit agencies' downgrades on sovereign ratings carried on, reflecting the general perception that lack of action would inevitably lead to a disorderly debt default. Contagion engulfed other exposed sovereign markets, which until then had been very

Figure 1.12
Euro Area: Mergers and Acquisitions by Nationality of Buyer, 2005–11
(Number of deals)



Source: SNL Financial LC.

Figure 1.13
Euro Area: Banking Sector Risk Index, 2007–11[1]



Sources: Bloomberg L.P.; Datastream; and IMF staff calculations.
[1]Normalized score from a principal component analysis on 5-year senior bank credit default swap spreads, estimated using daily data (Jan. 1, 2005–Sep. 5, 2011). The core risk index comprises CDS spreads of 35 banks and the GIP risk index 10 banks (from GRC, IRL and PRT). The first principal component captures 85.05% of the common variation across core country banks and 85.27% across GIP country banks.

liquid (such as Belgium, Italy, and Spain), also affecting stock valuations and interbank markets.

As a response, European leaders took important steps to strengthen their crisis management framework at their July summit. In particular, to stem contagion, they agreed to make the European Financial Stability Facility (EFSF) more flexible, by allowing precautionary credit lines, funding to strengthen banks' capital buffers even in non-program countries, and secondary market bond purchases. In addition, the terms of EFSF support were softened, by lengthening loan maturities and lowering lending rates (close to funding rates) to support debt sustainability. European leaders also agreed to design and support a new program for Greece, involving voluntary private sector involvement. In that context, the EFSF will provide credit enhancement to underpin the quality of collateral if and when credit agencies downgrade Greek sovereign bonds to selected default status, to allow continued access to ECB liquidity, lifting a key hurdle to the debt restructuring operation.

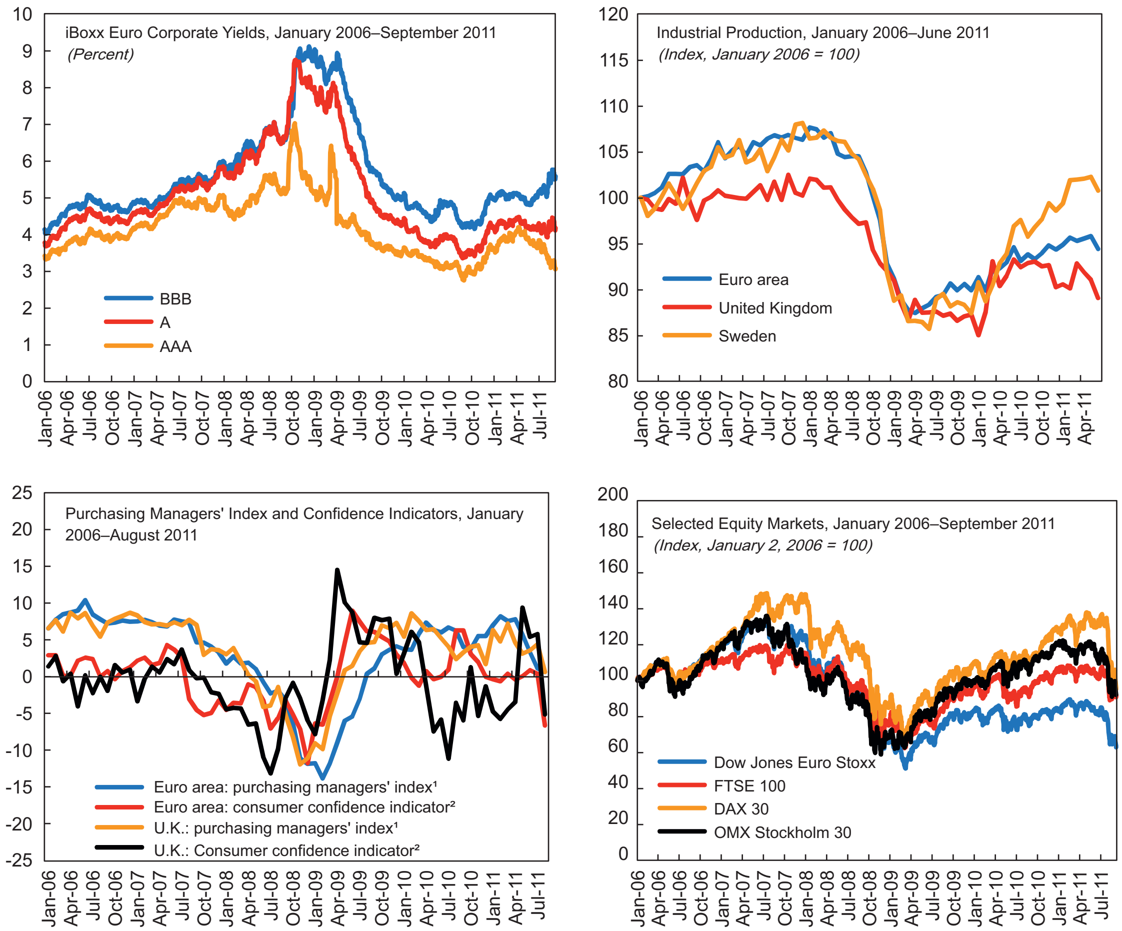
While markets took reassurance in the renewed commitment to secure debt sustainability in the program countries, they remained concerned that some countries might eventually have to follow through with sovereign debt restructuring. After a short lull, market tensions flared up again, with sovereign spreads back to their record highs and stock markets plummeting in August. The debate about side deals on collateral for lending to Greece by some euro area countries did not help. Some sense of order was restored after the ECB stepped up its Securities Market Program (SMP), purchasing significant amounts of sovereign bonds, including of Italy and Spain. From €74 billion in early August, the stock of accumulated securities under the SMP stood at €143 billion a month later. Markets also began to differentiate more between the three program countries, with conditions in the market for Irish sovereign bonds improving the most. To stem renewed tensions in financial markets, the ECB extended its refinancing operations as fixed-rate tender procedures with full allotment until the end of the year, and in August re-introduced a six-month operation. Still, markets have generally remained on tenterhooks (Figure 1.13).

Moderating growth ahead…

In this context, any baseline scenario is subject to considerable uncertainty. What is clear is that growth momentum will be tempered by a combination of factors, ranging from a less supportive global environment—especially in the United States, where a weak recovery is now foreseen—to heightened

Figure 1.14

Selected European Countries: Key Short-Term Indicators, 2006–11



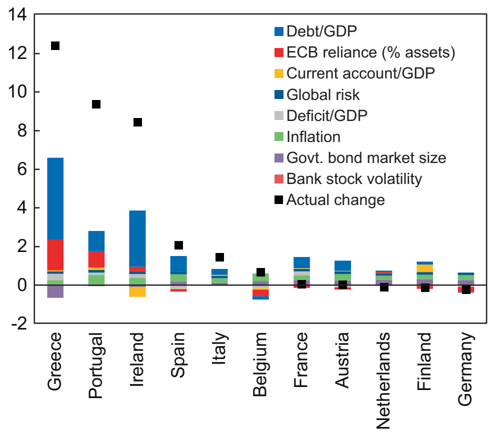
Sources: Datastream; Eurostat; European Commission Business and Consumer Surveys; Haver Analytics; and IMF staff calculations.
[1]Seasonally adjusted; deviations from an index value of 50.
[2]Percentage balance; difference from the value three months earlier.

global risk aversion, and fiscal consolidation (Table 1 in the Introduction and Overview). The escalation of the financial turmoil in the euro area will also continue to take its toll on confidence (Figure 1.14).

Within the euro area, real GDP growth is therefore projected to slow from 1.6 percent in 2011 to 1.1 percent in 2012. Countries under market pressure will continue to suffer from deeper fiscal austerity measures, sharper private-sector balance sheet deleveraging, and more severe structural unemployment—with Portugal and Greece expected to remain in recession until mid-2012 and early 2013, respectively. In Italy and Spain, higher interest costs on the sovereign debt, front-loaded fiscal adjustment, and increased tensions surrounding banks will constitute additional drags on already soft activity. Meanwhile, weaker global growth momentum will weigh on northern euro area countries, slowing the closing of their output gaps and the improvement in their labor markets. Solid corporate profitability will not be much of a mitigating factor as long as confidence remains depressed. Germany, for instance, will see its growth pace halved from 2.7 percent in 2011 to 1.3 percent in 2012.

A similar pattern will be at play outside the euro area. Sweden will continue to benefit from robust domestic demand, supported by low unemployment

Figure 1.15
Selected European Countries: Decomposition of Change in 10-Year Government Bond Spreads vis-à-vis OIS Rate, 2009:Q3–2011:Q2
(Percent)



Sources: Bloomberg L.P.; Datastream; and IMF staff calculations.
Note: The decomposition shows the contribution of various explanatory factors in a panel regression of 10-year government bond spreads vis-à-vis the 10-year overnight index swap (OIS) rate. Square dots represent the actual change in sovereign spreads (in percent) over the period October 31, 2009–July 2, 2011. Country fixed effects are of minor importance and are not reported.

and buoyant asset markets. Yet, its growth is expected to moderate slightly from 4.4 percent in 2011 to 3.8 percent in 2012, as balance sheets and fiscal retrenchment in advanced countries dent demand for Swedish consumer durables and capital goods. Similarly, with little slack left, the Swiss economy will decelerate from 2.1 percent growth in 2011 to 1.4 percent in 2012, as renewed currency appreciation and a weaker external environment will challenge export resilience. By contrast, with serious headwinds on the domestic front from depressed real disposable income, negative wealth effects, and fiscal consolidation, growth in the United Kingdom will remain sluggish in 2011 at 1.1 percent, before rebalancing to 1.6 percent as past depreciation of the pound starts translating into stronger net export growth.

Over the medium term, growth prospects are likely to remain subdued. As is well documented, this is typical following severe financial crises, and likely even more so in the current context where much of the world has been affected and rebalancing is proceeding only gingerly. For the euro area, one additional hurdle is that the widening of interest rates on sovereign bonds is likely to be permanent for many euro area countries, unless the institutional setup of the monetary union is modified. Reversing the strong movement of interest rate convergence that occurred at the creation of the euro, markets now no longer consider sovereign debt as a risk-free asset. The blow-out in spreads has taken place since mid-2009—first touching Greece, Ireland, and Portugal, then Cyprus, and most recently Italy, Spain, and, to a lesser extent, Belgium. An analysis of the fundamentals driving these spreads suggests that higher yield differentials than over the last decade are here to stay in the countries currently under severe market pressure (Figure 1.15). And they might still increase from their current level in other countries with less severe but still substantial fiscal vulnerabilities. As this reassessment proceeds, higher spreads will also be passed on to corporate funding, with detrimental consequences for credit, investment, and confidence in the affected countries (Harjes, 2011).

…contingent on no further escalation

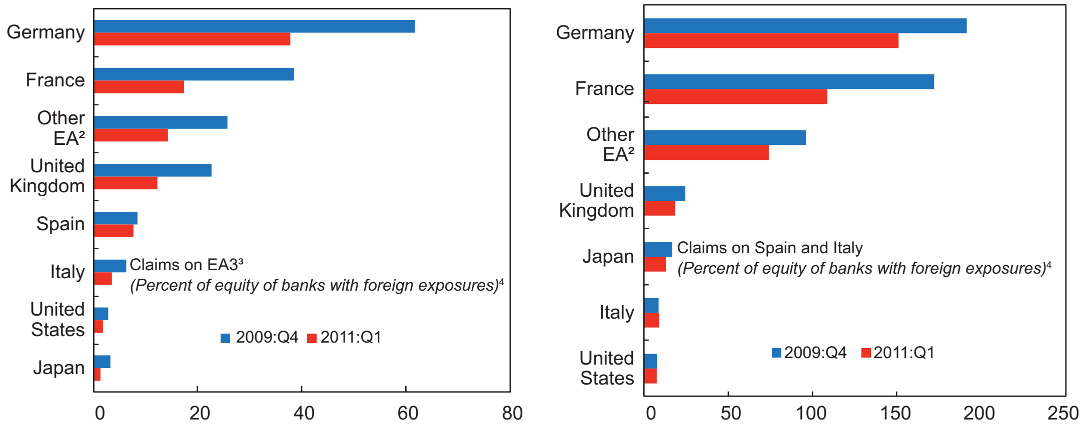
Given persistent tensions on euro area sovereign markets and global weaknesses, downside risks remain particularly acute. Any disappointment regarding the implementation of mitigating measures either in one of the program countries or at the euro area level could amplify the shockwaves witnessed during the summer throughout the euro area with adverse repercussions regionally and globally. Funding could dry up, jeopardizing the functioning of the financial system, at a time when banks and sovereigns are facing major rollover requirements. Moreover, despite some reduction since the onset of the crisis, cross-country financial exposures remain substantial (Figure 1.16). Compounding the intra-euro area stresses, a further setback in global growth would generate negative spillovers.

Policies to Stop the Slide

With growth momentum waning and financial tensions rising, policy adjustments are called for.

Figure 1.16

Selected Advanced Countries: Claims on Domestic Banks and Public Sector, 2009:Q4 and 2011:Q1[1]



Sources: Bank of England; Bankscope; BIS Consolidated Banking Statistics; IMF, *International Financial Statistics*; and IMF staff calculations.
[1]The exposures were adjusted using data from the Bank of Ireland to account for the fact that a significant portion of the claims are claims on foreign banks domiciliated in Ireland.
[2]Other EA countries include Austria, Belgium, Ireland, the Netherlands, and Portugal. 2011:Q1 only for Belgium; for all other countries 2010:Q4 data.
[3]EA3: Greece, Ireland, and Portugal.
[4]The exposures are calculated in percent of the equity of banks that have foreign exposures. Banks that do not have exposures to Greece, Ireland, Portugal, and Spain are not included in the computation.

Fiscal consolidation remains necessary, but the pursuit of nominal deficit targets should not come at the expense of risking a widespread contraction in economic activity. Countries that have credible medium-term adjustment plans or front-loaded consolidation efforts should consider allowing automatic stabilizers to work fully. And countries that have access to funding at historically low yields should consider delaying some of their fiscal consolidation if downside risks to growth materialize. The withdrawal of monetary support or the monetary tightening in the cyclically more advanced economies will need to be paused or even reversed in cases where downside risks to inflation and growth persist. Finding a durable solution to the euro area sovereign crisis has become more than overdue, while much work remains to be done on the structural front—to strengthen financial systems and support growth. The former will require some difficult decisions to improve crisis management and a demonstration of unity behind the project of economic and monetary union (EMU) that will convince markets.

Adjusting the policy-mix

While the deteriorated state of public finances—and renewed market concerns over sovereign debt—leave no option but to strengthen fiscal positions, the slowdown in growth is calling for caution. From a long-term perspective, and unlike in some other advanced economies, fiscal consolidation is proceeding appropriately in Europe and should broadly continue as planned (Table 1.1 and Figure 1.17). The effort should remain broad-based, as contingent fiscal liabilities related to aging loom large everywhere. Where pressures are most severe, the consolidation should continue to be front-loaded. Italy's decision to bring forward some of the fiscal consolidation measures initially planned for 2013–14 and the additional measures taken by France and Spain should help relieve some of the recent pressure on sovereign bonds. While fiscal consolidation will undeniably have a negative impact on activity in the short term, the alternative scenario of intensifying market pressures is hardly an option.

Nonetheless, a narrow focus on nominal targets is unwarranted. In many countries, medium-term fiscal consolidation plans are credible or

Table 1.1

Advanced European Countries: Main Macroeconomic Indicators, 2009–12

(Percent)

	Current Account Balance to GDP				General Government Overall Balance to GDP[1]			
	2009	2010	2011	2012	2009	2010	2011	2012
Advanced European economies[2]	0.7	0.8	0.8	1.0	-6.4	-6.0	-4.3	-3.3
Euro area	-0.3	-0.4	0.1	0.4	-6.3	-6.0	-4.1	-3.1
Austria	3.1	2.7	2.8	2.7	-4.1	-4.6	-3.5	-3.2
Belgium	0.0	1.0	0.6	0.9	-5.9	-4.1	-3.5	-3.4
Cyprus	-7.5	-7.7	-7.2	-7.6	-6.0	-5.3	-6.6	-4.5
Estonia	4.5	3.6	2.4	2.3	-2.1	0.2	-0.1	-2.3
Finland	2.3	3.1	2.5	2.5	-2.8	-2.8	-1.0	0.3
France	-1.5	-1.7	-2.7	-2.5	-7.5	-7.1	-5.9	-4.6
Germany	5.6	5.7	5.0	4.9	-3.1	-3.3	-1.7	-1.1
Greece	-11.0	-10.5	-8.4	-6.7	-15.5	-10.4	-8.0	-6.9
Ireland	-2.9	0.5	1.8	1.9	-14.2	-32.0	-10.3	-8.6
Italy	-2.1	-3.3	-3.5	-3.0	-5.3	-4.5	-4.0	-2.4
Luxembourg	6.9	7.8	9.8	10.3	-0.9	-1.7	-0.7	-1.2
Malta	-7.5	-4.8	-3.8	-4.8	-3.7	-3.8	-2.9	-2.9
Netherlands	4.9	7.1	7.5	7.7	-5.5	-5.3	-3.8	-2.8
Portugal	-10.9	-9.9	-8.6	-6.4	-10.1	-9.1	-5.9	-4.5
Slovak Republic	-3.2	-3.5	-1.3	-1.1	-8.0	-7.9	-4.9	-3.8
Slovenia	-1.3	-0.8	-1.7	-2.1	-5.6	-5.3	-6.2	-4.7
Spain	-5.2	-4.6	-3.8	-3.1	-11.1	-9.2	-6.1	-5.2
Other EU advanced economies								
Czech Republic	-3.3	-3.7	-3.3	-3.4	-5.8	-4.7	-3.8	-3.7
Denmark	3.8	5.1	6.4	6.4	-2.8	-2.9	-3.0	-3.0
Sweden	7.0	6.3	5.8	5.3	-0.9	-0.3	0.8	1.3
United Kingdom	-1.7	-3.2	-2.7	-2.3	-10.3	-10.2	-8.5	-7.0
Non-EU advanced economies								
Iceland	-11.7	-10.2	1.9	3.2	-8.6	-5.4	-4.1	-2.3
Israel	3.6	2.9	0.3	0.7	-5.6	-4.1	-2.8	-2.2
Norway	12.9	12.4	14.0	12.8	10.6	10.9	12.0	11.2
Switzerland	11.4	15.8	12.5	10.9	0.5	0.4	0.8	0.6
Memorandum								
European Union[2]	-0.1	-0.1	-0.2	0.0	-6.8	-6.5	-4.6	-3.6

Source: IMF, World Economic Outlook database.

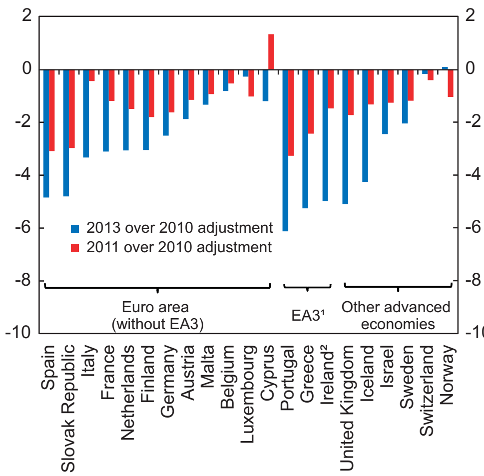
[1] Net lending only. Excludes policy lending.

[2] Weighted average. Government balance weighted by purchasing power parity GDP; current account balance by U.S. dollar-weighted GDP.

Figure 1.17

Selected Advanced European Countries: Changes in General Government Fiscal Deficits, 2010–13

(Percentage points of GDP)



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
[1]Greece, Ireland, and Portugal.
[2]Excluding bank support measures for Ireland.

have been front-loaded, providing room to allow automatic stabilizers to work fully to deal with growth surprises. Furthermore, if activity were to undershoot current expectations and risk a period of stagnation or contraction, countries that face historically low yields (for example, Germany and the United Kingdom) should also consider delaying some of their planned consolidation.

Pursuing the withdrawal of monetary stimulus needs to be reconsidered. While this approach would still be appropriate where output gaps are in the process of closing, the revised outlook sees much lower inflationary pressures with, in some cases, growth falling below potential rates. In the euro area, the recent financial turmoil and downgraded outlook point in this direction, calling on the ECB to maintain a very accommodative stance. In addition, it should lower its policy rate if downside risks to growth and inflation persist. Similarly, in the United Kingdom, where the recovery is tepid, and fiscal tightening stronger, the accommodative stance will need to be maintained for some time, and the Bank of England should further loosen its monetary stance if the recent weakening of the growth and inflation outlook continues. The risk to growth, and hence inflation prospects, should dominate monetary policy decisions, and pockets of excessive risk taking that might arise with policy rates kept very low for a long time should be addressed through macro-prudential or fiscal measures. Countries that have fully regained pre-crisis output levels or are already operating above potential (such as Israel, Norway, and Sweden) are in a slightly more comfortable position, but they may still need to consider a pause in their tightening cycles.

Further breakthroughs in crisis management still needed

Crisis management in the euro area needs to go beyond its current approach to ensure success. Repeatedly, financial markets have signaled pressure points, the ECB has correctly stepped in to prevent financial instability, and policymakers have stated their commitment to do whatever it takes to preserve euro area stability. Measures actually adopted have been steps in the right direction, but political constraints have led to an incremental approach that subsequently proved to remain behind the curve. Implementation of the July 2011 summit measures is proving to be protracted, with parliamentary approval stretching into the autumn, and negotiations on collateral for financial assistance to Greece have weakened the earlier display of unity.

Euro area leaders need to spell out and recommit to a common vision of how the euro area is expected to function in the future. This is essential to anchor market expectations and dispel the prevailing uncertainty. Overall, a definite strengthening of fiscal and economic governance of the monetary union is needed. While strengthening national budgetary rules, countries will need to cede some control over their fiscal position to a central euro area body. Increased ex-ante fiscal risk sharing, through a euro area bond or revenue sharing, is likely to be necessary together with a common approach and backstop to the financial system of the euro area. Policies that remain national will need to be subject to stronger discipline.

In terms of current crisis management, stronger support to countries seeking to overcome debt sustainability problems may well be crucial. Alternatively, a significant increase in crisis management resources, with a full range of intervention tools, including guarantees and the possibility to backstop the financial system directly, would send a signal of renewed commitment. Of course, none of these tools can absolve countries from taking the necessary adjustment measures to regain competitiveness and secure fiscal sustainability. Hence, increased support will need to be accompanied with strong conditionality.

While these changes are being put in place, a number of actions to deal with the crisis should be undertaken urgently. Implementation of the July 21 summit decisions should be accelerated. Now that the legislative package of governance reforms at the EU level is proceeding, the focus should switch to ensuring that the strengthened Stability and Growth Pact (SGP) and the newly introduced Excessive Imbalance Procedure effectively support a more integrated economic and monetary union. Strengthening the banking system remains essential, and full use should be made of the expanded mandate of the EFSF to assist countries in doing so. Equally important to maintain orderly sovereign debt markets is a continued involvement of the ECB via its SMP. An explicit commitment to do so for as long as necessary, within a strong conditionality framework and backed by a restatement from euro area member states of their readiness to indemnify the ECB for any incurred losses would be very helpful. Strengthening of fiscal institutions is essential.

Put the financial sector on a sounder footing

In the meantime, uncertainties prevailing over bank balance sheets, the high degree of interconnectedness across the EU, and the lack of effective resolution frameworks for large and cross-border banks all continue to rattle investors. Yet, deleveraging achieved by shrinking assets risks undermining the recovery in continental Europe, where bank-based financing still dominates. To avoid the experience of Japan, where insufficient restructuring led to a lost decade of growth, and help mitigate the sovereign tensions affecting many banks, Europe's financial sector needs to be restored to health.

The July 2011 stress tests coordinated by the European Banking Authority (EBA) and their follow-up are unlikely to achieve this outcome. On the positive side, bank equity issuance was stepped up in the run-up to the tests, which were conducted more rigorously than in the previous year, and led to a welcome improvement in transparency. However, the test scenarios for financial shocks, especially on the sovereign front, were mild compared to the most recent market developments. The banks that failed or barely passed the stress tests now have until mid-October 2011 to submit remedial action plans, but not all weak banks were identified by the tests, in part because the EBA sample was limited. They will continue to cast a shadow over the entire banking system, until more comprehensive actions toward restructuring and front-loaded strengthening of banks' capital buffers are undertaken.

Ideally, capital should be raised through private, preferably cross-border, solutions (IMF, 2011b). In some countries, national authorities are already doing so, for example, by fostering injection of private capital into banks (as in the recent initial public offerings [IPOs] conducted by some Spanish saving banks) or cross-border investment (as recently in Ireland, where private equity participation included non-resident investors taking a minority stake). Absent this, supervisors will either have to make the case for injecting public funds into weak banks—which will be difficult in an environment of fiscal consolidation—or close them down. Where public resources are not available, EFSF resources should be tapped to strengthen viable banks' capital buffers, addressing in that manner both bank weaknesses and related tensions on national sovereigns.

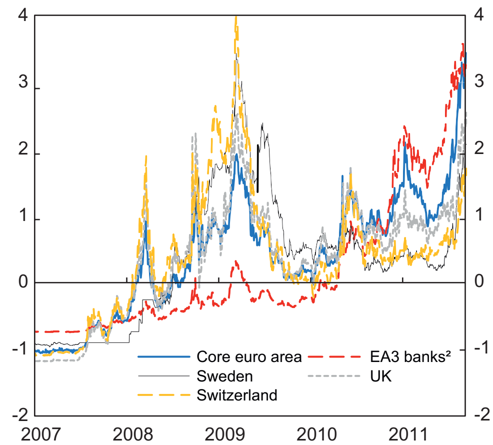
Meanwhile, extraordinary liquidity provision measures should stay in place in the euro area until financial market tension abates. They have helped and continue to support bank profitability during times of acute market stresses (Box 1.2). Refinancing at a fixed rate with full allotment, now in place until at least January

Box 1.2

Monetary Policy and Bank Performance in Advanced Europe

The global financial crisis caused a deep recession in advanced Europe and led to elevated levels of systemic risk. GDP growth in advanced Europe (defined in this box as the euro area, United Kingdom, Sweden and Switzerland) fell between 4.5 and 10 percent on a quarterly basis in late 2008–early 2009. Since then, the economic recovery has proceeded, although cautiously and unevenly. Bank systemic risk remained elevated in the aftermath of the Lehman crisis and has risen again—notably in the euro area—since late 2009, after revelations of the actual size of Greece's fiscal deficit (see first figure). More recently, tensions flared up again in euro area financial markets, as the sovereign crisis spread to markets that so far have remained fairly liquid, leading to new highs in bank systemic risk.

EU Advanced Countries: CDS-Based Bank Risk Indices, 2007–11[1]



Sources: Bloomberg, L.P; Datastream; and IMF staff calculations.
[1]Normalized score from a principal component analysis on 5-year senior bank credit default swap spreads, estimated using daily data (Jan. 1, 2005–Sep. 5, 2011). The core euro area risk index comprises CDS spreads of 35 banks and the EA3 risk index 10 banks from GRC, IRL and PRT. The UK index comprises 6 banks and the index for Sweden and Switzerland 4 banks. The first principal component captures 85.2% of the common variation across core euro area banks and 84.2% across EA3 country banks. For UK, Swedish and Swiss banks, it captures more than 90 percent of the common variation.
[2]EA3: Greece, Ireland, and Portugal.

After some accommodation at the time of the global financial crisis, fiscal and monetary support was being gradually withdrawn, until new tensions erupted in the summer of 2011.

- Fiscal policy was loosened substantially in 2008 and 2009 to support activity during the global recession, and in some cases, to recapitalize banks, guarantee bank debt, and purchase or guarantee bank assets; fiscal support is now being withdrawn everywhere—and in some cases in a more front-loaded way, in response to market pressures.

- Monetary policy has been supportive through conventional measures, with central banks lowering interest rates to very low levels between mid-2008 and early 2009. In some countries, they remain at this lower bound, while in others—including the euro area—they have since been raised (see left panel, second figure). Nevertheless, the general stance remains fairly accommodative.

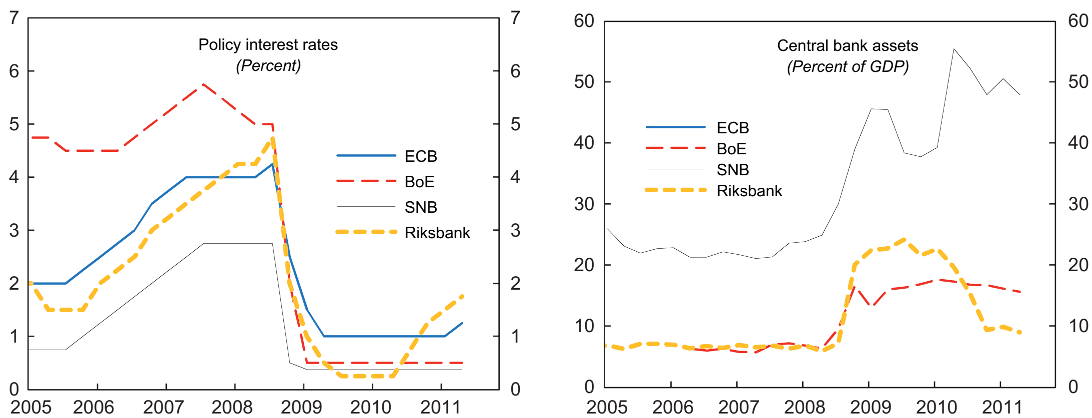
- Unconventional monetary policy measures were also implemented, in the form of interventions in securities markets and increased reliance by banks on central bank funding. They led to a rapid expansion of central banks' balance sheets and helped banks in need of liquidity (see right panel, second figure). Over the past year, these unconventional measures were scaled back gradually as the situation in the interbank market improved. In the summer of 2011, however, tensions re-emerged in European banking markets and some unconventional policies have been reactivated: the ECB relaunched a 6-month refinancing operation in August and its sovereign bond purchase program was resumed.

IMF staff analysis shows that monetary policy has been supportive in restoring bank profitability. The effects of monetary policy measures on bank profitability are inferred from quarterly and semi-annual panel regressions with proxies for conventional and unconventional policy measures as explanatory variables, separately for banks in the euro area, Sweden and United Kingdom, to account for differences in monetary regimes and policies across

Note: The main author of this box is Nico Valckx.

Europe.[1] These monetary policy measures are interacted with bank-specific variables that reflect key weaknesses, such as low capital buffers, low liquidity, and high reliance on wholesale or high loan-deposit ratios. The estimates show that the differences across banks are particularly important, as weak banks—those with low capital and low liquidity—have benefitted more from lower policy interest rates.

Advanced Europe: Conventional and Unconventional Central Bank Policies

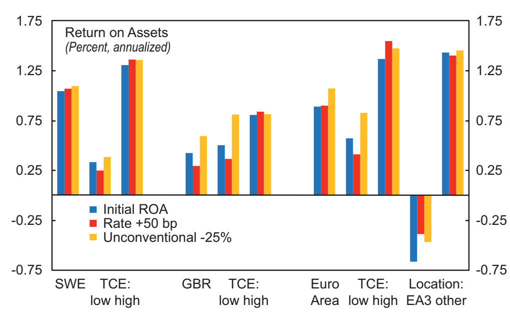


Sources: Bank of England; ECB; Haver Analytics; Riksbank; and SNB.

The results also suggest that withdrawal of unconventional measures should happen only gradually, once tensions abate and frictions on monetary policy transmission channels recede; profitability would then be on safer ground. Bank profitability suffered particularly strongly during periods of increased systemic risk, as the result of malfunctioning markets, which necessitated unconventional policy measures. This is reflected in the panel regressions, which show a significant impact of unconventional policies (both individually and through interaction with indicators of bank strength) on profitability, while also controlling for bank systemic risk through bank systemic risk indicators.

In addition, the withdrawal of monetary policy measures should be embedded in a comprehensive approach to tackle the crisis. Based on the results of the panel regression, a scenario where policy rates are raised and central banks' balance sheets reduced is used to illustrate the effect of monetary policy measures on bank profitability. Altogether, the results indicate that a comprehensive approach to solve the crisis, including recapitalization, is needed for (weak) banks, as is

A rise in interest rates would weigh on (weak) banks' profits, whereas withdrawal of unconventional policies would be positive–reflecting their emergency role.



Sources: Bloomberg, L.P.; and IMF staff calculations.
Note: Shown are panel regression-based simulations for UK (29), Swedish (5) and euro area (86) banks' return on assets (ROA) in 2011:H1 (2010:Q4 for euro area), for a 50 bp increase in the 3-month interbank rate and a 25 percent reduction in the central bank's balance sheet (a proxy for unconventional measures), for all banks and differentiated by levels of TCE capital ratios and location within the euro area (EA3 for banks in GRC, IRL, and PRT). The ROA impact is evaluated at the median, 10th (low) and 90th (high) percentile of the TCE ratio. For Sweden, unconventional policies did not depend on the bank-specific situation.

[1] See Valckx (2011) for a more detailed review of models and methodology of ECB policy impact on euro area banks.

Box 1.2 *(concluded)*

incorporated in current EU/IMF programs. Weak(er) banks should also raise capital in preparation for the withdrawal of standard measures. More specifically:

- *Conventional policies*. When rates are raised by 50 basis points, weaker banks (with low TCE ratio) would suffer, while others would be affected less (see third figure). In the euro area, banks in program countries would see their ROA improve but would remain loss-making, whereas the effect on banks in other euro area countries would be minor. These outcomes reflect differences across banks as regards their balance sheet structure, with weaker banks having more short-term liabilities subject to sharper repricing as interest rates change.
- *Unconventional policies*. High systemic risk has usually coincided with the need for reinforced unconventional policies. This also explains the result that the improvement in banks' performance would coincide with central banks' decision to gradually reduce the size of their balance sheets to pre-crisis levels. As systemic risk recedes and the economic outlook improves, a withdrawal of unconventional measures would see banks capable of raising their profitability, as this would allow for a steepening of the yield curve and an improvement of banks' (net) interest margin.

2012, continues to be critical for banks with limited access to wholesale or interbank funding. Moreover, the ECB might need to reinstate some of its longer-term liquidity provision operations—as it did in August—if stresses on interbank markets intensify further. Yet, these unconventional support measures should not be a substitute for tackling the underlying problems in the financial sector.

Strengthening the financial sector will also entail a larger role for EU-wide regulatory and supervisory institutions. The European Systemic Risk Board (ESRB) and the European Supervisory Authorities (ESAs) started operating at the beginning of 2011, but their credibility still needs to be established. Some gaps in the framework will need to be filled, in particular in formalizing the collaboration among EU institutions and the relationship between these new institutions and national authorities. For example, the EBA should rapidly rise to its role as the guardian of high standards of supervision for banks operating across euro area and EU borders. Beyond, moving decisively in the direction of a unified European financial market will require adopting a single rulebook common to all EU banks, in the spirit of the Single Market, as currently envisaged. Harmonized standards set at the EU level under the CRD4 directive will be important, but the current Commission proposal should be further strengthened by focusing on capital of the highest standards and setting capital requirements that exceed Basel III standards to deal with interconnectedness and the absence of an EU-wide bank backstop. Moreover, sufficient flexibility should be allowed for macro-prudential measures to address country-specific risks, governed by a common macro-prudential policy toolkit, to be developed under the leadership of the ESRB (Box 1.3).

Finally, a unified European financial architecture will not be complete without a common resolution and stability framework, especially for the euro area. To end the intertwining of sovereign and banks' balance sheets once and for all requires setting up mechanisms for rapidly financing resolution efforts, especially for banks operating cross-border or with cross-border implications. The new mandate of the EFSF, which allows funds to be used to strengthen banks' capital buffers, is a step in that direction, but a bolder long-term vision is needed. Ultimately, a European Resolution Authority, backed by common deposit guarantee and resolution funds, would provide a permanent instrument to do so, while also improving ex-post burden sharing and providing an EU-centered backstop.

Growing out of the crisis

Sustainable growth will remain the best ingredient for securing long-lasting fiscal and political stability and safeguarding Europe's cohesion.

Box 1.3

Macro-prudential Reforms in the EU: Objectives and Progress

The new institutions underpinning the EU financial sector architecture are now in place, but their credibility and effectiveness remains to be established. Since January 1, 2011, the European Systemic Risk Board (ESRB), in charge of macro-prudential oversight at the EU level, and the new European Supervisory Authorities (ESAs)—endowed with enhanced supervisory and regulatory powers—have become operational and are expected to become the core of an integrated European financial stability framework. On the macro-prudential front, this framework will require appropriate collaboration among EU institutions to be effective, including sharing of information and adequate access to data. In addition, a set of macro-prudential instruments common to all EU Member States will have to be designed. Because of the deep interconnection of EU financial systems and the scope for externalities, the ESRB will have to play a forceful role in developing and establishing this EU macro-prudential policy toolkit, in collaboration with other EU institutions and national authorities. It should also coordinate national policies and ensure reciprocity to minimize regulatory arbitrage.

To be effective, the EU macro-prudential framework also requires adequate national macro-prudential frameworks.[1] Identification and analysis of risks will require a "bottom-up" element (information and analysis coming from the national level) to complete the analysis and decision-making of the ESRB. The national dimension will be essential to implement on the ground the ESRB "top-down" recommendations too. Because the ESRB's risk warnings and recommendations are not binding on EU Member States, it is essential that strong macro-prudential mandates—including an EU dimension—and powers are established at the national level to overcome likely biases for inaction from policy makers. But to ensure a timely follow-up on ESRB recommendations, it is likewise essential that an *adequate* and *common* macro-prudential toolkit be established at the national level. Since the ESRB has no binding power, the EU Commission is the only institution that can set mandatory standards for macro-prudential frameworks that are common to all EU countries.

Institutional arrangements for macro-prudential oversight are indeed being strengthened at national levels.

- The United Kingdom, as part of the major overhaul of its financial regulatory structure, is taking the lead in establishing a strong macro-prudential framework. A Financial Policy Committee (FPC) in charge of macro-prudential oversight of the United Kingdom's financial system is being established within the Bank of England, alongside the Monetary Policy Committee (MPC).[2] In particular, the FPC will be given power over specific macro-prudential instruments by Parliament and will have the power to require regulatory agencies to take specific policy actions in response to growing systemic risks.
- France established in 2010 a Financial Regulation and Systemic Risk Council (FRSRC),[3] headed by the Finance Minister, to coordinate macro-prudential analysis by the Banque de France and the regulatory agencies, and advise policy-makers on how to prevent and manage systemic risk in the financial sector, taking into account ESRB risk warnings and recommendations.
- In several other countries, macro-prudential oversight (with varying mandates and powers) has been given to the central bank (Hungary and Ireland), or such a move is being considered (Belgium, Germany, and the Netherlands).

Note: The main author of this box is Thierry Tressel.

[1] See Nier and Tressel (2011).

[2] An interim FPC has been established, and met in June 2011. It foreshadows the role of the future statutory FPC and is preparing analysis and proposals on potential macro-prudential toolkits being discussed in EU forums.

[3] Conseil de Régulation Financière et du Risque Systémique, established under Law 2010-1249 of October 22, 2010.

Box 1.3 *(continued)*

- Finally, financial stability councils tasked with the monitoring and coordination of work on financial stability are in place in a number of countries (for example, Belgium, Bulgaria, Italy, Poland, Portugal, and Spain), with an explicit macro-prudential mandate in some cases (Greece).

Many EU countries, notably the "New EU Member States," have already relied upon macro-prudential policies to stem house price appreciation or to limit capital inflows. Even before the financial crisis, macro-prudential policies had been applied in New EU Member States to try and contain credit booms, mostly fueled by capital inflows, with ambiguous results. Measures taken by authorities included enhanced reserve requirements (often differentiated by currency or origin of funds), marginal reserve requirements in excess of an allowed ceiling, higher capital requirements or capital conservation measures, tighter asset classification and provisioning, or limits on loan-to-value-ratios (LTVs) or debt-to-income ratios.[4] More recently, advanced EU countries have introduced measures aimed at containing house price appreciation. In 2007, Italy introduced constraints on LTVs to discourage mortgages with less than 20 percent down-payments. In October 2010, Sweden imposed an 85 percent limit on LTVs. In Spain, the decade-old dynamic provisioning was complemented in 2008 by more stringent treatment for commercial and residential real estate exposures.

However, key elements of an effective EU macro-prudential framework are often still missing. While macro-prudential instruments remain to be established in most EU countries, national agencies or committees often lack the legal power to use, direct to use, or calibrate regulatory tools for macro-prudential purposes. This might be particularly costly when swift and timely response to systemic risks is crucial. In several countries, such as Romania and Sweden, the regulatory agency has strong independent powers to modify financial regulations. But the rule-making power of the regulatory agency is generally constrained and often requires consultation with and approval of the Treasury (as in Finland, France, Germany, and the Netherlands), or in some cases even a parliamentary act.

In that context, a proposal for a macro-prudential toolkit common to all EU countries is being developed under the aegis of the ESRB. The Instrument Working Group of the ESRB is developing key principles that will provide a framework for an EU macro-prudential toolkit. The aim is to address two broad risk dimensions highlighted in international forums: a cyclical dimension associated with credit booms and asset markets, and a time dimension resulting from common exposures and interconnectedness. The ESRB and EU Member States are also of the view that the approach should link instruments to intermediate targets and objectives, but underlying causes of financial instability should be carefully analyzed. Although this approach is appropriate, a common, carefully selected toolkit should not be too restrictive to ensure that proper tools are in place to address future country-specific or sub-regional systemic risks.

As part of the broader implementation of the Basel III standards, the EU Commission is proposing steps to harmonize and coordinate EU macro-prudential policies, but the proposal lacks some flexibility at the national level. The draft Capital Requirement Directive IV (CRD4) released in July 2011 to design the roadmap toward Basel III implementation in the EU proposes to grant power to the Commission to tighten capital requirements temporarily across all EU institutions for specific activities or exposures, under a specific urgency procedure triggered by macro-prudential developments. The draft CRD4 provides some flexibility at the national level for macro-prudential purposes by allowing national authorities to set the countercyclical capital buffer (agreed upon in Basel III) under the guidance and monitoring of the ESRB, and by allowing higher capital requirements and limits on LTV ratios for loans secured by real estate. To prevent regulatory arbitrage, measures taken by national authorities would appropriately apply to all European institutions doing business in or exposed to the

[4] *May 2010 Regional Economic Outlook: Europe—Fostering Sustainability*; and "Macro-prudential Policy: What Instruments and How to Use Them? Lessons from Country Experiences" (MCM Board Paper).

country considered.[5] While these steps go in the right direction, more flexibility will be needed to allow national authorities to introduce macro-prudential tools within the common framework, including adjusting capital and liquidity requirements, or varying risk weights to address emerging systemic risks.

[5] An exception is made for the countercyclical capital buffer for which reciprocity will be mandated only up to 2.5 percent of risk weighted assets, as in the Basel III agreement.

As further elaborated in Chapter 3, the reform agenda spans a wide range of sectors; if implemented thoroughly, it stands ready to unleash Europe's growth potential, in particular its chronically underutilized labor force. Reforms should focus on deepening financial integration—as explained above—and reducing public ownership and involvement in the banking sector, lowering remaining barriers to competition in network industries, retail trade and regulated professions—as foreshadowed in the Services Directives—and addressing labor market segmentation, informal economy and inadequate wage flexibility. In program countries suffering from competitiveness problems, in particular Portugal, a fiscally neutral shift in taxes from labor to consumption (e.g., value added tax—VAT) is being considered to rebalance the economy in favor of exports—which are not subject to VAT—and smooth the required decline in labor costs where downward rigidity to wages exists.

With fiscal consolidation ahead, an additional concern is that public investment in research, education, and infrastructures will be curtailed, harming future growth performance. This should be avoided through appropriate prioritization of spending. Unleashing EU structural funds for the crisis-affected countries could also help to some extent (Marzinotto, 2011). The recent proposal by the European Commission to reduce national co-payments for some of the EU funds directed to program countries goes in that direction, although care should be taken that such funds are properly channeled to growth-enhancing sectors, in particular the tradable sectors, and that bottlenecks are tackled in those countries that have experienced low absorption in the past (Allard and others, 2008).