INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/204

EURO AREA POLICIES

July 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Euro Area member countries, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 24, 2015 consideration of the staff report that concluded the Article IV consultation with Euro Area member countries.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 24, 2015, following discussions that ended on June 3, 2015, with the officials of Euro Area member countries on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 10, 2015.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for the Netherlands.

The document listed below has been or will be separately released.

Selected Issues

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July 27, 2015

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IMF Executive Board Concludes 2015 Article IV Consultation on Euro Area Policies

On July 24, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Euro Area.

The recovery is strengthening, driven by rising domestic demand and supported by lower oil prices, the ECB's quantitative easing under the expanded asset purchase program, and a weaker euro. The improving sentiment, rising inflation expectations, and easing credit conditions suggest that the recovery is likely to continue in the near term. In this context, euro area GDP is expected to accelerate from 1.5 percent this year to 1.7 percent next year. Headline inflation is expected to remain close to zero this year and rise to 1.1 percent next year, reflecting a still large output gap.

Risks to growth are now more balanced than in recent years when they were clearly to the downside. On the upside, low oil prices, quantitative easing, a weaker euro, and rising confidence could bring larger-than-anticipated benefits. Downside risks include lingering weakness and low inflation, a potential slowdown in emerging markets, geopolitical tensions, and financial market volatility, whether from asymmetric monetary policies or contagion from events in Greece.

But the medium-term outlook is subdued, as a chronic lack of demand, impaired corporate and bank balance sheets, and weak productivity continue to hold back employment and investment. Potential growth, estimated to average around only 1 percent over the medium term, is well below what is needed to reduce unemployment to acceptable levels in many countries. Because growth prospects are subdued and policy space is limited, the euro area is vulnerable to negative shocks and prolonged low growth, with negative spillovers.

Addressing the weak medium-term outlook requires a comprehensive policy response. Cleaning up bank balance sheets would encourage banks to lend and firms to invest, while accelerating

[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

structural reforms and strengthening further the economic governance framework would help secure lasting growth for Europe and create positive spillovers for the global economy.

Executive Board Assessment[2]

Executive Directors welcomed the strengthening of the recovery in the euro area on the back of lower oil prices and a weaker euro, supported by strong policy actions, notably by the European Central Bank. Directors noted, however, that the medium-term outlook remains subdued, held back by insufficient demand, still high unemployment, impaired balance sheets, and persistent structural weaknesses.

Directors considered that, while risks to the outlook are more balanced than in recent years, the euro area remains exposed to vulnerabilities. Although market reaction to the recent reform package passed in Greece has been broadly positive, further episodes of significant uncertainty and volatility arising from the situation cannot be ruled out. Directors urged policymakers to use all the available instruments, if needed, to manage contagion risks that might originate from Greece. They also highlighted the need to continue enhancing the architecture of the monetary union and European firewalls.

Directors recommended a concerted, comprehensive approach to bolster domestic demand, especially in surplus countries, clean up bank balance sheets, accelerate structural reforms to raise productivity, and strengthen the economic governance framework. They noted the complementarities among these priorities and the benefits of a more balanced policy mix in generating growth, employment, and positive external spillovers. These efforts would also facilitate further external rebalancing within the euro area.

Directors noted that quantitative easing under the expanded asset purchase program has improved confidence and financial conditions, and raised inflation expectations. They supported full implementation of the expanded asset purchase program, with flexibility in asset purchases, until there is a sustained adjustment in inflation consistent with meeting the medium-term price stability objective, while addressing potential financial stability concerns through macro-prudential policies. Directors saw room for growth-friendly fiscal measures to lessen the burden on monetary policy and its potential spillover concerns. They considered that countries with fiscal space and low public debt should make full use of the flexibility embedded in the Stability and Growth Pact to support investment and structural reforms. They welcomed efforts underway to swiftly implement the centralized investment plan, carefully select high-return projects, and remove regulatory barriers. 3

Directors underscored the urgency of repairing bank balance sheets and severing bank-sovereign links, crucial for credit growth and effective monetary policy transmission. They encouraged comprehensive action to reduce the high level of non-performing loans, tighten supervision,

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

improve insolvency regimes, and develop distressed debt markets. Directors stressed the need for common deposit insurance with an effective fiscal backstop, a well-resourced Single Resolution Fund, and ease of access to direct bank recapitalization from the European Stability Mechanism. They looked forward to further advancement toward a complete banking union.

Directors urged further reforms to improve labor markets and productivity, the business climate, and potential growth. They recommended focusing regional efforts on implementing the Services Directive, and establishing a single market in transport, energy, and the digital economy. Directors looked forward to an action plan to deepen the integration of capital markets, aimed at diversifying funding sources and enhancing cost efficiency.

Directors welcomed proposals for a more effective governance framework, including a consideration of outcome-based benchmarks for setting priorities in structural reforms. They noted that independent councils could help enhance monitoring and innovation. Directors also saw scope for simplifying the fiscal framework, based on a single fiscal anchor and a single operational target.

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

July 10, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATIONS WITH MEMBER COUNTRIES

KEY ISSUES

Context. The recovery is strengthening, underpinned by lower oil prices and the ECB's expanded asset purchase program. But the medium-term outlook remains weak, weighed down by the legacies of insufficient demand, lagging productivity, and weak bank and corporate balance sheets.

Policies. A concerted, collective effort is needed to sustain the recovery, avoid overburdening monetary policy, and lift potential growth over the medium term, which would have positive spillovers for the rest of the world:

Demand support. Quantitative easing (QE) has boosted confidence and improved financial conditions. The ECB's clear communication to stay the course on QE until inflation is on a sustained adjustment path will help anchor expectations. Countries should adhere to the SGP, but those with fiscal space should use it to support investment and structural reforms.

Balance sheet repair. High non-performing loans (NPLs) in some banks are eroding profitability and discouraging new lending. Complementary policies are needed to incentivize NPL resolution through strengthened prudential supervision, insolvency reforms, and development of distressed debt markets. Asset management companies (AMCs) could help banks to offload NPLs and assist with corporate restructuring.

Productivity-enhancing structural reforms. Labor and product market reforms should be combined with faster implementation of the Services Directive, further improvements of insolvency regimes, and a greater push toward a single market in capital, transport, energy, and the digital economy. A capital markets union would help diversify funding sources and reduce reliance on bank lending.

Better economic governance. A more effective and simpler governance framework, including a move towards "outcome-based" benchmarking, could help advance structural reforms, while the fiscal framework could be simplified and strengthened.

Approved By
Poul Thomsen and Hugh Bredenkamp

Discussions took place during May 18–June 3, 2015. Mission members included M. Pradhan (head), K. Kang, S. Aiyar, J. John, A. Banerji, P. Berkmen, H. Lin, A. Jobst, S. Saksonovs (all EUR), T. Kinda (FAD), and J. Franks, B. Barkbu, and H. Schoelermann (all EUO). Executive Director M. Snel and his Advisor L. Piana as well as ECB Observer at the IMF G. Pineau participated in some meetings. Support was provided from headquarters by J. Bluedorn, T. Wu, K. Cincotta, X. Shao, and J. Siminitz (all EUR) and from Brussels by L. Hobbs (EUO).[1]

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[1] The mission would also like to thank euro area authorities, in particular President M. Draghi (European Central Bank), Chairperson D. Nouy (Single Supervisory Board), Head of Secretariat F. Mazzaferro (European Systemic Risk Board), Managing Director K. Regling (European Stability Mechanism), President J. Dijsselbloem (Eurogroup), Director General M. Buti (European Commission), and Chairperson A. Enria (European Banking Authority), as well as their staff for their time, support, and accessibility. The mission has also benefitted from the Fund’s bilateral Article IV consultations with euro area countries and from discussions with national authorities during meetings of the Eurogroup and the Eurogroup Working Group.

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CONTEXT: CYCLICAL RECOVERY UNDERWAY…

1. **The recovery continues.** After weakness through mid-2014, growth picked up late last year and has continued in 2015, driven by domestic demand (Figure 1 and Table 1). Private consumption remained robust, reflecting rising employment and real wages, while fixed investment has expanded moderately. Among the large economies, Germany continues to grow slightly above 1½ percent, while Spain is rebounding strongly. Italy is emerging from three years of recession, and activity in France picked up at the beginning of this year.

2. **Very low inflation appears to be bottoming out.** After widespread deflation in early 2015, the rebound in oil prices since March has helped return inflation to positive territory. HICP inflation in June was 0.2 percent (y/y) with core inflation remaining around 0.8 percent (Figure 2). Inflation is expected to remain close to zero this year before rising to 1.1 percent in 2016, reflecting the still large output gap (2¼ percent of GDP).

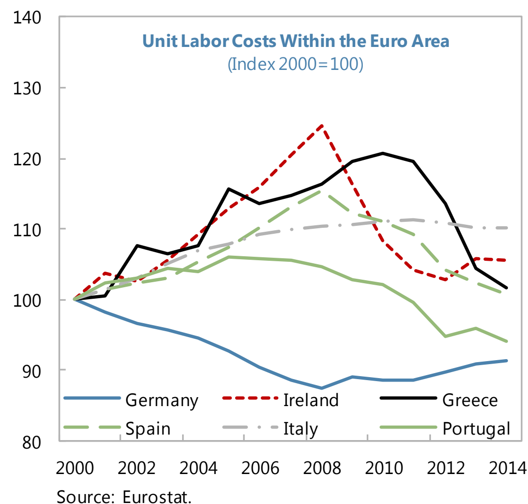
3. **Cheaper oil, monetary easing, and a weaker euro are expected to support the upturn in the near term.** The nearly 50 percent decline in USD oil prices through early 2015 has lifted consumer and business spending. European Central Bank (ECB) monetary policy action, including quantitative easing (QE), has boosted confidence, improved financial conditions, and contributed to a reduction in financial fragmentation (Figure 8).[2] While recent volatility has returned bond yields to levels of last fall in many countries, equity markets and inflation expectations are up. The euro in June was around 7 percent weaker in nominal effective terms compared to 2014, and given the lagged pass-through should boost exports through 2016. And after substantial fiscal adjustment through 2013, the euro area fiscal stance is projected to remain broadly neutral this year and next. Reflecting these factors, growth is projected to rise modestly to 1.5 and 1.7 percent in 2015–16.[3]

4. **The external position is strengthening…** The current account remained in surplus last year even as real imports picked up strongly (Figure 3). Overall, the euro area's external position in 2014 was broadly consistent with the level implied by medium-term fundamentals (Table 2). The REER depreciation of the euro so far in 2015 has been beneficial given the economic cycle, but the currency is now moderately weaker than the level consistent with medium-term fundamentals. Along with accommodative monetary policy, a broader reform agenda that strengthens growth and inflation would contribute to a gradual strengthening of the real exchange rate over the medium term.

[2] QE here refers to the ECB's expanded asset purchase program (APP) which adds the purchase of public sector securities to pre-existing programs to purchase private asset-backed securities and covered bonds.

[3] For comparison, the June 2015 Eurosystem (ECB) staff projections foresee growth of 1.5, 1.9, and 2.0 percent for 2015–17 with risks more balanced, but still tilted to the downside. The European Commission's Spring Forecast (May) also has growth of 1.5 and 1.9 percent for 2015–16, with risks evenly balanced.

5. **...but masks continuing external imbalances within the euro zone.** Current account balances among debtor countries (those with negative external debt positions) have improved, but rebalancing has failed to take place among creditor countries with the large current surpluses of Germany and the Netherlands continuing to grow and moving farther away from levels implied by medium-term fundamentals. The weaker euro will benefit debtor countries, particularly those whose exports have recently responded more to the exchange rate. Greece, Ireland, Portugal, and Spain, in particular, have improved competitiveness through lower unit labor costs. However, the weaker euro is also likely to exacerbate imbalances in surplus countries without a strengthening of domestic demand. Further rebalancing within the currency union will ultimately require addressing excess saving and weak investment in creditor countries, while improving further the competitiveness of debtor countries.



Source: Eurostat.

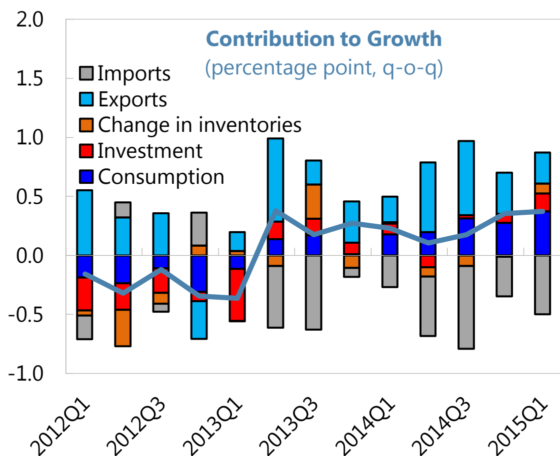
6. **Risks are now more balanced than in recent years when vulnerabilities dominated** (Table 3). On the upside, low oil prices, QE, a weaker euro, and rising confidence could bring larger-than-anticipated benefits. Downside risks include lingering weakness and low inflation, a potential slowdown in emerging markets, geopolitical tensions, and financial market volatility, whether due to asymmetric monetary policies or contagion from events in Greece.

7. **Managing potential contagion from evolving developments in Greece will require timely and effective policy actions.** Initial market reaction to the breakdown in talks between Greece and official creditors was relatively contained, but recent difficulties have raised market volatility and uncertainty: sovereign spreads have widened among some euro area economies, but the impact on nominal yields has been smaller as Bund yields fell on safe haven flows; equities, especially bank shares, have fallen; and the euro has weakened moderately. The spillover impact compared to a few years ago is lower, reflecting in part the addition of tools such as QE, OMT and TLTROs. The situation in Greece is fluid, however, and remains a key source of uncertainty. To manage contagion risks, policy-makers should stand ready to deploy, and if necessary adapt, the full arsenal of available instruments; the ECB in particular should ensure that banks continue to have access to ample liquidity and maintain orderly conditions in sovereign debt markets. If financial conditions tighten significantly, the ECB should consider further loosening monetary policy through an expansion of its asset purchase program (see below).

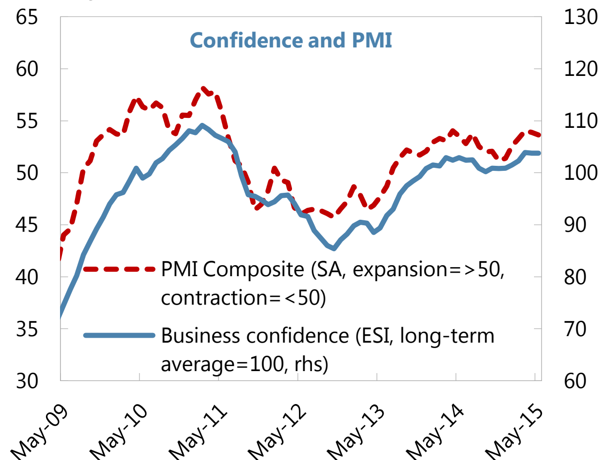
8. **Beyond the near term, there should be a concerted effort to accelerate steps to strengthen the monetary union and European firewalls.** Fully severing bank-sovereign links would require a common deposit insurance scheme with a fiscal backstop, a larger and fully funded Single Resolution Fund, and easier access to direct bank recapitalization from the ESM. The greater risk-sharing implied by these measures should be underpinned by a strengthened fiscal and structural governance framework which could require possible Treaty changes. These reforms are desirable in any case, but accelerated progress could help bolster market confidence in the face of recent events.

Figure 1. High Frequency and Real Economy Developments

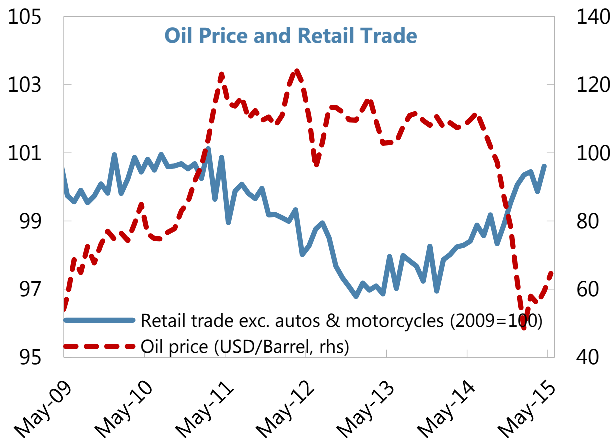
Domestic demand is now driving growth.



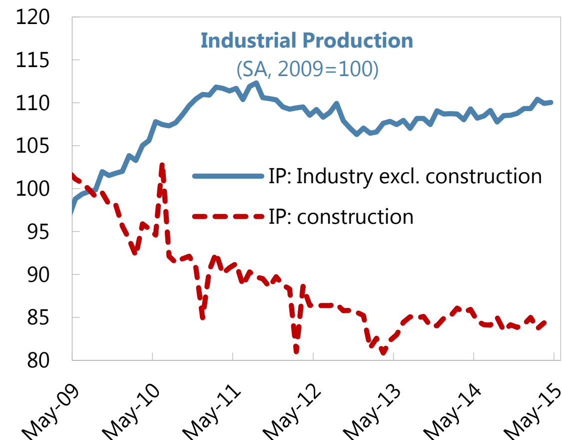
Improving business confidence points to the recovery continuing…



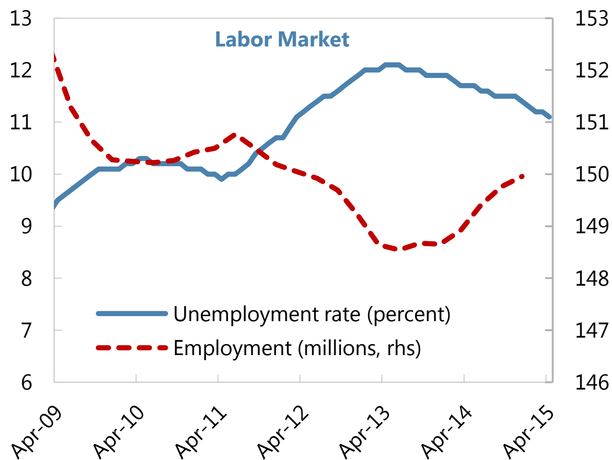
…led by lower oil prices and higher consumer spending.



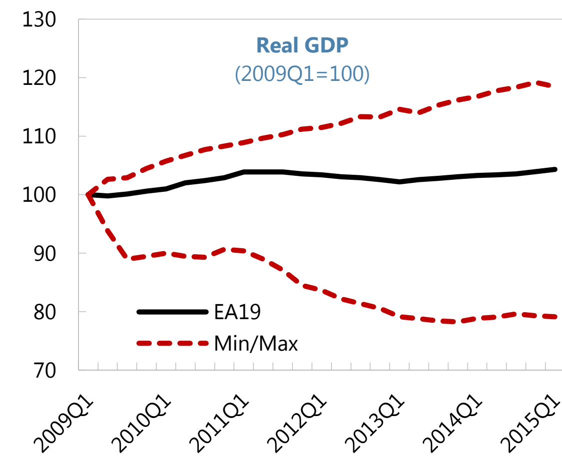
Industrial production however remains subdued.



The unemployment rate has come down, but is still high and employment remains well below pre-crisis levels…



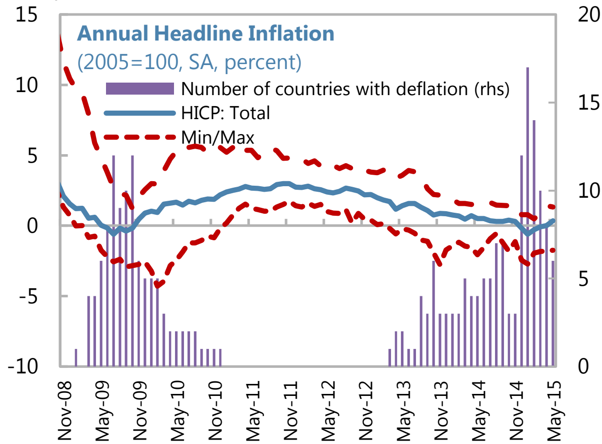
…while output continues to diverge across the euro area.



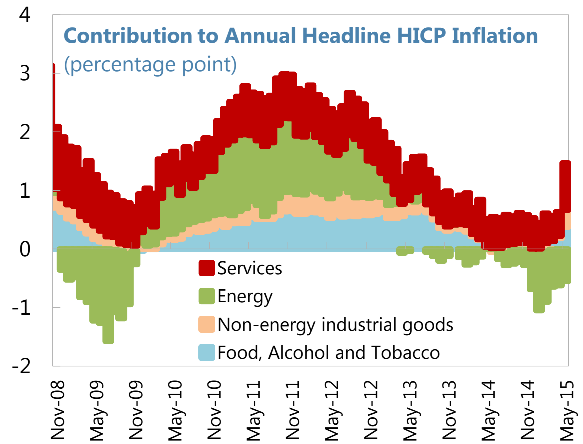
Sources: Haver Analytics and Eurostat.

Figure 2. Inflation Developments

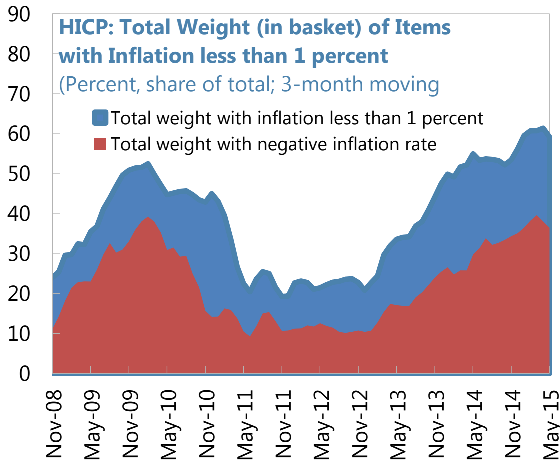
Inflation remains low, with one-third of countries in deflation in May...



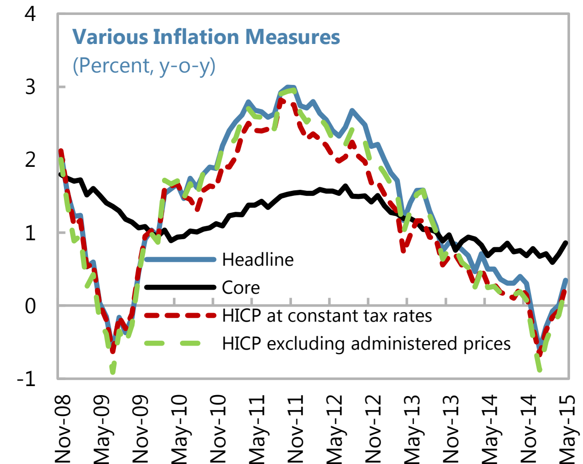
... driven especially by the decline in energy prices.



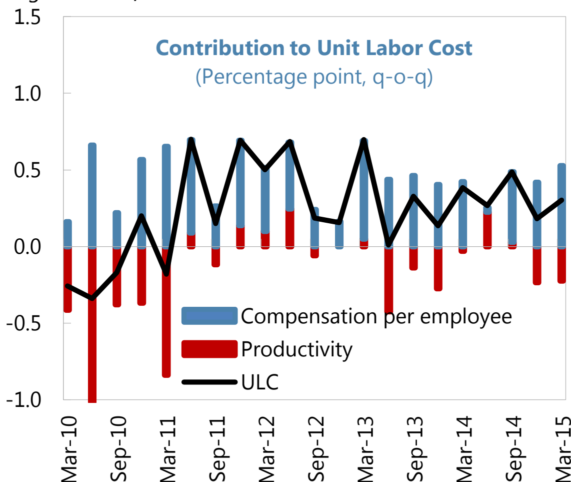
Low inflation is broad-based within the HICP basket, where the share of goods with declining prices remains high.



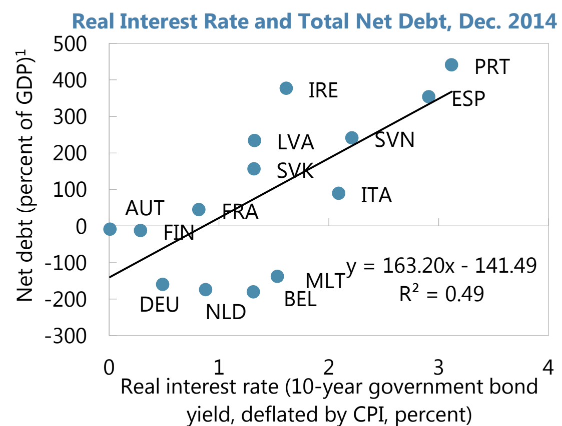
Core inflation has also remained subdued.



Labor costs have continued to rise, led mainly by higher wages, albeit from low levels.



Low inflation is also pushing up real rates, more in countries with higher debt burdens.

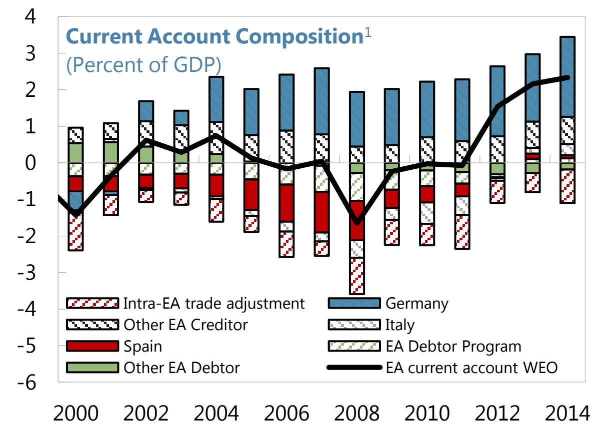


Sources: ECB; Haver Analytics; and Eurostat.

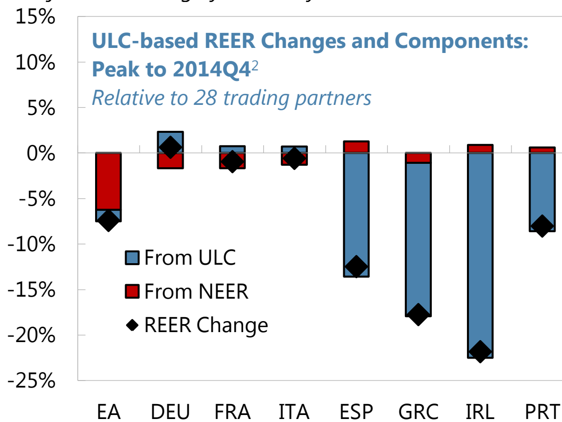
[1] Net debt is the total economy's financial liabilities minus assets.

Figure 3. External Sector Developments

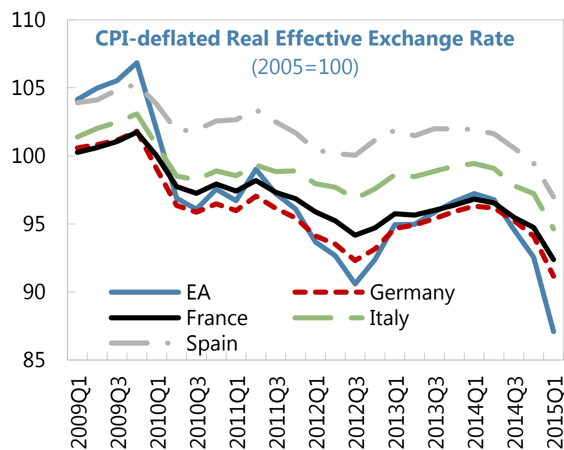
Current accounts continue to strengthen, while external imbalances within the euro area have widened.



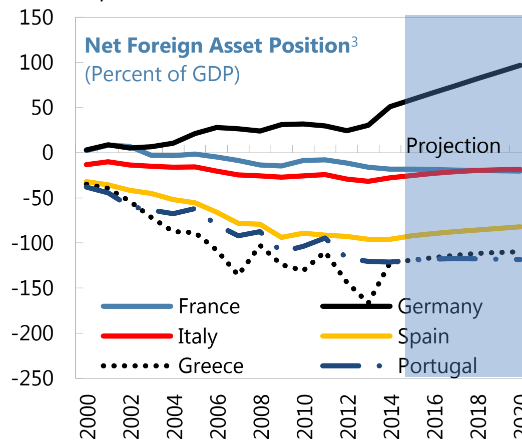
Relative to their peaks, several countries have experienced large REER adjustments, largely driven by lower unit labor costs.



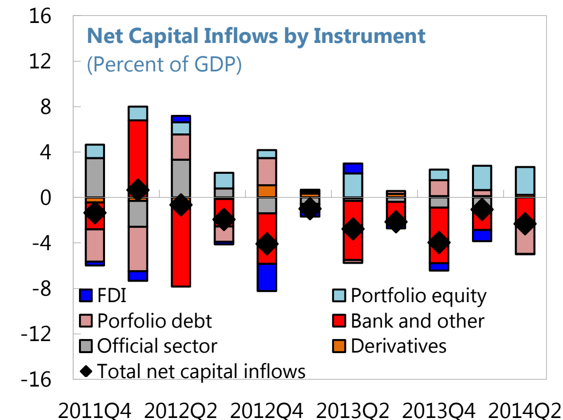
The REER has declined substantially since early 2014.



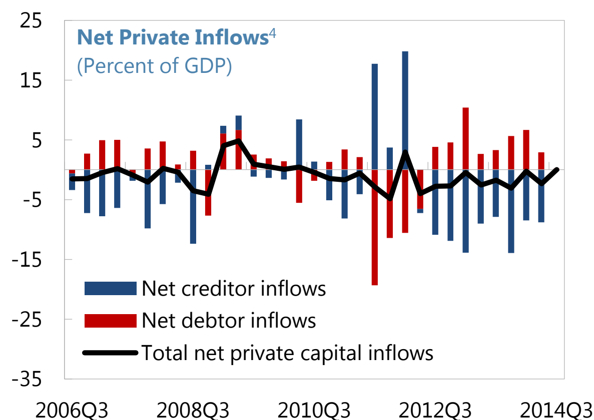
Net foreign asset positions are expected to improve only slightly for a number of countries.



Capital outflows have been mostly driven by bank-related assets...



...partly reflecting large debt outflows from creditor economies in the euro area.



Sources: Eurostat; Haver Analytics; IMF World Economic Outlook and Financial Flow Analytics databases; staff calculations.

[1] Creditor countries are DEU, NLD, AUT, BEL, FIN, LUX, and MLT (end-2013). All other countries have negative external debt positions.

[2] REER Peaks: 08Q1 for ESP, 08Q2 for IRL and PRT, 09Q4 for EA, GRC, DEU, FRA, and ITA.

[3] NFA/GDP implied by WEO projections, assuming no stock-flow adjustments or valuation effects going forward.

[4] Net private inflows exclude inflows to the official sector.

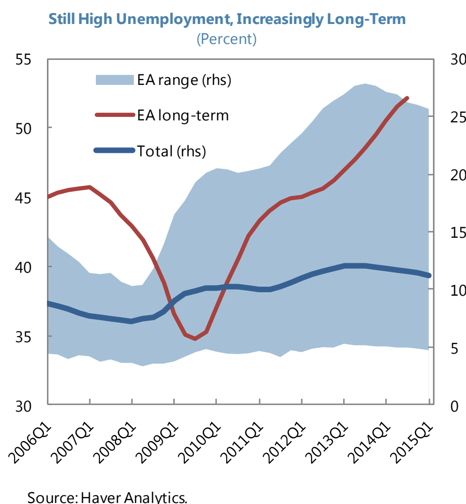
Table 1. Risk Assessment Matrix[1]

Sources of Risk	**Likelihood of Risk** (high, medium, or low)	**Expected Impact of Risk** (high, medium, low)	**Policy Response**
Structurally weak growth in key advanced economies	**High** • Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and accumulation of financial imbalances.	**High** • Low investment, high and persistent long-term unemployment, leading to lower growth potential and higher output gaps. • Undermines public debt sustainability, balance sheet repair, intra-euro area rebalancing.	• Ease monetary policy to raise inflation, support demand. • Repair bank, corporate, and household balance sheets to enhance monetary transmission. • Use fiscal space within SGP framework and fiscal rebalancing to support demand and promote structural reforms. In an adverse scenario, invoke systemic escape clause in SGP to provide near-term demand support while strengthening medium-term fiscal commitments. • Accelerate structural reforms to spur investment, productivity and competitiveness, advance rebalancing.
Structurally weak growth in key emerging economies (including China)	**Medium** • Maturing of the cycle, misallocation of investment, excess corporate leverage and insufficient progress with reforms leading to significant medium-term growth slowdown.	**Medium** • Slower export growth, higher output gap. • Lower growth and inflation weakens public debt sustainability and private balance sheets.	
Risks to energy prices	**Medium** • Persistently low prices triggered by supply factors reversing only gradually, and weaker demand.	**High** • Downward pressure on inflation. • Somewhat higher growth because of positive impact on disposable incomes.	• Adjust monetary policy appropriately to address low inflation risks and anchor inflation expectations.
Russia/Ukraine	**Medium** • Mounting conflict depresses business confidence and heightens risk aversion amid disturbances in global financial, trade and commodity markets.	**Medium** • Increased investor uncertainty, exacerbating low investment and growth.	• Counteract investor uncertainty by implementing structural reforms to improve business climate and facilitate balance sheet repair • Press forward on integrating energy platforms
Tighter global financial conditions and a surge in financial volatility	**High** • Sharp asset price adjustment and decompression of credit spreads as investors assess underlying risk and respond to unanticipated changes in growth prospects, Fed policy rate path and increases in U.S. term premia, with poor market liquidity amplifying the effect on volatility.	**Medium** • Tightening of financial conditions. • Bank-sovereign-real economy links could re-intensify via contagion and loss of market confidence. • Negative shocks to growth, worsening an already weak growth outlook.	• Accelerate balance sheet repair to enhance monetary transmission and support credit • The ECB should stay the course on QE and look through temporary episodes of market volatility to focus on its price stability objective
Euro area bond market contagion	**Medium** • Sovereign and financial sector stress re-emerges across the euro area due to protracted policy uncertainty and delays in debt servicing in Greece, faltering reforms, and political and social upheaval.		• To manage contagion risk, use full range of instruments, such as QE, OMT, and TLTROs • Strengthen the monetary union to improve resilience. Key steps to help break bank-sovereign links include a common deposit insurance scheme, accelerated build-up of SRF funds, and approval of the SRF agreement to enable ESM direct bank recapitalization, although preconditions should be relaxed
Euro area insurance sector stress from low interest rates	**High** • Stress on life insurer balance sheets due to investment returns falling below minimum return guarantees.	**Medium** • Absent a unified supervisory or resolution regime, the failure of a mid-size insurer could trigger an industry-wide loss of confidence.	• Restrict the use of guarantee-based products by bringing minimum returns in line with current interest rates, and encouraging alternative long-term investments to spur diversification subject to proper supervision. Some vulnerable insurers may need additional capital and reserves before Solvency II comes into force in 2016

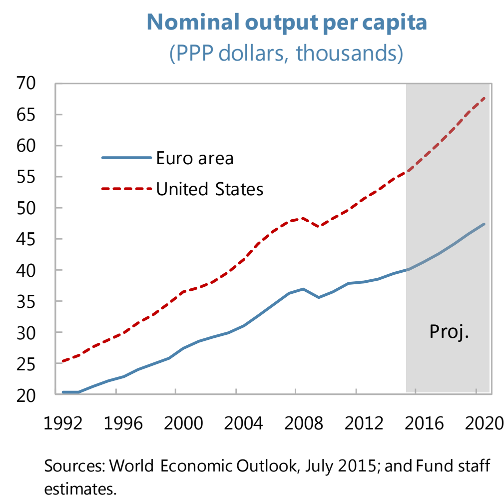
[1] The Risk Assessment Matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more).

…BUT A SUBDUED MEDIUM-TERM OUTLOOK

9. **Only tepid growth is expected over the forecast horizon.** Despite the cyclical upturn, growth of only about 1.6 percent is expected over the medium term, with potential growth averaging around 1 percent. The output gap would close around 2020 with unemployment still near nine percent and inflation reaching 1.7 percent, somewhat below the ECB's medium-term price stability objective. The picture is more disappointing in comparison to the U.S. with the per capita income gap now the largest since the start of EMU, and projected to widen further.



Source: Haver Analytics.

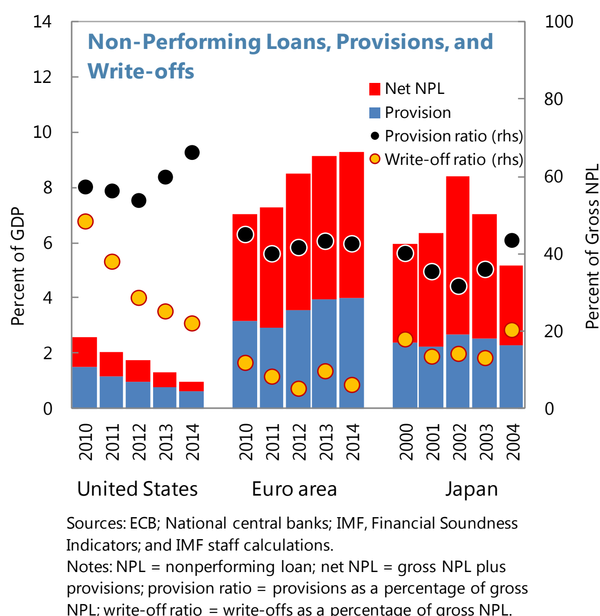


Sources: World Economic Outlook, July 2015; and Fund staff estimates.

10. **A chronic lack of demand, impaired corporate and bank balance sheets, and deeply-rooted structural weaknesses are behind the subdued medium-term outlook:**

- *Insufficient demand*. Business investment continues to lag the cycle, remaining well below pre-crisis levels, reflecting weak demand, as well as high corporate debt, policy uncertainty, and tight credit.[4] While overall unemployment has begun to recede, it remains above 11 percent, with long-term and youth unemployment near historic highs.[5] Fiscal policy is broadly neutral, but is not providing offsetting support.

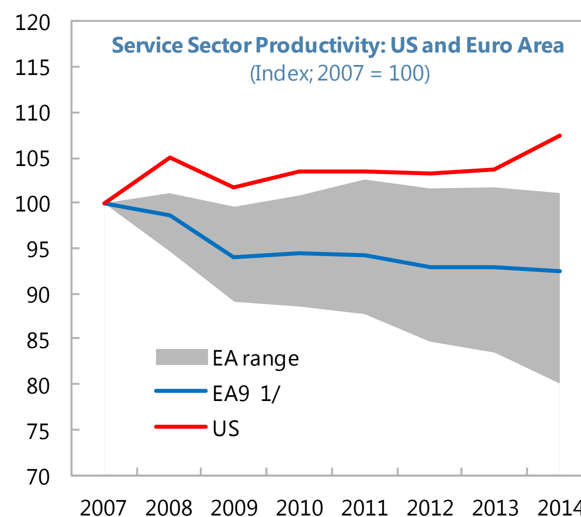
- *Weak balance sheets*. The ECB's comprehensive assessment (CA) found that



Sources: ECB; National central banks; IMF, Financial Soundness Indicators; and IMF staff calculations.
Notes: NPL = nonperforming loan; net NPL = gross NPL plus provisions; provision ratio = provisions as a percentage of gross NPL; write-off ratio = write-offs as a percentage of gross NPL.

[4] See "Investment in the Euro Area: Why has it Been Weak?," IMF Working Paper (WP/15/32), February 2015.
[5] See, "Youth Unemployment in Advanced Economies in Europe: Searching for Solutions," IMF Staff Discussion Note (SDN/14/11).

banks had raised capital, but also saw NPLs continuing to rise, reaching systemic levels in some countries. High levels of NPLs and debt have held back bank lending and investment, limiting the pass-through of easier financial conditions. Europe's experience contrasts sharply with that of the U.S. recently and Japan in the 2000s where, after their financial crises, aggressive NPL resolution helped support a faster recovery in credit.



Source: Statistical Office of the European Communities.
Note: 1/ EA9 countries include: AUT, BEL, DEU, ESP, FIN, FRA, ITA, NLD, and PRT.

- *Low and divergent productivity*. Progress on structural reforms has been piecemeal and uneven across countries, as highlighted by the slow implementation of Country-Specific Recommendation (CSR) reforms under the European Semester. Productivity remains well below pre-crisis levels and lags the U.S., especially in important sectors such as information technology and professional services.

11. **Without more determined collective action, the euro area is vulnerable to shocks and prolonged stagnation.** Staff analysis suggests that in a downside scenario, a demand shock that lowers investment and raises real interest rates through disinflation could reduce the level of output by about 2 percent by 2020, threaten public debt sustainability, and worsen euro zone imbalances (Box 1). With limited policy space, the euro area runs the risk of being mired in a bad equilibrium, with negative consequences elsewhere. Countries with close trading ties, especially those in central and eastern Europe, would suffer from weaker external demand and imported disinflation. Other non-euro area countries and especially those defending pegs to the euro, could face complications from capital inflows, upward real exchange rate pressure, and negative deposit rates. Without comprehensive policies to stimulate demand and lift potential growth, the euro area could remain overly reliant on monetary policy, generating negative external spillovers through lower growth and inflation, and a weaker euro.[6]

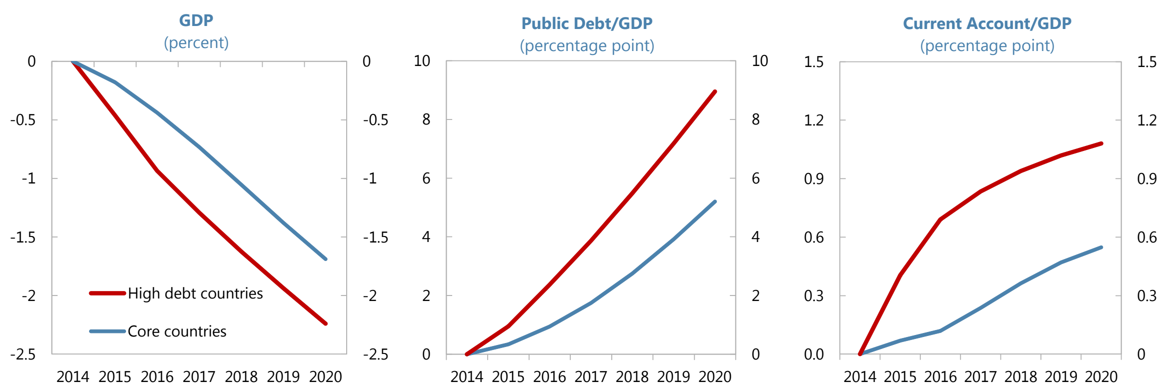
[6] See also the 2015 Spillover Report, which discusses potential monetary policy spillovers, and the benefits of a balanced policy approach, including from greater infrastructure investment.

Box 1. A Downside Scenario of Stagnation in the Euro Area[1]

Subdued medium-term prospects leave the euro area susceptible to negative shocks. A modest shock to confidence—for example, from lower expected future growth, or heightened geopolitical tensions—that lowers private investment could affect households via labor income and wealth. Expectations of lower inflation at the zero lower bound would keep real interest rates high. For countries with high public debt, risk premia could rise, amplifying the shock and raising the risk of a debt-deflation spiral. Policy space would be limited with short-term interest rates at the zero lower bound and public debt high in countries with large output gaps (Bullard, 2013).

An illustrative downside scenario, assuming lower investment for all euro area countries and increased risk premia for high debt countries, suggests that euro area output could be nearly 2 percent lower by 2020. The main channels would be through higher real interest rates depressing investment and consumption as well as lower inflation and wage growth constraining adjustment within the euro area. The impact would vary across countries with real interest rates higher in countries with weaker balance sheets. Fragmentation progress would reverse and public debt would increase more in high debt countries due to lower fiscal balances and nominal output. "Bad" internal rebalancing would follow, as current accounts in high debt countries would rise due to import compression. Lower inflation would worsen external imbalances, by forcing countries with large output gaps and imbalances to adjust through lower prices and employment.

Illustrative Model Results: Deviation from Baseline



Spillovers to the global economy would be through weaker imports and higher global risk premia. The euro area current account would increase by 0.7 percent of GDP, with real imports contracting by 3 percent. In particular, other EU countries' exports would fall by 1.2 percent, while the rest of the world's exports would decline by 0.6 percent. Although not captured in the model, negative spillovers could also stem from confidence effects and financial links through higher global risk aversion. The results of this illustrative scenario highlight the importance of broader actions now to strengthen the euro area's resilience and lift potential growth.

[1] See accompanying Selected Issues Paper titled "Risks from Low Growth and Inflation in the Euro Area". Modeling scenario prepared with assistance from B. Hunt and S. Mursula (both RES).

Authorities' Views

12. **The authorities see a stronger cyclical recovery.** While sharing staff views on the factors behind the cyclical upturn, the ECB was more optimistic about the recovery's strength and saw QE (the expanded asset purchase program) working via improved credit conditions, greater confidence, higher inflation expectations, and, indirectly, through the exchange rate. The European Commission (EC) also saw greater benefits from the European Fund for Strategic Investments (EFSI) to promote investment. The authorities largely shared staff views on the sources of risks with the ECB seeing risks as slightly tilted to the downside.

13. **The ECB was more upbeat on inflation, expecting it to rise more quickly along with the closing of the output gap.** They noted that the dispersion of inflation had fallen among euro area countries and that the Phillips curve has steepened in some places, perhaps reflecting reforms in the crisis-affected countries that could lead to higher inflation as employment recovers. In the near term, however, these structural changes have rendered the relationship between the output gap and inflation more uncertain.

14. **The authorities view the exchange rate as close to the value implied by fundamentals and long-term averages.** They saw few signs of misalignment, with the weaker euro reflecting divergent monetary policies and economic outlooks. The EC considered that the early rebalancing via import compression among deficit countries had slowed in recent years as these economies recovered. Exports have played a larger role in rebalancing lately, but a further shift in resources to export sectors will need to rely on structural reforms to improve flexibility and productivity. In terms of outward spillovers, the authorities considered low growth and inflation in the euro area as a more serious threat to other economies than temporary weakness in the euro.

15. **The euro area now has greater capacity to deal with potential risks from Greece.** While acknowledging uncertainty on the potential impact of adverse developments in Greece, the authorities considered that the toolkit with respect to both monetary policy and crisis management facilities of euro area countries (e.g., OMT, QE, and the ESM) has been greatly enhanced in recent years and would help prevent contagion. They agreed that a common deposit guarantee scheme and fiscal backstop for the banking union would reduce risks further—points emphasized in the Five Presidents' Report—but these do not yet command wide support among member states.[7]

16. **The authorities concurred on the subdued medium-term outlook.** Although somewhat more optimistic on the near-term forecast, the authorities nevertheless agreed with staff on the weak medium-term outlook, including the likelihood that potential growth could be only around 1 percent, and noted that demographics are already weighing on potential growth. The ECB highlighted the possibility that inflation could rise to the price stability objective, but with very high structural unemployment. For this reason, the ECB and EC placed heavy emphasis on structural reforms to address low growth, employment, and productivity.

[7] See the Five Presidents' Report, "Completing Europe's Economic and Monetary Union," released on June 22, 2015.

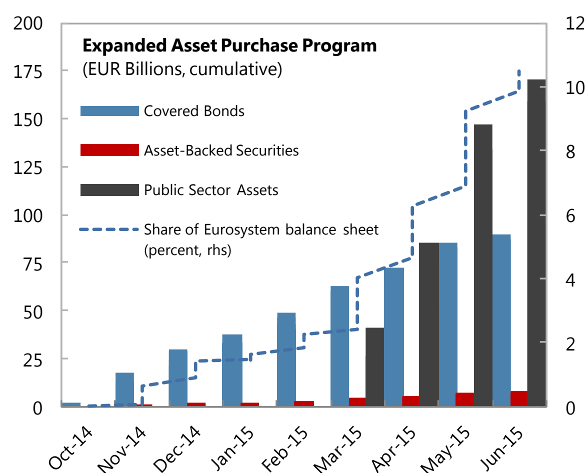
A COLLECTIVE, CONCERTED COMMITMENT TO LASTING GROWTH

17. **Given the weak medium-term outlook, a stronger collective push is urgently needed to consolidate the recovery, raise potential growth, and strengthen the union's resilience.** A concerted commitment should build on four key pillars: continuing demand support, cleaning up bank balance sheets, accelerating structural reforms, and strengthening the economic governance framework to incentivize reforms. Action in these areas would be self-reinforcing and strengthen the monetary union's resilience to shocks.

18. **A more balanced policy mix would generate a large growth dividend for Europe and positive spillovers for the global economy.** To assess the impact of a comprehensive approach, staff examined the combined impact of monetary easing with a stronger credit channel, use of fiscal space and SGP flexibility, and implementation of structural reforms (Box 2). This upside scenario suggests that combined action could lift growth and inflation rates substantially in 2015 and 2016, close the output gap much faster, and bring down unemployment more quickly. These results reflect important policy interactions: a stronger credit channel increasing the effectiveness of monetary policy; QE limiting crowding out from fiscal expansion, lowering real interest rates, and boosting nominal growth, which would help address weak balance sheets; and structural reforms boosting productivity and bringing forward additional investment. While the sizeable near-term growth benefits are largely one-off, spending now could raise potential growth by reducing hysteresis and deepening capital investment. Higher growth and inflation in the euro area would also have positive spillovers for the rest of the world via stronger domestic demand and import growth in the euro area, as well as higher prices that appreciate the real exchange rate.

A. Strengthening Demand—Staying the Course with QE

19. **Sovereign QE builds on previous easing.** The purchase of public securities follows a series of easing measures since mid-2014: negative deposit rates, targeted long-term refinancing operations (TLTROs), and private asset purchase programs (covered bonds and asset-backed securities). While markets had anticipated sovereign QE, the announced program was larger and more open-ended than expected; and the clear commitment to QE until inflation is on a sustained adjustment path has helped anchor expectations (Figures 4, 7, and 8). So far, the Eurosystem has purchased more than €193 billion of sovereign and supranational debt—expanding the Eurosystem's balance sheet by about 14 percent— with about €44 billion of public sector securities purchases expected per month until at least September 2016.[8]

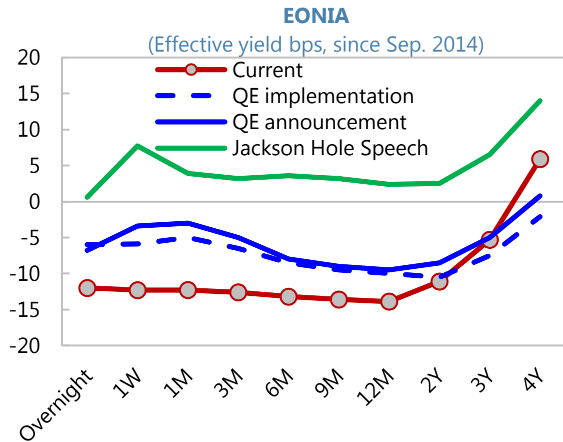


Sources: Bloomberg, LP; Eurostat; and Fund staff calculations.

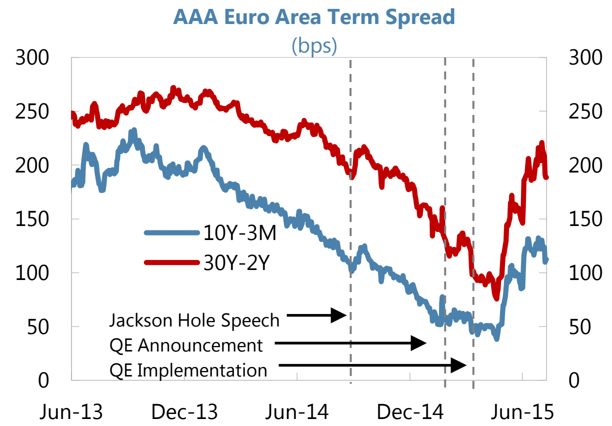
[8] See Selected Issues paper, "Euro Area: An Early Assessment of Quantitative Easing."

Figure 4. Monetary Policy Channels

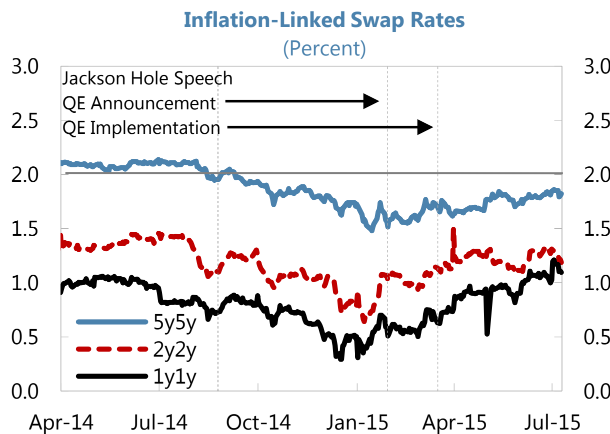
With QE announcement, short-term interest rate expectations shifted down and have remained negative over the near term despite the recent market correction.



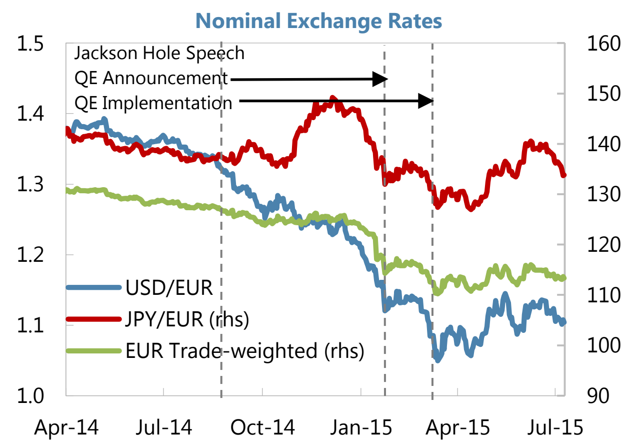
However, most of the term spread compression since late summer 2014 has been unwound recently.



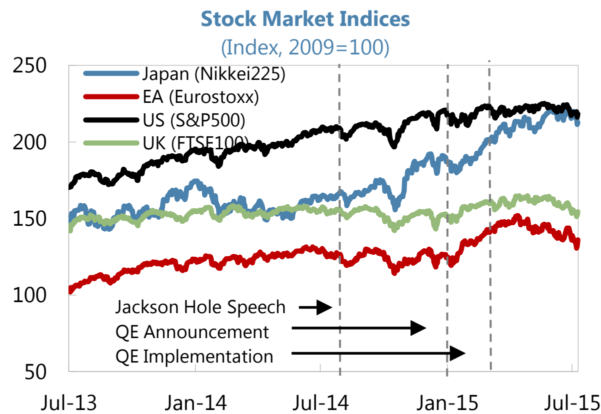
Inflation expectations, especially at the short-end have risen significantly …



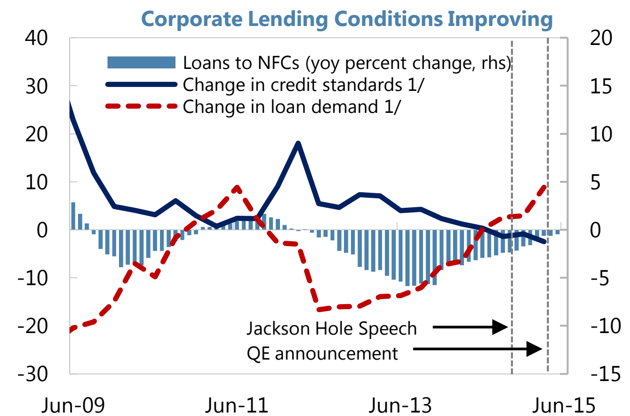
… and the euro has depreciated, even after recent reversals.



Equity markets initially surged, closing part of the gap with other advanced economies, but have fallen recently.



Credit standards are easing as the pace of credit contraction slows, and loan demand is increasing.



Sources: ECB; Haver Analytics; and Eurostat.
[1] Greater than or equal to zero implies tightening credit standards / rising loan demand.

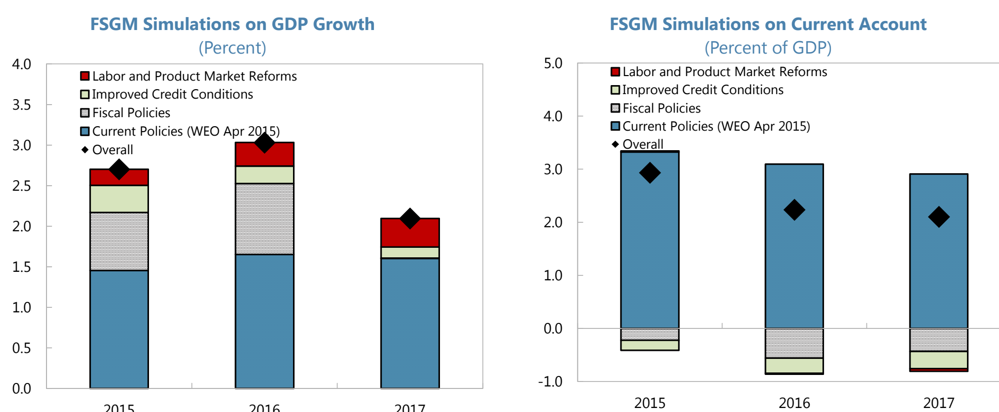
Box 2. An Upside Scenario of Demand Support and Comprehensive Reforms

A scenario combining monetary easing, fiscal support under the SGP, and comprehensive structural reforms would include:

- **Monetary easing**. Current interest rate policy continues through 2020 and QE through September 2016.
- **Fiscal space within the SGP**. For the eurozone, fiscal space available within the SGP could amount to 0.6 percent of euro area GDP. This includes (i) room under countries' Medium-Term Objectives (MTOs) (0.3 percent of euro area GDP); (ii) SGP flexiblity that a few qualifying countries could use for structural reforms (0.2 percent of euro area GDP); (iii) windfalls from lower interest payments due to QE (0.1 percent of euro area GDP) for one-off investments or structural reforms for a few countries already meeting their MTOs; and (iv) growth-friendly fiscal rebalancing for countries with limited fiscal space to lower the labor tax wedge by two percentage points, financed by base-broadening measures.
- **Centralized investment**. An increase in private investment of 0.2 and 0.8 percent of euro area GDP in 2015 and 2016 is assumed, which is equivalent to ⅓ of the targeted amount of European Fund for Strategic Investments (EFSI) projects.
- **Clean-up of bank and corporate balance sheets** A fully functioning credit channel is simulated as a decline in corporate borrowing rates, by 80 basis points in Italy, 25 basis points in Germany and France, and 50 basis points in the rest of the euro area. This would bring the spread between selected and core countries roughly to pre-crisis levels.
- **Structural reforms.** Gradual implementation of product and labor market-related reforms in the 2014 G20 Comprehensive Growth Strategy could increase total factor productivity (TFP) by about 0.1 percent in 2015, 0.5 percent in 2017, and 0.9 percent in 2020. The implied TFP changes would differ substantially among member countries, with France, Italy, and Spain enjoying the largest gains.

The growth dividend of a balanced policy mix can be large. The EUROMOD module of the IMF's Flexible System of Global Models (FSGM) points to a substantial growth dividend, particularly from fiscal policies and the improvement of the credit channel. Real growth for the euro area would increase by 1.3 and 1.4 percentage points to 2.7 and 3.0 percent for 2015 and 2016, and HICP inflation rate in these two years would rise to 0.6 and 2.1 percent. The output gap would close by the end of 2016, about four years faster than in the baseline, and unemployment would be 0.8 percentage point lower than in the baseline by 2016.

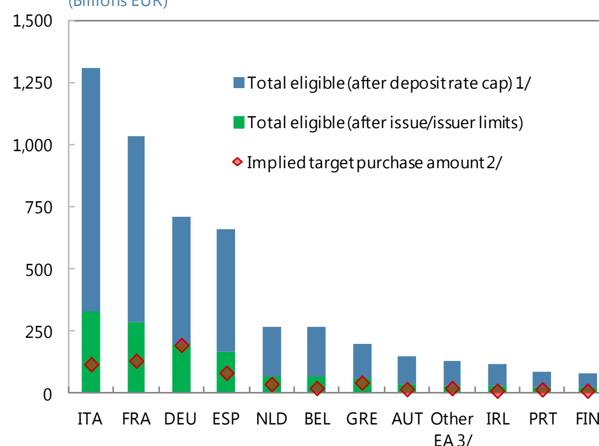
A balanced policy mix would also generate positive external spillovers. Stronger growth and inflation would reduce the current account surplus by 0.4 percent of GDP in 2015 and by 0.9 percent of GDP in 2016. The spillovers to other EU countries are especially large due to trade links, raising their GDP by 0.4 percentage point in 2015 and 0.6 percentage point 2016. Comprehensive policies could also help external rebalancing within the euro area, since current account balances in creditor countries would decline more than in external debtor countries. For instance, the current account surplus in Germany would decline by 1.3 percent of GDP in 2016, much larger than changes in Italy (-0.4 percent of GDP), France (-0.4 percent of GDP), and other countries with negative external debt positions.



20. **Staying the course on QE is essential to meet the inflation objective.** While the trend decline in inflation expectations has been reversed, they still remain below the historical average and the ECB's medium-term price stability objective. Despite early signs of a turnaround in lending, previous episodes of QE suggest that the impact on credit (and inflation) will take more time, especially given banks' weak balance sheets and corporate deleveraging. In light of risks from low inflation, staff strongly supports the ECB's intention to implement QE fully until at least September 2016, looking through temporary periods of volatility. If inflation and inflation expectations fail to pick up as expected, the ECB should stand ready to extend the program. Continued clear communication of the Governing Council's intentions will help mitigate excessive market volatility and reinforce its commitment to meeting the price stability objective.

ECB PSPP: Eligible Outstanding Amount and Target Purchase Volumes of Government Debt (until Sept. 2016), Nominal Amounts, as of June 15, 2015

(Billions EUR)



Sources: Barclays; Bloomberg LP; ECB; EBA (Oct. 2014); J.P. Morgan; and IMF staff calculations.

Note: 1/ Excludes bonds ineligible due to nominal yield below deposit facility rate (-20 bps). 2/ Based on ECB capital key in market value terms, converted into nominal amounts. 3/ Includes Estonia, Latvia, Lithuania, Luxembourg, and Malta.

21. **Greater flexibility would enhance the effectiveness of the asset purchase program**. Given the Eurosystem's large purchases, the restriction on sovereign bond purchases below the negative deposit rate combined with the ECB's single issuer and exposure limits have raised concerns about possible shortages of sovereign bonds and their availability as collateral. Although there are few signs of scarcity currently, the ECB could preempt this risk by:

- *Expanding flexibility in asset purchases*. The list of eligible national agency debt leaves a relatively small share available for purchase outside core economies (4.7 percent). The ECB could widen the eligibility of agency debt, increase purchases of supranational debt, and relax security issue/issuer limits and private sector asset purchase criteria, which are slightly more stringent than for public assets with similar risk.

- *Developing a common securities lending framework*. The conditions on pricing and eligibility to re-lend securities under the Public Sector Purchase Program (PSPP) differ across NCBs. To improve market functioning and access to collateral, the ECB could preemptively harmonize conditions for securities lending and promote use of specialized securities lending agents across NCBs.

22. **If financial stability risks arise in the future, macroprudential policies should be used.** The ECB and Single Supervisory Mechanism (SSM) should remain vigilant regarding excessive risk-taking and asset price bubbles, and coordinate macroprudential policies as the first line of defense, should risks emerge (Figure 9). Macroprudential tools could include raising capital buffers; imposing stricter requirements on capital, liquidity, large exposures, and risk weights; and national measures such as loan-to-value limits to dampen real estate lending. The ECB should also intensify macroprudential surveillance of non-bank financial institutions in close coordination with the ESRB. On combating anti-money laundering, the SSM should consider entering into memorandums of understanding (MoUs) with national competent authorities (NCAs) responsible for anti-money laundering and combating the financing of terrorism (AML/CFT) to formalize cooperation in identifying and mitigating such risks.

23. **Further steps to establish a common backstop would help sever the bank-sovereign link.** The resolution framework and bail-in regime under the Bank Recovery and Resolution Directive (BRRD) are expected to be operational from 2016. In addition, more work is needed in the following areas:

- *Resolution:* The financial capacity of the Single Resolution Fund (SRF) is limited (€55 billion) relative to the size of the euro area banking sector (€22 trillion).To ensure that funding is indeed available to resolve large banks in a crisis, the schedule for SRF funding and the mutualization of "national components" should be accelerated from the current eight-year transition period and its capacity expanded.

- *Direct recapitalization:* The current preconditions for ESM direct recapitalization of banks—bail-in of at least 8 percent of bank liabilities, followed by a sovereign recapitalization (if necessary) to raise common equity tier 1 to 4.5 percent of liabilities—are too high and should be relaxed. Consideration should also be given to raising the €60 billion ceiling on the ESM direct recapitalization capacity.

- *Deposit guarantees:* Deposit guarantee schemes (DGSs) across the euro area have been harmonized under the recent DGS Directive, but still fall short of a pan-European DGS. To discourage liquidity "ring-fencing" within national jurisdictions, a pan-European DGS should be established. Since such a pan-European DGS will take time, consideration should be given now to developing a common fiscal backstop to national DGSs, perhaps through the ESM.

24. **Low interest rates pose risks for life insurers.** As noted in the April GFSR, many life insurers in Europe may face future stress since investment returns have fallen below minimum return guarantees. Past stress tests assumed higher interest rates than have prevailed recently and may understate insolvency risks from prolonged low rates. To avoid medium-term risks materializing, regulators should reassess the viability of guarantee-based products while adopting prudential measures to improve the sector's asset-liability matching and diversification of long-term investments. Some vulnerable insurers may need to raise capital before Solvency II comes into force next year and so might allocate less profit to policyholders.[9] With less than half of EU countries having insurance guarantee schemes, harmonizing national policy holder protection schemes and unifying resolution frameworks would reduce the risk of contagion from a single failure.

Authorities' Views

25. **The ECB stressed the importance of fully implementing QE until inflation is on a sustained adjustment path, notwithstanding the near-term cyclical upturn.** The ECB viewed the initial impact of QE as fairly strong and broad-based, working through term premia, expectations, and, given significant differences in the monetary cycles among major advanced economies, exchange rate effects. It stressed the need to continue with QE until there is a sustained adjustment in the path of inflation consistent with the ECB's aim of achieving inflation rates below, but close to, 2 percent over the medium term.

26. **The ECB agreed on the need for flexibility in asset purchases and a harmonized securities lending program to avoid collateral scarcity.** It stands ready to expand the range of eligible assets

[9] The Solvency II framework represents a risk-based regulatory framework for insurance companies, which overhauls the current book value-based accounting framework under Solvency I.

and widen the scope for "substitute purchases" of agency and supranational debt securities, if warranted, but emphasized that no shortages were evident. To preempt potential collateral scarcity, the ECB decided that securities would be available for lending in a harmonized manner across NCBs and the ECB. The ECB also indicated that price and other incentives could help encourage dealers to borrow securities from NCBs before approaching the ECB.

27. **The ECB intends to look through temporary market volatility.** With the risk-free rate at the zero lower bound, the recent surge in bond market volatility did not arise unexpectedly. The ECB intends to "look through" episodes of volatility and continue with the announced schedule of asset purchases until there is a sustained adjustment in the path of inflation consistent with price stability. Market volatility is a factor only to the extent that it tightens financial conditions and undermines the ECB's ability to meet its objective, in which case the ECB can flexibly alter the composition, amount, and timing of its purchases. Currently, the ECB conducts QE operations in a "market-neutral" way, by buying at secondary market prices and with a weighted average maturity broadly consistent with the outstanding stock of securities. Information about its asset purchases is provided in weekly disclosures of cumulative purchases and the average maturity of holdings.

28. **ECB, SSM, and EC counterparts considered that financial stability risks remain contained at this time.** The main risks to financial stability, apart from developments in Greece, stem from an abrupt reversal of global risk premia and weak profitability prospects for banks and insurers. Credit growth is still low and the housing market recovery is still at an early stage. Macroprudential policies are the first option, although responsibility in this area is shared between the ECB and national authorities. While the ECB is not vested with AML/CFT supervisory powers, it is reviewing legal possibilities of entering into MoUs with NCAs responsible for AML/CFT.

29. **Progress is being made to break bank-sovereign links but there are still national obstacles to greater cross-border liquidity.** The transposition of the BRRD into national laws has been slow but is on track, with the majority of countries expected to complete the process by end-year. Moreover, the Single Resolution Board will be fully operational in January 2016. The authorities agreed that the threshold for direct recapitalization of banks by the ESM is very high, reflecting the desire to minimize the likelihood of public aid being deployed. The authorities concurred with the need for a single DGS; this would constitute the third pillar of a fully-fledged banking union, and potentially lessen the incentives for ring-fencing liquidity.

30. **Regulators considered the impact of the low interest rates on life insurers mostly a medium-term concern**. EIOPA, the European insurance regulator, saw the problems from low investment returns relative to liabilities as a medium-term risk, concentrated mainly among small and mid-size insurers that face difficulties in lowering guarantees and enhancing their capital positions. EIOPA and the ECB agreed on the benefits of a common resolution framework, perhaps similar to the BRRD, as well as harmonized policy holder protection schemes modeled after the Deposit Guarantee Scheme Directive, but saw few prospects for action in the near term. EIOPA has already encouraged national supervisors to limit certain underwriting activities, increase provisions, and restrict dividend pay-outs for some insurers. The lack of a unified supervisory or resolution regime makes it more difficult to deal with possible cross-border links, such that preventing contagion or a wider loss of confidence in the industry would depend on national backstops. The ECB also noted that Solvency II requirements may contribute to some challenges with respect to financial stability since some features of a risk-based approach to capital requirements could be at odds with efforts to reduce asset-liability mismatches among insurers.

B. Delivering Fiscal Support within the SGP

31. **Using fiscal space and flexibility within the SGP can support the recovery and complement QE** (Figure 5 and Box 2). Countries should adhere to their commitments under the SGP to strengthen the credibility of the collective framework, and where possible, seek to support investment and structural reforms.

- *Use fiscal space where available…* Countries with fiscal space under their medium-term objectives (MTOs) and benefiting from lower interest rates due to QE should use this space, totaling around 0.4 percent of euro area GDP. Countries without fiscal space under their MTOs should save their interest windfalls to reduce debt and meet their fiscal targets. In general, all countries should pursue growth-friendly fiscal rebalancing that lowers marginal taxes on labor and capital, financed by cuts to unproductive spending or base-broadening measures.

- *…and SGP flexibility to pursue structural reform.* Countries not under the EDP could use the flexibility under the SGP (i.e., one-off and temporary deviations from countries' MTOs) to support critical structural reforms. To ensure high-quality spending, the EC should identify structural reforms and investments that would qualify under the flexibility (see structural reform discussion below).

32. **Centralized support can provide a needed boost to lagging investment.** Centralized investment through the EFSI—leveraging €21 billion in public funds and guarantees to catalyze €315 billion in private investment—could help support the recovery in countries with limited fiscal space. Particular attention should be paid to project selection to support new, higher risk investments that would not be undertaken otherwise, and to removing regulatory barriers.

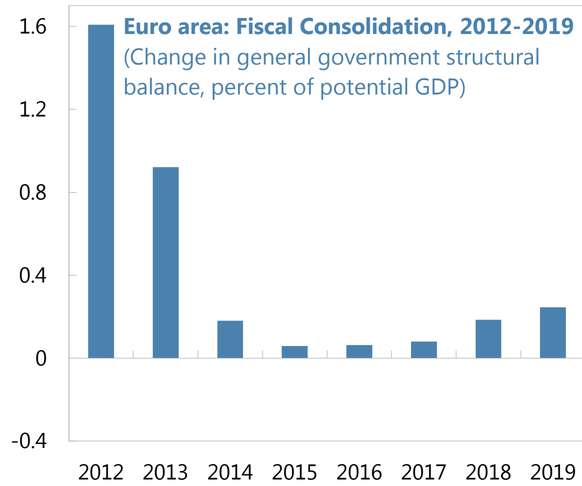
Authorities' Views

33. **The authorities cautioned on the need to uphold and strengthen SGP credibility.** They saw the neutral euro area aggregate fiscal stance this year as broadly appropriate, but noted the uneven distribution; countries with fiscal space are choosing not to use it, while those without fiscal space still need further adjustment. The authorities recognized the synergies from combining fiscal expansion with QE, but stressed the need to ensure compliance with the fiscal framework. QE has lowered interest bills, which countries in need of further adjustment are already spending. The authorities cautioned that these windfall savings should be used for deficit reduction, especially in countries with high debt. Interest savings could prove temporary if interest rates normalize, or trend growth could decline further. The EC also indicated that in practice eligibility conditions as well as safeguards against deviating from MTOs were likely to limit space for structural reforms and investment to qualify for flexibility under the SGP.

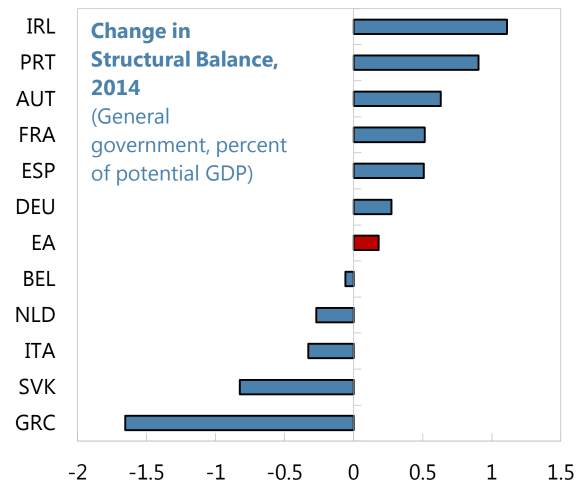
34. **Efforts to implement the EFSI swiftly are underway.** The authorities highlighted that the EIB had already approved several projects and the EFSI should be fully operational by autumn. They agreed that project selection would be critical, and pointed to the investment committee to help ensure the EFSI backs additional, riskier projects.

Figure 5. Fiscal Developments and Policies

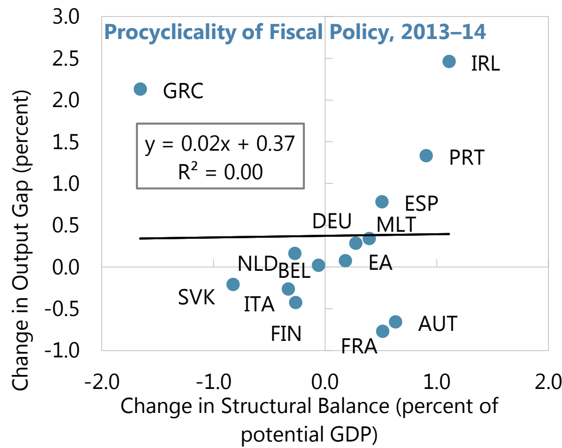
Fiscal consolidation slowed in 2014 and the fiscal stance is projected to be broadly neutral in the coming years...



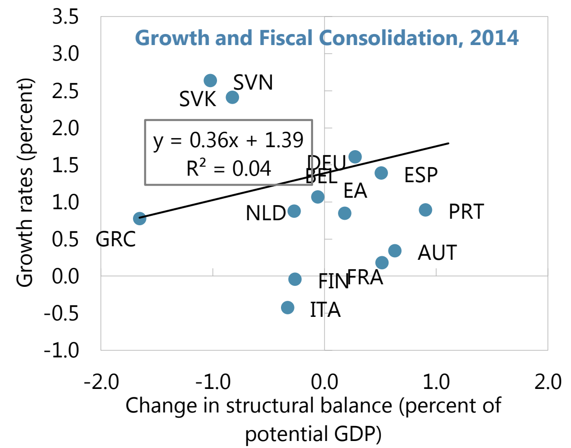
...but this masks differences in adjustment among countries.



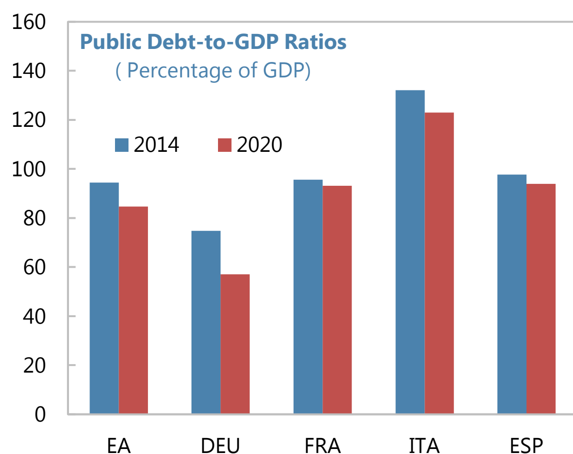
The procyclicality of fiscal policies has diminished...



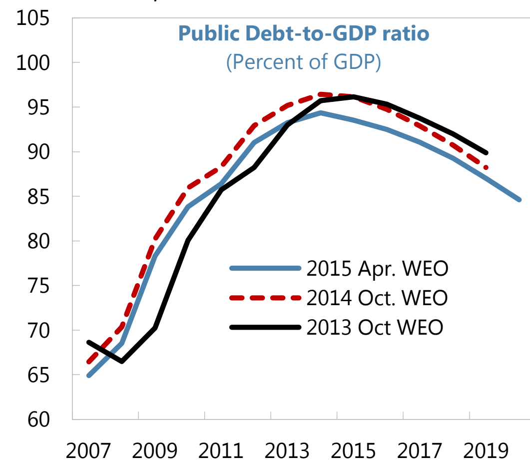
...resulting in a smaller fiscal drag on growth.



Public debt is expected to remain elevated in many countries.



With a gradual recovery, debt will decline modestly but remain above the pre-crisis level.



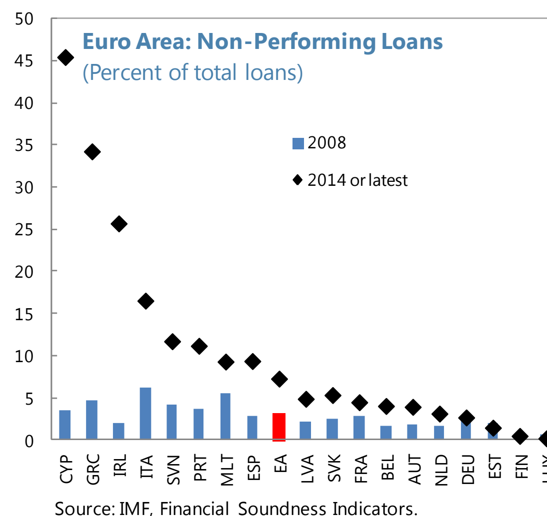
Sources: IMF World Economic Outlook database and staff calculations.

C. Balance Sheet Repair to Enhance Monetary Transmission

35. **High NPLs are hindering lending and the recovery.** By weakening bank profitability and tying up capital, NPLs constrain banks' ability to lend and limit the effectiveness of monetary policy (Box 3 and Figure 6). In general, countries with high NPLs have shown the weakest recovery in credit.

36. **A more centralized approach would facilitate NPL resolution.** The SSM is now responsible for euro area-wide supervisory policy and could take the lead in a more aggressive, top-down strategy that aims to:

- *Accelerate NPL resolution.* The SSM should strengthen incentives for write-offs or debt restructuring, and coordinate with NCAs to have banks set realistic provisioning and collateral values. Higher capital surcharges or time limits on long-held NPLs would help expedite disposal. For banks with high SME NPLs, the SSM could adopt a "triage" approach by setting targets for NPL resolution and introducing standardized criteria for identifying nonviable firms for quick liquidation and viable ones for restructuring.[10] Banks would also benefit from enhancing their NPL resolution tools and expertise.



Source: IMF, Financial Soundness Indicators.

- *Improve insolvency and foreclosure systems.* Costly debt enforcement and foreclosure procedures complicate the disposal of impaired assets. To complement tougher supervision, insolvency reforms at the national level to accelerate court procedures and encourage out-of-court workouts would encourage market-led corporate restructuring.

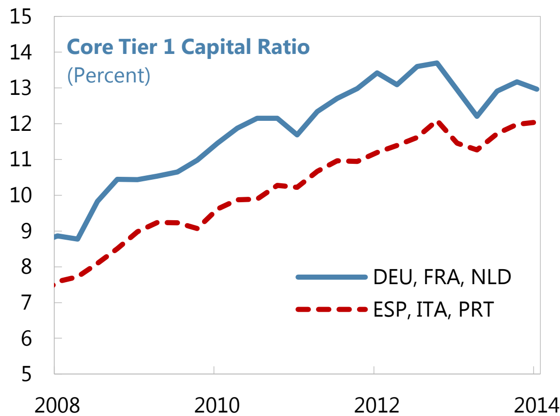
- *Jumpstart a market for distressed debt*. The lack of a well-functioning market for distressed debt hinders asset disposal. Asset management companies (AMCs) at the national level could support a market for distressed debt by purchasing NPLs and disposing of them quickly. In some cases, a centralized AMC with some public sector involvement may be beneficial to provide economies of scale and facilitate debt restructuring. But such an AMC would need to comply with EU State aid rules (including, importantly, the requirement that AMCs purchase assets at market prices).[11] In situations where markets are limited, a formula-based approach for transfer pricing should be used. European agencies, such as the EIB or EIF, could also provide support through structured finance, securitization, or equity involvement.

[10] See SDN on "Tackling Small and Medium-Sized Enterprise Problem Loans in Europe" (IMF SDN/15/04, March 2015).

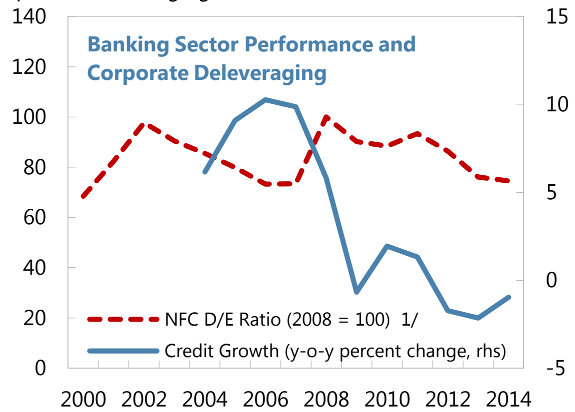
[11] Any public sector support for a financial institution is subject to investigation under EU State aid rules, and if deemed non-permissible by DG Competition, would result in such support being removed.

Figure 6. Banking Developments

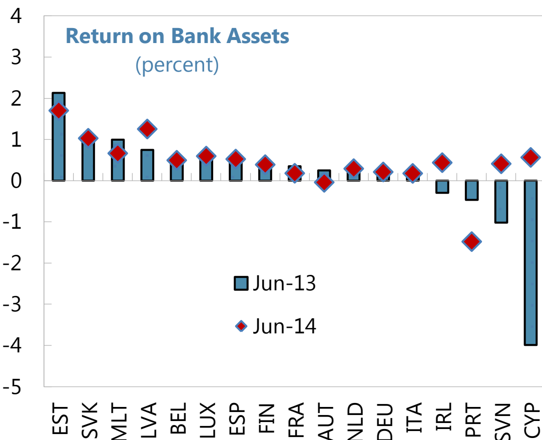
Capital ratios have been rising but remain lower in selected euro area economies.



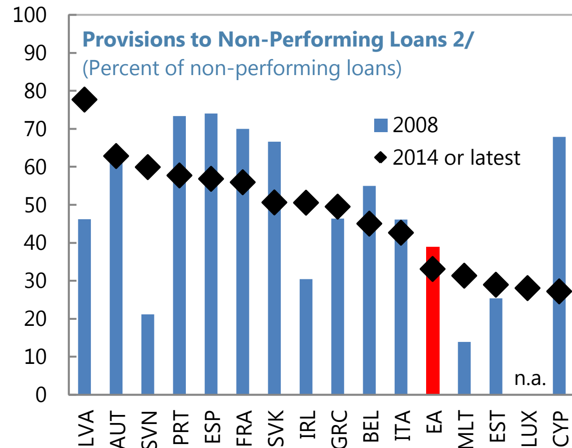
Credit is still contracting year-on-year as the pace of corporate deleveraging remains slow.



Bank profitability varies widely across countries…



… while loan loss provisions have lagged behind deteriorations in asset quality in many cases.

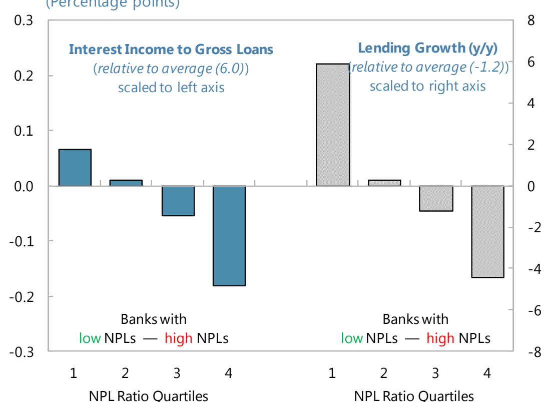


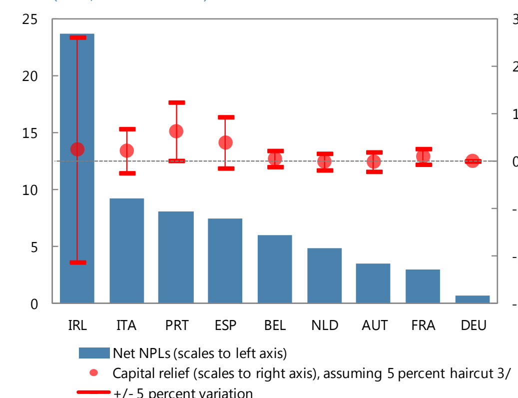
Sources: Bloomberg; Dealogic; ECB; World Bank, World Development Indicators database; IMF FSI database; and staff calculations.
Notes: 1/ NFC debt to equity ratio is NFC debt of partially consolidated or aggregate containing both consolidated and non-consolidated items to shares and equity of unspecified consolidation. 2/ Based on loan loss provisions and NPLs as reported in the IMF's Financial Soundness Indicator (FSI) database (as of March 2014); due to different national accounting standards and prudential definitions of NPLs these numbers might differ from those reported by national authorities.

Box 3. The NPL Problem in the Euro Area and Its Macro-Financial Implications[1]

High NPLs erode bank profitability and hold back new lending, limiting the effectiveness of monetary policy. Rising asset impairments tie up substantial amounts of capital due to diminished retained earnings and higher provisioning requirements, restricting banks' ability to support economic recovery (figure below). And a deteriorating balance sheet raises a bank's cost of capital, resulting in some combination of higher lending rates, reduced lending volumes, and increased risk aversion. Credit growth remains particularly slow in countries where banks report high levels of impaired assets.

Macro-financial Implications of NPLs and Capital Relief from NPL Reduction





Sources: Amadeus database; Bankscope; Bloomberg L.P.; European Banking Authority; ECB, Haver Analytics; SNL Financial; national central banks; and IMF staff calculations.
Note: 1/ Left graph shows annual interest income to gross loans, for over 100 euro are banks, relative to the annual average for banks with the same nationality, calculated over the period 2009–13. The right graph shows annualized lending growth relative to average lending growth in the same country, using data from the European Banking Authority for a sample of more than 60 banks over the period 2010–13. Outliers have been excluded, based on extreme values for lending growth, nonperforming loans and interest margins. 2/ Calculations based on bank-by-bank data from the EBA Transparency Exercise (2013). 3/ NPLs reduced to historical average and capital adequacy ratio (CAR) of 13.0 percent.

NPL disposal affects bank capital, and therefore potential credit supply. The illustrative analysis assumes that banks reduce the current stock of NPLs (end-2014) by selling their distressed loans to external investors. This reduces the regulatory capital charge of loan books in proportion to the share of NPLs (and their applicable credit risk weight). It is assumed that banks sell their loans at net book value (yielding the upper bound of capital relief), or at a uniform haircut to net book values of either five percent (mid-range), or at a 10 percent (lower bound). In practice, the selling price would reflect the expected foreclosure time (prices would be lower where foreclosure times are long and debt-enforcement regimes weak) and would need to offer a sufficiently high return on investment consistent with general profit expectations in distressed debt markets.[1]

NPL disposal can free up large volumes of regulatory capital and generate significant capacity for new lending. For a large sample of euro area banks covering almost 90 percent of all institutions under direct ECB supervision, the amount of aggregate capital that would be released if NPLs were reduced to historical average levels (between three and four percent of gross loan books) is calculated. This amounts to between €13–€42 billion for a haircut range of between zero and 5 percent, and assuming that banks meet a target capital adequacy ratio of 13 percent. This in turn could unlock new lending of between €167–€522 billion (1.8–5.6 percent of sample countries' GDP), provided there is corresponding demand for new loans. Due to the uneven distribution of capital and NPLs, capital relief varies significantly across euro area countries, with Portugal, Italy, Spain, and Ireland benefiting the most in this stylized example.

[1] For a detailed analysis taking these factors into account, see the SIP on "Policy Options for Tackling NPLs in the Euro Area."

37. **Harmonizing capital requirements would strengthen the resilience of the system.** While most banks already meet the minimum capital requirements under Basel III, definitions of capital still vary across countries under the transitional arrangements of the Capital Requirements Regulation (CRR). National differences in the definition of capital should be removed quickly to enhance regulatory consistency. In addition, banks, particularly in stressed economies, hold large amounts of deferred tax assets (DTAs) and goodwill, which are of doubtful loss-absorbing capacity.[12] Regulatory treatment of DTAs should be harmonized in a way that does not encourage excessive de-risking. Also, further work is required to close gaps between the CRR and Basel III rules regarding the treatment of leverage and liquidity risk in the banking sector.

Authorities' Views

38. **The ECB has made NPL resolution a policy priority, but faces hurdles.** It has placed a subset of banks with elevated NPLs under enhanced monitoring and to encourage the resolution of NPLs, will consider setting targets on restructured loans to either convert them to performing or write them off, and urging the NCAs to follow the same approach for less significant institutions. It is also reviewing bank assets not covered under the asset quality review (AQR) of the CA last year. The ECB stressed the importance of improving national insolvency and foreclosure regimes to facilitate NPL resolution. The ECB does not have the power to change International Financial Reporting Standards (IFRS) accounting rules, but will use all means possible to foster realistic provisioning and collateral valuation practices to encourage write-offs. The ECB agreed with staff on the possibility of using prudential measures to set time limits or capital surcharges on long-held NPLs.

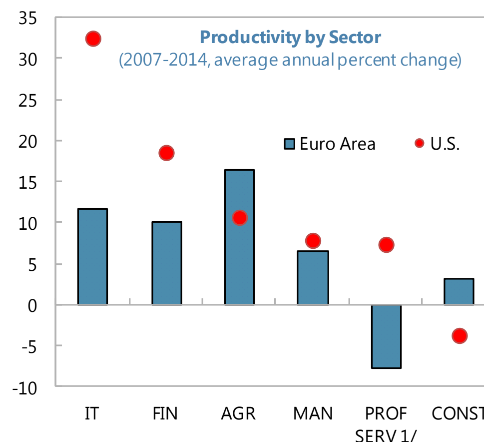
39. **National AMCs would need to meet EU State aid rules.** The authorities noted that the appropriateness of an AMC depends on the circumstances and asset composition (i.e., AMCs might work better for real estate than SME loans). There was little political appetite for a pan-European AMC given the large heterogeneity of legacy assets. Moreover, the scope for national AMCs may be limited due to large segments of NPLs that might not be the most appropriate for transfer to an AMC. They observed that EU State aid rules would require that assets be sold at market prices; for sales above the market price, banks would face bail-in of creditors under the State aid rules and BRRD. Where markets are very illiquid, a formula-based approach to determining market prices is possible.

40. **The harmonization of capital and liquidity will take some time.** The ECB is currently focused on harmonizing definitions of NPLs (and capital) across countries, in coordination with the European Banking Authority, and on supervisory implementation of the Single Rulebook. This will help to ensure a level playing field across banks and countries, although some options and national discretions remain outside the ECB's purview where transitional measures have been enacted under national laws. The ECB agreed that high levels of DTAs are a problem for bank loss absorption capacity in some countries.

[12] DTAs are instruments that may be used to reduce future tax obligations contingent on future profitability; these can currently count as part of regulatory capital. Because DTAs are not loss-absorbing, their use as capital will be phased out over a 10-year transition to Basel III. However, some economies have introduced legislative changes enabling DTAs to be transformed into Deferred Tax Credits, which are not contingent on future profits and can be counted as capital regardless of whether the bank is profitable.

D. Closing Structural Reform Gaps—Boosting Growth and Integration

41. **The opportunity provided by the cyclical upturn, SGP flexibility, and monetary easing should be used to accelerate structural reform priorities.** This would raise potential growth, improve confidence and help jumpstart investment, and strengthen the resilience of the euro area to shocks. Supportive macroeconomic policies would offset some of the negative demand effects from structural reform. Estimates indicate that implementation of product and labor market reforms, as described in Box 2, would boost the level of euro area output in 2020 by 1.6 percent.



Sources: Eurostat, U.S. Bureau of Economic Analysis, and Fund staff estimates.
Note: 1/ For the US, the category of professional and business services is used, while for EA countries the sector is professional, scientific and tech activities.

- At the *national level*, the priorities are labor market reforms to increase participation and flexibility, and reduce duality; and product market and service sector reforms to improve the business climate and increase competition. The latter should include measures to ensure stronger contract enforcement, improved public sector efficiency, and expanded access to credit, especially for SMEs. Table 4 lists a number of country-specific reform priorities.

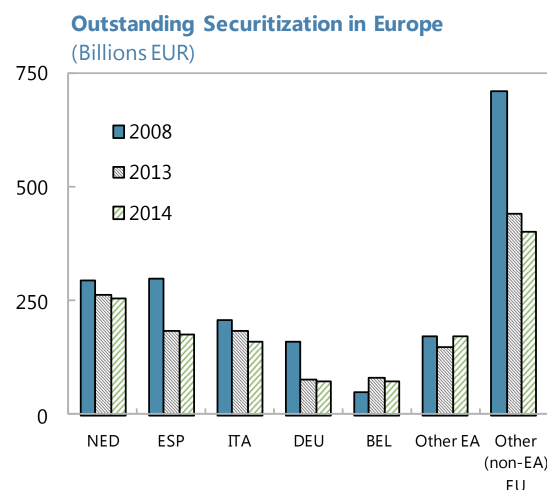
- At the *regional level*, there should be a renewed emphasis on convergence and productivity. Faster implementation of the Services Directive should be prioritized to phase out long-held national barriers. Deeper integration would improve the resilience of the EMU. To this end there should be a reinvigorated push toward completing the Single Market in goods, services, capital, transport, energy, and the digital economy, as well as harmonization of insolvency regimes. The new Commission has pushed for action in many of these areas, which has been echoed in the Five Presidents' report.

- Implementing both national and regional reforms together could yield synergies as countries that improve flexibility and competitiveness would be in a better position to benefit from deeper integration. For example, greater labor mobility through effective implementation of the Services Directive would complement national labor market reforms.

42. **A capital markets union would enhance access to finance.** The lack of cross-border integration limits the efficient allocation of savings to investment and the ability of the zone to respond to shocks. The EC's *Green Paper on Building a Capital Markets Union* (CMU) outlines principles for a broader and more efficient financial system, which will be followed in the fall by an action plan. Key priorities should include:

- *High-quality securitization.* Moving toward a pan-European definition of high-quality securitization (HQS) comprising simple, transparent, and efficient asset structures would help

diversify funding sources for European firms. HQS should be encouraged by preferential regulatory treatment (e.g., lower capital charges under Basel III) and time-bound official support.[13] These measures could prove especially beneficial to SMEs, which tend to be particularly reliant on bank lending.



Sources: AFME, Dealogic, SIFMA and IMF staff calculations.

- *Increasing transparency.* Common standards for market disclosure for firms, integrated tax and accounting regimes, and the development of credit registries (especially in countries where privacy laws have prevented greater information sharing) would facilitate investment, especially cross-border.
- *Removing national differences in market infrastructure and regulations.* The priority should be to standardize securities laws and remove barriers to efficient cross-border clearing and settlement.

43. **Agreement on an ambitious Transatlantic Trade and Investment Partnership (TTIP) would enhance growth and productivity.** Since tariffs are already low for most EU-U.S. goods trade, negotiations are focused on trade in services as well as enhanced regulatory cooperation and common standards and rules such as investor dispute resolution. Exposure to greater competition, especially in the services sector, could help encourage productivity-enhancing reforms, streamlining and harmonizing of regulations, as well as possibly greater cross-border investment.

Authorities' Views

44. **Further progress on structural reforms is needed to improve the outlook and increase resilience.** The authorities noted that progress has been mixed and slow, hence stepped-up action is needed, especially on product markets, repair of bank and SME balance sheets, and the business environment to support an investment recovery. The EC also stressed the need to improve services productivity, reduce structural and youth unemployment through active labor market policies, enhance vocational training, and lower labor taxation.

45. **The authorities agreed on the importance of better integrating national capital markets and developing them as an alternative to bank lending.** In the short term, the authorities put priority on increasing lending through HQS, private placements, and ways to expand financing for SMEs. Over the medium term, more difficult issues such as harmonization of insolvency regimes and a single regulator would need to be addressed.

46. **A TTIP agreement could yield growth benefits in the medium-term.** The EC estimates that TTIP implementation could permanently raise output by 0.5 percent of GDP with the bulk of the benefits coming from removal of non-tariff barriers. The authorities did not expect negotiation of TTIP to lead to harmonization within the EU—rather, areas already harmonized would likely be taken up in TTIP—but more competition once a trade deal is in place could help increase productivity.

[13] Aiyar and others, "Revitalizing Securitization for Small and Medium-Sized Enterprises in Europe," (IMF SDN, 15/07).

E. A Stronger, Simpler Economic Governance Framework

47. **A more effective and simpler governance framework would help advance structural and fiscal reforms, as emphasized in the Five Presidents Report**. Given the mixed record of adherence to EU targets and recommendations, a stronger framework to monitor, incentivize, and enforce reforms and sound fiscal policies could foster convergence within the euro area. Such a framework should promote increased ownership, transparency and accountability.

48. **"Outcome-based" area-wide structural benchmarks would help improve transparency and incentivize reform implementation.** Current peer review practices under the European semester could be strengthened by using concrete and measurable outcome-based indicators ("benchmarks") to define the reform agenda. Their use could improve transparency, simplify implementation, and promote innovation among member states in addressing reform challenges since each country could design its own approach to meet the target. Benchmarks should focus on reforms that are macro-critical and linked to ambitious euro area-wide goals, such as the number of days to enforce a contract or lowering labor tax wedges.

49. **EU legislation and SGP flexibility could help catalyze reform progress.** Compared to coordination, EU legislation is more binding and effective in enforcing outcomes (e.g., the directive on late payments). Consistent with the EU initiative to reduce excessive legislation, the EC could prioritize legislative action on critical reforms, such as integrating energy and digital markets. Further EC guidance to facilitate the use of SGP flexibility for reforms could enhance incentives by identifying *ex ante* a list of permissible reforms and using historical cross-country estimates for costing when possible.

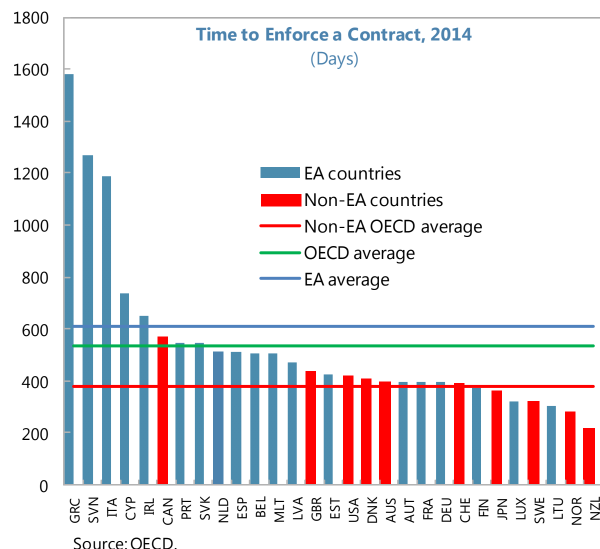
50. **Independent structural councils would improve monitoring and design of reforms.** An EU-level "structural council" of experts could be created to assess *ex post* the EC's prioritization and enforcement of structural reforms. In member countries, "national productivity councils" with wide representation could assist *ex ante* in translating euro area-wide reforms into a national reform agenda (as is done in Belgium, Germany, and Australia), thereby fostering ownership and innovation.

51. **Simplifying and strengthening the fiscal framework would enhance its effectiveness**. While successive reforms have improved some elements of the EU's fiscal framework (e.g., taking greater account of the economic cycle), they have increased its complexity, hampering effective monitoring, public communication, and compliance. The framework could be simplified by focusing on two main pillars: a single fiscal anchor (public debt-to-GDP) and a single operational target (an expenditure growth rule, possibly with a debt correction mechanism) linked to the anchor.[14] To enhance enforcement, fiscal policy monitoring could be improved through better interaction between national fiscal councils and the EC, possibly facilitated by the EU Network of Independent Fiscal Institutions (EUNIFI), or through an independent fiscal council at the EU level to assess application of fiscal rules.

[14] See Andrle and others, "Reforming Fiscal Governance in the European Union," (IMF SDN 15/09).

Box 4. "Outcome-Based" Structural Reform Benchmarking[1]

How would benchmarking work? "Outcome-based" structural reform benchmarks would increase the specificity of the reform agenda, and improve transparency and accountability in the application of the current framework. The first step would be for the EU and member states to prioritize area-wide structural reforms. Benchmarks should be concrete, measurable, under the control of policymakers, and linked to regional and global best practices. The EC and European Council would monitor and enforce progress toward achieving these benchmarks.



Source: OECD.

Which benchmarks? Reforms with a single market dimension—e.g., a common market for services, capital, and energy—could be prioritized, as well as reforms that improve the business climate and help eliminate intra-euro area gaps in productivity and competitiveness.These include the time to enforce contracts, complete insolvency, or obtain a business license; the burden of tax compliance; the labor tax wedge; differences between retail and wholesale electricity prices etc.

Advantage. Benchmarking could increase *ownership* as member states would decide them jointly; benchmarks would apply to all countries but member states would have leeway in developing action plans to achieve targeted outcomes; and, the process could spur greater discussions on the best way to achieve economic outcomes. Benchmarking would also improve the *prioritization* of reforms, and facilitate monitoring and pre-emptive corrective action where necessary. By increasing *transparency*, it would make performance gaps clearly visible and comparable across countries, reduce excessive discretion and a perceived lack of even handedness in the application of the existing governance framework, increase *accountability*, and *level the playing field* across members.

Challenge. It may be *operationally difficult* to identify and quantify specific benchmarks with all the desired characteristics, particularly given the uncertainty surrounding links to the outcome of some reforms. For example, targets on employment rates (such as those in the Europe 2020 strategy) may seem specific and outcome-based, but can be difficult to target effectively since they are not entirely under the control of policymakers. A better and more easily enforceable benchmark might be one on the labor tax wedge (e.g., "reduce labor tax wedge to x percent in y years") as this can be directly influenced by policy and has been shown to be associated with higher employment rates.

[1] See accompanying Selected Issues Paper titled "Euro Area Structural Reform Governance."

Authorities' Views

52. **Enhanced economic governance is desirable, but progress is likely to be made in stages.** As noted in the Five Presidents' Report, near-term efforts should focus on improving the operation of the current framework without deeper reforms that would require a Treaty change. The authorities broadly agreed with the proposals for an improved structural governance framework, but also highlighted practical challenges. They regarded greater ownership, specificity, transparency, independent evaluation, and accountability as appropriate principles.

53. **Outcome-based benchmarks could be useful for enhancing specificity and transparency.** This would facilitate a more rules-based approach to application of the Macroeconomic Imbalances Procedure (MIP). The EC noted, however, that identifying appropriate outcome-based benchmarks could be operationally difficult, in particular identifying measurable indicators under the control of country authorities that can deliver desired outcomes, and indicators may not accurately reflect reform progress. More consistent and transparent application of the existing structural reform governance framework, including the MIP, could strengthen credibility and compliance.

54. **There are limits to how much legislation and SGP flexibility could help advance reforms.** Greater use of legislative approaches could help achieve action on product market and other reforms, but without treaty changes, the EU has limited legislative jurisdiction, and the appetite for additional EU legislation is low. While in principle there is a case for supporting structural reforms through SGP flexibility, a cautious approach is needed to avoid undermining credibility of the framework and debt sustainability, especially given uncertainty about the impact of structural measures and the commitment of countries to follow through on reform pledges.

55. **The proposed approach to SGP reforms is sensible, but again, broader changes are unlikely now.** The authorities agreed on the merits of focusing on a debt anchor and an expenditure growth rule. More prominence could be given to the expenditure benchmark and debt criterion within the current fiscal framework, but the authorities saw little support now for deeper changes that may entail modification of the Treaty to streamline the complicated framework. The ECB noted the importance of enforcement problems. The authorities saw some merit in the idea of a technical EU-level fiscal council to underpin economic judgment on use of the room for maneuver under the SGP and dispel perceptions of politicized enforcement of it.

STAFF APPRAISAL

56. **The cyclical recovery is gaining strength, supported by a number of tailwinds.** Although unemployment is still high, steady job growth and rising real wages have underpinned a rebound in consumption. Low oil prices, accommodative monetary policy, including QE, and a weaker euro are supporting the upturn, with major euro area economies expected to grow near or above last year's rate. With oil prices stabilizing, domestic demand recovering, and QE helping support inflation expectations, prices are expected to rise gradually through the medium term.

57. **The external position continues to strengthen.** The euro area's external position in 2014 was broadly consistent with the level implied by medium-term fundamentals. The real depreciation of the

euro so far this year has been beneficial given the economic cycle, but the currency is now moderately weaker than the level that would be consistent with medium-term fundamentals. A broader reform agenda that raises growth and inflation would contribute to a gradual strengthening of the euro over the medium term, and limit potential spillovers from relying too heavily on accommodative monetary policy.

58. **Risks to the forecast are now more balanced than recent years when they were clearly to the downside.** Greater positive impact than expected could come from low oil prices, QE, a weaker euro, and rising confidence. These offset risks from potential for lingering weakness and low inflation, a slowdown in emerging markets, geopolitical tensions, and financial market volatility from asymmetric monetary policies among major economies or developments in Greece.

59. **Managing potential contagion from evolving developments in Greece will require timely and effective policy actions.** Policy-makers should stand ready to deploy, and if necessary, adapt available instruments, such as QE, OMT and TLTROs, to manage contagion risks. If financial conditions tighten significantly, the ECB should consider expanding its asset purchase program. Beyond the near term, there should be a concerted effort to strengthen the monetary union and European firewalls. Fully severing bank-sovereign links would require a common deposit insurance scheme with a fiscal backstop, a larger and fully funded Single Resolution Fund, and easier access to direct bank recapitalization from the ESM in a systemic crisis.

60. **Despite the cyclical upturn, only subdued growth is expected over the medium term.** The tepid medium-term outlook reflects insufficient demand, weak balance sheets, and slow progress on structural reforms gaps that continue to hold back employment and investment. As one-off factors driving the cyclical recovery fade, there is a risk that low growth and limited policy space leave the euro area vulnerable to shocks.

61. **A stronger collective push is urgently needed to strengthen the recovery and deepen integration.** Concerted action should focus on four pillars: continuing demand support, cleaning up bank balance sheets, accelerating structural reforms, and strengthening the economic governance framework. A more balanced policy mix that includes not only ongoing monetary accommodation, but also fiscal support within the SGP, improved credit conditions to enhance monetary transmission, and structural reforms to boost productivity would yield larger growth dividends and positive external spillovers.

62. **Staying the course on QE is essential.** QE's initial implementation has improved confidence and financial conditions, and raised inflation expectations. Given still important risks from low inflation, fully implementing QE and looking through temporary periods of market volatility are critical to meeting the inflation objective, and the program should be extended if there is not a sustained adjustment in inflation consistent with meeting the medium-term price stability objective. Although there are few signs of scarcity, the ECB could expand the list of assets eligible for purchase and work with NCBs to preemptively harmonize conditions for re-lending securities to ensure sufficient availability of collateral for smooth market functioning.

63. **Potential financial stability risks should be addressed through macroprudential and other policies.** Close monitoring remains appropriate, and macroprudential policies should be used as a first line of defense. To address challenges faced by life insurers in a low interest rate environment, the

viability of guarantee-based products should be reassessed, minimum returns should be brought in line with interest rates, and steps should be taken to improve asset-liability matching.

64. **Fiscal support within the SGP and centralized investment can help support demand.** Countries should adhere to their SGP commitments, but those countries with fiscal space, including from lower interest costs due to QE, should use it to raise investment and pursue structural reforms. Others should use windfall savings to reduce debt and meet fiscal targets. Rapid implementation of the EFSI would help boost investment, especially in countries with limited fiscal room. Careful project selection to target additional and higher-return investments, as well as removal of regulatory barriers will help maximize potential impact of the EFSI.

65. **More comprehensive actions are needed to reduce the high level of NPLs.** NPL resolution should be accelerated through strengthened provisioning and collateral valuation, as well as capital surcharges or time limits on long-held NPLs. Insolvency reforms and more effective out-of-court workout procedures are needed in many countries. Policies should also seek to jumpstart a market for distressed debt to assist in corporate restructuring, including through use of AMCs, subject to EU State aid rules.

66. **Structural reforms are urgently needed to raise potential growth.** Notwithstanding some progress in recent years, long-standing challenges have contributed to lagging productivity. Priorities at the national level should include labor market reforms to reduce duality and increase employment opportunities, as well as product and service sector reforms to improve the business climate. At the regional level, faster implementation of the Services Directive, further improvements to insolvency regimes, and a greater push toward a single market in capital, transport, energy, and the digital economy would help further integration. A capital markets union would enhance access to finance; efforts in this area should focus on increasing transparency, improving market infrastructure and regulations, and promoting high quality securitization, especially for SMEs. Agreement on an ambitious TTIP would boost growth and productivity.

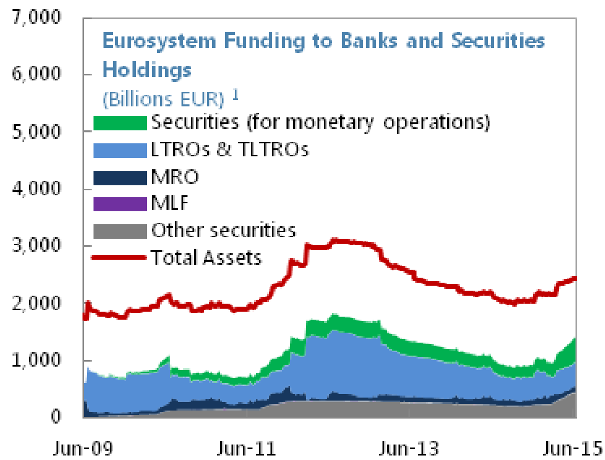
67. **A more effective governance framework would help advance structural reforms.** Using outcome-based structural reform benchmarks would improve transparency and accountability. Selective use of EU legislation would help achieve progress in critical areas, and better use of SGP flexibility for countries undertaking structural reforms would provide incentives for action. An independent structural council at the EU level would enhance monitoring *ex post*, while national-level productivity councils could enhance ownership and innovation in the design of reform programs.

68. **The fiscal framework would also benefit from simplification and strengthening.** The complex framework would be made more effective by focusing on two key pillars: a single fiscal anchor (public debt-to-GDP) and a single operational target (an expenditure growth rule, possibly with a debt correction mechanism). Enforcement, monitoring, and coordination of fiscal policy could be improved through better interaction between national fiscal councils and the EC, and possibly by an EU-level independent fiscal council to assess SGP application.

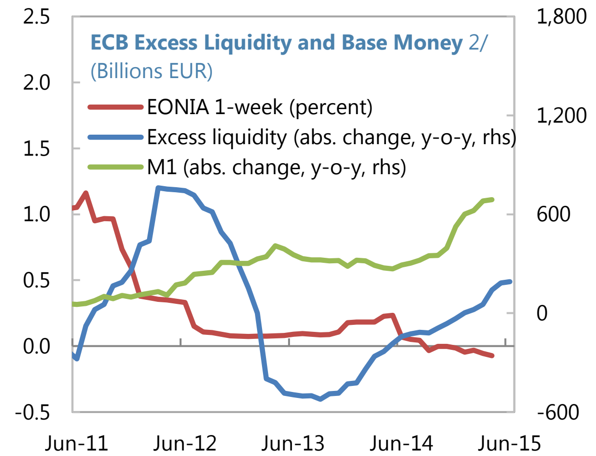
69. **It is proposed that the next Article IV Consultation on euro area policies take place on the standard 12-month cycle.**

Figure 7. Monitoring Sovereign QE

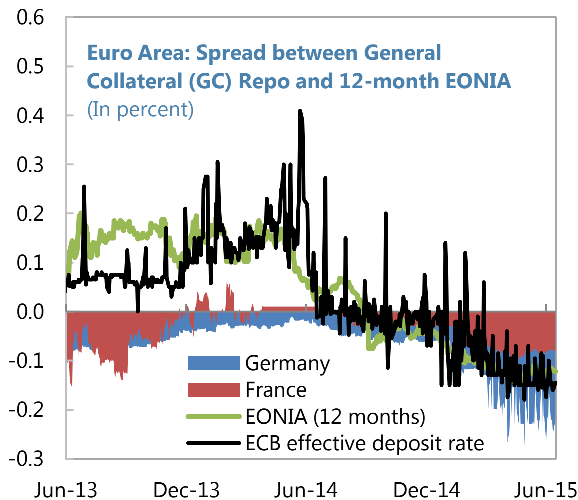
Sovereign QE reversed the contraction of the Eurosystem's balance sheet…



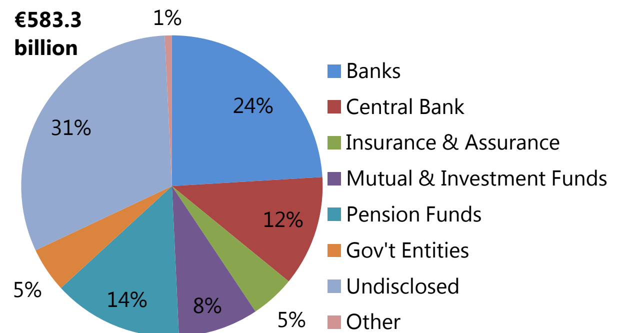
… and further improved liquidity conditions.



Market-making in government debt is less attractive with the cost of borrowing collateral below the deposit rate.



Banks are a relatively small share of potential lenders of securities to offset a potential scarcity of collateral in the market.

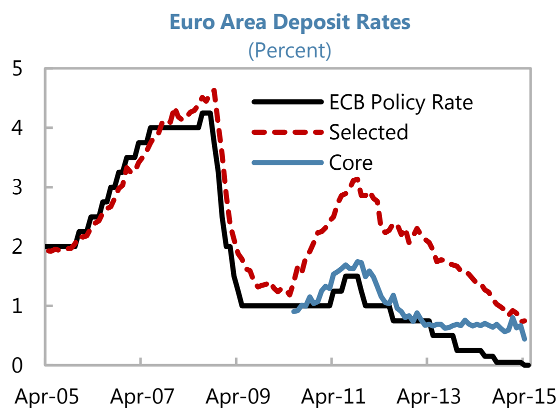


Sources: Bloomberg LP; Eurostat; ICAP; Markit; and IMF staff calculations.

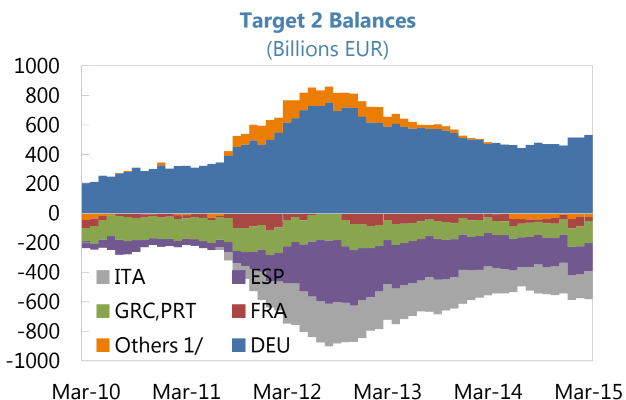
[1] Securities held for monetary policy purposes (SMP, CBPPs, ABPP, and PSPP). LTROs and TLTROs are long-term refinancing operations and targeted long-term refinancing operations. MRO are main refinancing operations. MLF is the marginal lending facility. 2/ Excess liquidity=current account + overnight deposits-min. reserve requirement-MLF.

Figure 8. Fragmentation

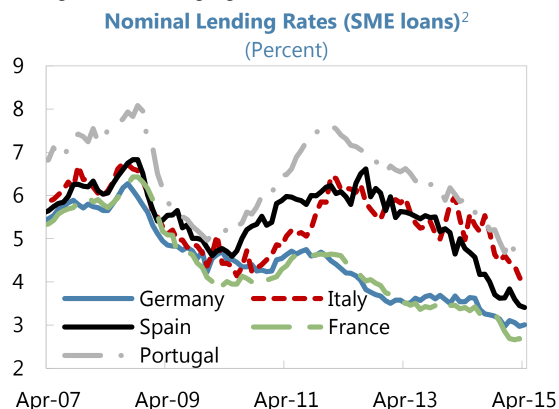
Differences in deposit rates have disappeared.



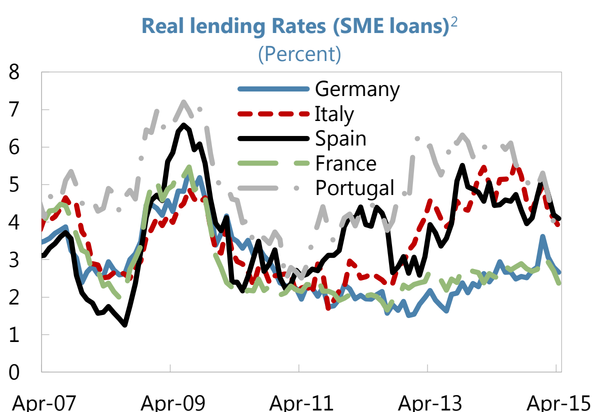
Target 2 imbalances have fallen, but still remain high relative to pre-crisis.



Fragmentation on the lending side also declined with lending rates converging.



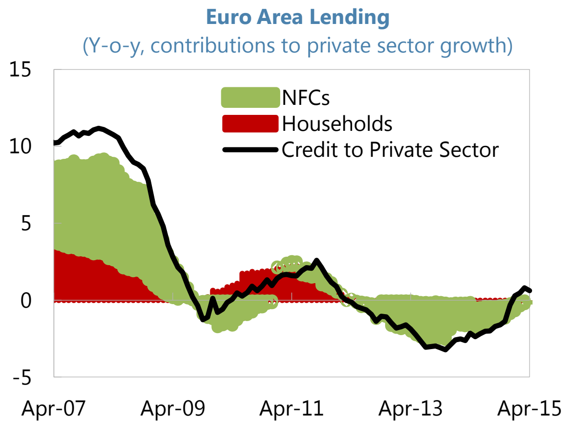
Real lending rates have also declined, albeit at a slower pace due to low inflation.



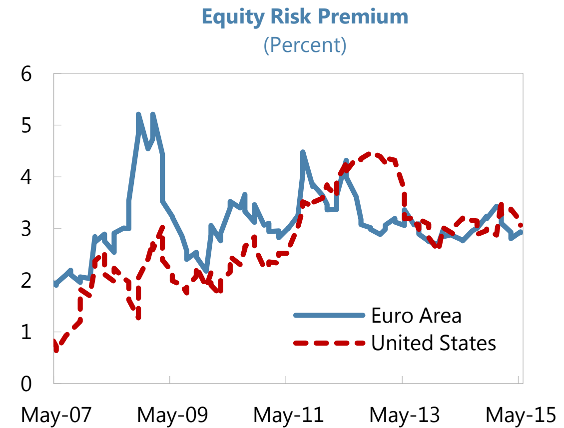
Sources: Haver Analytics; Eurostat; ECB; and staff calculations.
Note: Core countries: DEU, FRA, NLD; selected countries: ESP, ITA, PRT.
[1] Others: AUS, BEL, FIN and NLD.
[2] Un-weighted averages; MFI lending to corporations under €1 million, 1–5 years.

Figure 9. Financial Stability

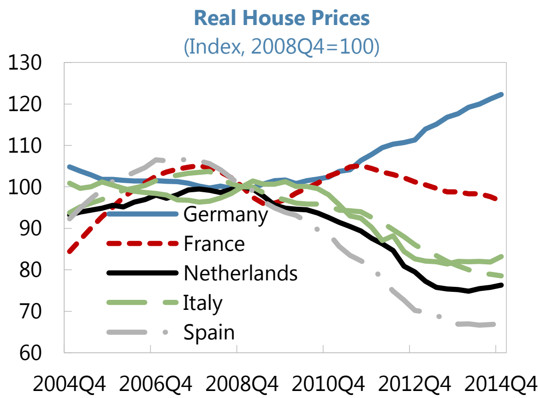
The recovery of credit has been slow.



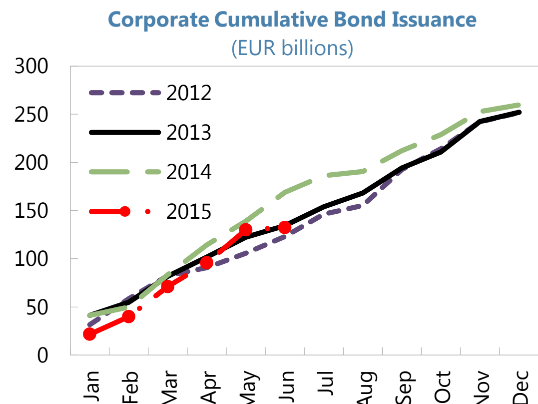
Equity markets do not appear overpriced.



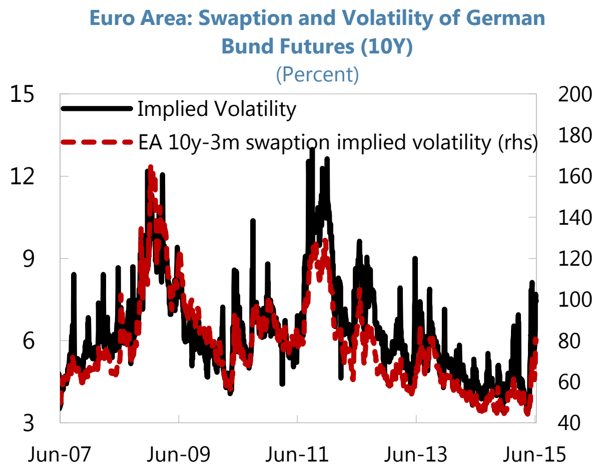
The recovery in house prices has been weak in most countries.



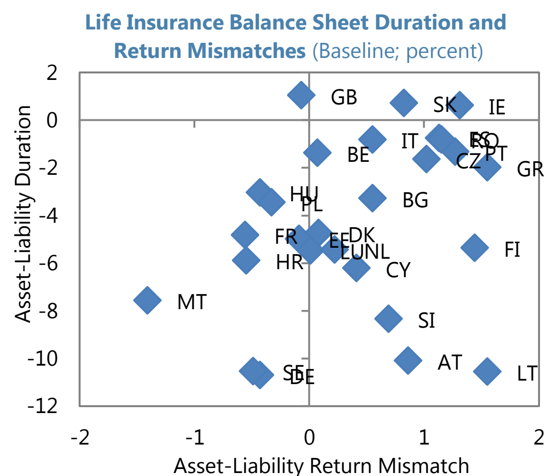
Corporate bond issuance has been broadly in line with past years.



The "Bundshock" raised volatility under illiquid conditions…



…while life insurers are under stress in the low rate environment.



Sources: Haver Analytics; Dealogic; Eurostat; ECB; IMF, RES–MFU; and staff calculations.

Table 2. Main Economic Indicators, 2012–2020

(Annual percent change, unless stated otherwise)

				Projections 1/					
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Demand and Supply									
Real GDP	-0.8	-0.4	0.8	1.5	1.7	1.6	1.6	1.6	1.5
Private consumption	-1.3	-0.6	1.0	1.8	1.5	1.5	1.5	1.5	1.5
Public consumption	-0.1	0.2	0.6	1.0	0.6	0.5	0.6	0.6	0.6
Gross fixed investment	-3.7	-2.4	1.2	1.8	2.3	2.5	2.4	2.4	2.4
Final domestic demand	-1.5	-0.8	0.9	1.6	1.5	1.5	1.5	1.5	1.5
Stockbuilding 2/	-0.8	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0
Domestic Demand	-2.3	-0.7	0.8	1.4	1.5	1.5	1.5	1.5	1.5
Foreign balance 2/	1.4	0.3	0.0	0.1	0.3	0.2	0.1	0.1	0.1
Exports 3/	2.7	2.0	3.8	4.1	4.4	4.5	4.5	4.4	4.4
Imports 3/	-0.7	1.3	4.1	4.2	4.3	4.5	4.6	4.6	4.6
Resource Utilization									
Potential GDP	0.5	0.5	0.8	1.0	1.0	1.1	1.2	1.2	1.2
Output gap	-1.9	-2.8	-2.7	-2.2	-1.5	-0.9	-0.5	-0.2	0.1
Employment	-0.5	-0.7	0.6	0.9	0.8	0.8	0.8	0.7	0.7
Unemployment rate 4/	11.4	12.0	11.6	11.1	10.6	10.1	9.7	9.4	9.0
Prices									
GDP deflator	1.3	1.3	0.9	1.1	1.0	1.2	1.3	1.4	1.5
Consumer prices	2.5	1.3	0.4	0.2	1.1	1.3	1.4	1.6	1.7
Public Finance 5/									
General government balance	-3.6	-2.9	-2.6	-2.3	-1.8	-1.4	-1.0	-0.6	-0.4
General government structural balance	-2.0	-1.1	-0.9	-0.9	-0.8	-0.7	-0.5	-0.3	-0.2
General government gross debt	91.0	93.2	94.4	93.5	92.5	91.1	89.3	87.0	84.6
External Sector 5/, 7/									
Current account balance	1.2	1.9	2.1	3.3	3.1	2.9	2.8	2.6	2.5
Interest Rates 4/, 6/									
EURIBOR 3-month offered rate	0.2	0.3	0.1	0.0	...	...	...	...	...
10-year government benchmark bond yield	2.3	3.3	1.5	1.3	...	...	...	...	...
Exchange Rates 6/									
U.S. dollar per euro	1.30	1.37	1.23	1.12	...	...	...	...	...
Nominal effective rate (2000=100)	99.8	108.6	105.7	98.3	...	...	...	...	...
Real effective rate (2000=100) 6/	90.0	96.0	91.1	84.4	...	...	...	...	...

Sources: IMF, *World Economic Outlook,* Global Data Source, DataStream, and Eurostat

1/ Projections are based on aggregation of WEO projections submitted by IMF country teams for July 2015.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent.
5/ In percent of GDP.
6/ Latest monthly available data for 2015.
7/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

Table 3. External Sector Assessment

<table>
<tr><th></th><th>Euro Area</th><th>Overall Assessment</th></tr>
<tr><td>Foreign asset and liability position and trajectory</td><td>Background. The net international investment position (NIIP) of the euro area deteriorated through the crisis, to -17 percent of GDP in 2008, but has since rebounded to around -11.6 percent in 2014:Q4, as a result of improved current accounts, modest nominal GDP growth, and valuation effects. A more stable outlook and projections of continued current account surplus suggest that the NIIP to GDP ratio will continue to improve at a moderate pace, rising to about zero percent over the medium term.
Assessment. The NIIP positions of individual member countries still vary greatly. Despite recent improvements, external vulnerabilities persist due to market perceptions of the capability of some euro area countries with sizable net foreign liabilities to service their debts.</td><td rowspan="6">Overall Assessment:

The external position of the euro area in 2014 was broadly consistent with the level implied by medium-term fundamentals and desirable policies. In 2015, the current account is projected to rise, reflecting continued weak demand, an improvement in the net oil balance, and the weaker euro, pointing to a strengthening external position. The REER depreciation so far in 2015 has been beneficial, given the current stage of the economic cycle and the need to address low inflation and reduce deflation risks. At the same time the REER is moderately weaker than the level that would be consistent with medium-term fundamentals. Along with accommodative monetary policy, a broader policy agenda that includes more growth-friendly fiscal policy, a strengthening of bank balance sheets, and productivity-enhancing structural reforms, would contribute to a gradual real appreciation of the euro over the medium term.

In addition, imbalances in the external position remain at the national level, stemming from weak demand, low inflation, persistently high unemployment, and financial fragmentation. Further adjustment is needed for both surplus and deficit member states to rebalance their external positions.

Potential policy responses:

Continued monetary accommodation is appropriate to lift inflation closer to the ECB's medium-term price stability objective, which should mitigate the real depreciation caused by the weaker euro, help increase demand and facilitate relative price adjustments at the national level. Monetary easing should be complemented with policies to strengthen banks' balance sheets, structural reforms to enhance productivity and improve competitiveness, and more growth-friendly fiscal policy to promote investment and structural reforms. This should also help achieve external rebalancing within the union.</td></tr>
<tr><td>Current account</td><td>Background. The current account (CA) balance for the euro area strengthened slightly in 2014 to 2.3 percent of GDP, up from 2.2 percent of GDP in 2013. The cyclically-adjusted current account in 2014 is estimated to be a surplus of about 1.9 percent of GDP. The cyclical position and adjustment of the CAs, however, varies significantly across member countries.
Assessment. Staff assesses that the euro area 2014 current account is broadly in line with the level suggested by medium-term fundamentals and desired policies (as in the EBA estimated norm), with a CA gap ranging from -1 to 1 percent of GDP. The CA norm of 2.0 percent of GDP reflects primarily the adverse demographics and weak medium-term growth prospects in the euro area. The CA is expected to strengthen further in 2015 by nearly one percent of GDP, reflecting an improvement in the net oil balance by about 0.7 percent of GDP, some competitiveness gains, and continued weak domestic demand. External imbalances at the national level remain and are expected to persist. Improvements in the current accounts of debtor countries have been driven mainly by import compression, reflecting sluggish domestic demand, while surpluses in large creditor countries continue to increase.</td></tr>
<tr><td>Real exchange rate</td><td>Background. The CPI-based real effective exchange rate was essentially unchanged from 2013 to 2014, but fell by 10 percent as of May 2015, compared with its average level in 2014, reflecting both a nominal depreciation and slowing inflation in the euro area relative to its trading partners. The nominal depreciation in 2015 is expected to persist, not least due to the divergent economic and monetary policy outlook among the major advanced economies.
Assessment. Staff assesses the euro area real exchange rate in 2014 (year average) to be consistent with medium-term fundamentals, with a REER gap of between -5 to 5 percent. The REER depreciation in 2015 is also consistent with the near-term cyclical outlook and the need for continued monetary accommodation. Important differences, however, remain at the national level and are expected to persist.</td></tr>
<tr><td>Capital and financial accounts: flows and policy measures</td><td>Background. The slight rise of the CA surplus in 2014 was mirrored by financial outflows on a net basis. In particular, the financial account deficit was predominantly driven by bank-related and portfolio debt outflows, which were partially offset by increases in portfolio equity inflows.
Assessment. The trend of financial flows has closely followed developments in the current account and was supported by easing financial conditions in the euro area. Looking ahead, the return of capital flows would depend crucially on growth prospects of the region, external conditions, and institutional reform efforts including the long-term vision to complete the architecture of the EMU.</td></tr>
<tr><td>FX intervention and reserves level</td><td>Background. The euro has the status of a global reserve currency.
Assessment. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td>Technical Background Notes</td><td>1/ The IMF EBA analysis for the euro area covers 11 euro area members, which are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain. The assessments of CA and REER gaps for the euro area are derived from GDP-weighted averages of the assessments of the individual countries listed above, as well as from estimates for the euro area as a whole. 2/ When applying GDP-weighted aggregation for the euro area, the CA is corrected for reporting discrepancies in intra-area transactions, as the CA of the entire euro area is about ½ percent of GDP less than the sum of the individual 11 countries' CA balances (for which no such correction is available).3/ Data vintage as of June 2, 2015. Revision since then indicates that the current account balance in 2014 is 2.1 percent of GDP in the euro area.</td></tr>
</table>

Table 4. Structural Reform Plans and Progress in Selected Euro Area Countries

	Reform priorities	Recent progress	Staff recommendations
France	• Reform government spending to reach medium term fiscal objective. • Improve functioning of labor markets to re-absorb the unemployed, with a focus on the young and low-skilled. • Increase competition in service sectors with high economic impact. • Pursue a business-friendly environment for enterprises.	• 2014 pension reform (higher rates and longer contribution period for full pension). • Tightened budgetary target for health spending (ONDAM). • Targeted expenditure reviews. • Cut in employer's social security contribution (Responsibility Pact). • Tax credit (CICE) on firms' payroll on wages below 2.5*minimum wage. • Flexibility on hours and pay for firms in difficulties (Accords de maintien de l'emploi - AMEs). • Subsidized jobs for the young and low-skilled. • Introduction of portability of professional training rights across jobs and unemployment. • Reduced judicial uncertainty around individual dismissals through reform of the prud'hommes system (Macron law). • Reformed union representation and streamlined mandatory discussions between social partners (Rebsamen law) • Liberalization of the sale of some health products. • Liberalization of legal professions, coach transport, retail trade opening hours, and expansion of competencies of the Competition Authority (Macron law). • Creation of Business Simplification Council. • Simplification of housing-related regulations.	• Institutionalize broad spending reviews to improve efficiency at all levels of government. • Reverse the growth in public employment at all levels of government. • Improve targeting of social benefits, including for unemployment, housing, and families. • Raise effective retirement age, making complementary pension pillar financially sustainable, and streamlining special pension regimes. • Tighten caps on local taxes and borrowing, and eliminate "universal competency" clause. • Reform the minimum wage formula. • Reform unemployment benefits and strengthen job search framework. • Expand flexibility for social partners to agree on hours and pay at the enterprise level • Improve the targeting of professional education and training. • Strengthen the Competition Authority; allowing SMEs to launch class actions in anti-trust cases. • Further reduce disincentives for SMEs to grow above certain employee thresholds. • Liberalize regulated professions not covered by the Macron law. • Enhance the effectiveness of the Business Simplification process. • Alleviate constraints on the supply of affordable housing and improve targeting of benefits. • Reduce regulated savings rates and review tax incentives for savings and insurance products.
Germany	• Increase labor force participation and facilitate immigration of qualified workers. • Increase productivity and competition, in particular in the services sector. • Clarify future energy policy with respect to pricing and infrastructure.	• Progress in extending child care provision. • The contribution rate for statutory pension insurance was reduced and the personal basic tax-free allowance for income tax and the monthly pay threshold for mini-jobs were increased in 2013. • A law to facilitate recognition of qualifications obtained abroad came into force in 2012. The EU blue card facilitates immigration of skilled workers. • Additional allocation to research and development in the 2012–2014 budgets.	• Lower the tax wedge, in particular for the low-skilled and women. • Improve the provision of child care. • Further deregulate professional services. • Strengthen the regulator's powers to stop discrimination against the incumbent operators' competitors in railways and postal services.
Greece	• Improve labor market flexibility. • Foster competition in service and product markets. • Improve the business environment.	• Progress in all reform priorities is lagging. The new government would like to reverse recent labor market reforms, including increasing the minimum wage back to the 2012 level, abolishing the subminimum wage and firm-level bargaining, and reinstating the favorability clause and extension of collective agreements. The new government has committed to implementing only a handful of OECD recommendations aiming at enhancing competition in key sectors of the economy. • The authorities appear ready to proceed with the liberalization of a few restricted professions, reduction of administrative burdens, and simplification of the licensing system on a restricted basis. Concrete measures in these areas are under discussion.	• No backtracking on any of the recent labor market reforms, including the minimum wage which still today on a GDP per capita basis is at the top end of the EU countries. Keep the subminimum wage as youth unemployment at 26 percent is the highest in the EU. Adopt legislative changes to align framework on collective dismissals and industrial actions in line with EU best practices. • Continue opening up regulated professions; Implement pending OECD recommendations to reduce barriers to competition and expand the work in additional sectors; Continue to reduce administrative burdens. • Continue overhauling the licensing system in line with international best practice while reducing the costs of establishing new businesses under the existing system. Simplify customs procedures in line with EU practices, including electronic submission system for trade declarations and electronic payment.

Table 4. Structural Reform Plans and Progress in Selected Countries (Concluded)

	Reform priorities	Recent progress	Staff recommendations
Portugal	• Alleviate impediments to external competitiveness and potential growth. • Continue to improve the functioning of labor and product markets.	• The planning unit of Ministry of Finance has been given a formal mandate by the Council of Ministers to monitor, evaluate, and coordinate structural reforms. • A proposed one-time levy on GALP, the largest natural gas provider, would be applied to reduce gas prices by 3 to 5 percent for end users for the next three years, if it becomes effective. • Renegotiation of one port concession contract has been completed, with another four expected to follow suit soon. • New bylaws for 18 services and regulated professions were approved by the Council of Ministers and are currently under review in the Parliament.	• Revisit reforms that have not yielded the hoped-for-results, fully implement already initiated reforms, and address remaining bottlenecks through fresh reforms. • Upgrade the quality of public services and policies, including raising the effectiveness of public administration at the central and local levels, reviewing the functioning of the courts, and increasing the payment discipline of public sector entities. • Continue measures to reduce the cost of energy, the use of transport infrastructure, and the costs of professional and other services. • Strengthen market integration at the European level. • Promote managerial skills; more inclusive labor support system; avoid excessive increase of the minimum wage and find alternative policy tools to fight poverty.
Spain	• Address labor market duality and reduce high structural unemployment (especially among the youth and unskilled). • Boost productivity and competitiveness, particularly for small firms. • Improve access to financing for SMEs.	• The 2012 labor reform reduced severance payments and eased the use of fair dismissals; facilitated firm-level agreements. • Introduction of special contract for small firms that incentivizes hiring of permanent workers, particularly unemployed youth. • Social security (SS) contribution's flat rate for permanent hires replaced by exemption of first 500 euros of SS contribution. • New active labor market policies (ALMP), aiming at improving the skills of the long-term unemployed and low-skill youth. • Approved Market Unity Law (2013). • Insolvency regime: introduction of a "fresh start" for individuals and entrepreneurs; amendments to the out-of-court restructuring mechanism for SMEs, restructuring and liquidation procedures.	• Build on the 2012 labor reform to address duality, including by moving to a system of seniority-based dismissal cost for all workers. • Ensure the conditions for continued wage moderation and wage growth differentiation across firms and sectors. • Monitor, evaluate, and strengthen ALMPs and training. • Reduce obstacles to firm growth by: addressing excessive regulatory burden; swiftly implementing the Market Unity Law; eliminating tax and size-related rules and regulations that create disincentives for firms to grow; liberalize professional services. • Continue to support the internationalization SMEs, for example, by helping reduce high fixed costs of exporting. • Facilitate private sector deleveraging through legal reform: ensuring an effective design and implementation of the "fresh start;" facilitating in-court and out-of-court agreements to rehabilitate viable firms; and harmonizing all processes in light of recent changes.
Italy	• Raise public sector efficiency. • Improve the efficiency of civil justice. • Improve flexibility of the labor market. • Increase competition in product markets and services.	• The draft enabling law on public administration reform outlines ideas to reform recruitment and managerial compensation, reorganize public administration, digitize procedures, and streamline legislation governing SOEs. • New mandatory mediation scheme, measures to deal with backlog of pending cases and speed up case processing (2013). • Some judicial reform measures (e.g., reducing leave time for judges) to reduce backlog and speed up processing. • New law on civil liability of judges (2015); procedural reforms; and extension of competence of specialized commercial chambers (2015). • The Jobs Act (Dec 2014) introduces a new labor contract with gradually increasing protection, lowers dismissal costs, and reduces the scope for reinstatement. The law also expands the social safety net and plans to strengthen active labor market policies. • Social partners agreed upon a Consolidated Act on Representation in 2014. Firm-level bargaining remains relatively unused.	• Adopt and implement the planned public administration reform. The reform should specifically include reforms to the provision of local public services; tendering procedures; and human resources management in the public administration to unlock productivity. • Further measures are needed to improve the efficiency of civil justice: rationalize types of cases that reach the Supreme Court; allow further specialization of courts; push ahead with the project develop court performance indicators; and use ad hoc measures to reduce the backlog of pending measures. • Legislate and implement concrete measures to redesign wage-supplementation scheme to turn it into universal support system conditional on job search and training, and strengthen active labor market policies as envisioned in the Jobs Act. • Further decentralize wage setting by allowing greater flexibility in national contracts and tackling the existing constraints to second-stage wage bargaining. • The swift approval and implementation of the Annual Law on Competition and addressing existing regulatory barriers in key sectors—such as retail and transport—would support growth. The full implementation of already legislated reforms by all levels of government is needed to improve business environment.

Source: IMF country teams

Appendix 1. Progress Against IMF Recommendations

	2014 Article IV Policy Advice	Actions since 2014 Article IV	Next Steps
Monetary Policy	If low inflation and fragmentation are not reversed, expand the ECB's balance sheet substantially.	In addition to private asset purchases (since 2014Q4), sovereign QE was announced in January 2015 (and started in March 2015), involving public sector security purchases until at least September 2016.	Stay the course and if inflation fails to pick up after a reasonable period, stand ready to extend the program. Expand flexibility in asset purchases and develop a (proactive) common securities lending framework within the Eurosystem to expand and facilitate market access to NCBs' sovereign bond holdings.
Fiscal Policy	Negative growth surprises should not trigger additional consolidation efforts.	Fiscal consolidation slowed in 2014 and the fiscal stance is projected to be broadly neutral in the coming years.	Use fiscal space and flexibility within the SGP to support investment and structural reforms.
	Over the medium term, simplify and strengthen the fiscal governance Framework.	Discussions are ongoing.	Focus the fiscal framework on a single fiscal anchor (public debt-to-GDP) and a single operational target (an expenditure growth rule, possibly with a debt correction mechanism) linked to the anchor.
Financial Policies	Complete AQR, reduce corporate debt overhang. Complete the banking union and ensure operational readiness of SSM as integrated supervisor.	Under the Comprehensive Assessment (CA), banks have boosted their capital positions with only a few institutions showing a capital shortfall. There has been progress in reducing corporate leverage in some countries.	Develop a multi-faceted strategy for NPL resolution, combining stricter supervision, structural reforms to enforcement and insolvency regimes, and measures to develop a market for distressed debt. Harmonize capital requirements, including for deferred tax assets.
	Establish a common fiscal backstop to effectively sever sovereign-bank links.		Ratify SRF agreement and accelerate SRF funding plans. Relax preconditions for using ESM direct recap and consider increasing the SRF.
	Integrate capital markets and broaden funding sources for SMEs. Support development of securitization markets.	The EC issued a *Green Paper on Building a Capital Markets Union*, which stressed the need for common standards for loan reporting requirements, greater integration of tax regimes, and harmonized debt enforcement and insolvency regimes.	Remove national differences in capital market infrastructure regulations. Promote SME securitization.

	2014 Article IV Policy Advice	Actions since 2014 Article IV	Next Steps
Structural Policies	Develop a comprehensive strategy to tackle youth unemployment.	Pan-European initiatives (e.g., Youth Guarantee, and Youth Employment Initiative) ongoing. See Table 4 for country-specific progress.	See Table 4 for country-specific recommendations.
	Higher infrastructure investment in the creditor countries to reduce excessive surpluses.	A centralized investment initiative (European Fund for Strategic Investment (EFSI) was launched on July 4 and first transactions are expected in the second half of 2015.	Implement swiftly the EFSI. Particular attention should be paid to project selection to support new investment and to removing regulatory barriers.
	Progress with reforms to product and labor markets.	Ongoing. See Table 4 for country-specific progress.	See Table 4 listing country specific recommendations and progress.
	Implement the Services Directive	Review of implementation to be completed by end-2015.	Faster implementation of the Services Directive to promote cross border competition in services.
	Make progress with free trade agreements.	The negotiations for Transatlantic Trade and Investment Partnership are ongoing. Free trade agreement with Canada completed.	Progress on the Transatlantic Trade and Investment Partnership (TTIP) to support greater integration.
	More closely integrate energy platforms and policies.	The EC announced an ambitious proposal for an energy union aiming to reduce vulnerabilities to supply disruptions, integrating energy markets, improving energy efficiency, reducing carbon emissions and strengthening research and development. First legislative proposals are expected in late 2015 or early 2016.	Progress on energy market union, including through benchmarking of reforms.

Appendix 2. Statistical Issues[1]

European statistics are developed, produced, and disseminated within their respective spheres of competence by the European Statistical System (ESS) and the European System of Central Banks (ESCB). The ESS, composed of Eurostat and the national statistical institutes (NSIs), and the ESCB, composed of the ECB and the national central banks (NCBs), operate under separate legal frameworks reflecting their respective governance structures and cooperate closely when designing their respective statistical programs.[2] The European statistics produced by the two statistical systems are of sufficient coverage, quality, and timeliness for effective macroeconomic surveillance. This appendix provides an update on developments of statistical issues since the previous Article IV consultation with the euro area member states.

1. **Transition to the new international statistical standards[3] is largely complete**. All member states now compile national accounts according to the new European System of National and Regional Accounts (ESA 2010) and many took the opportunity to implement benchmark revisions and introduce other statistical improvements, including to data sources and compilation methods to improve the consistency and completeness of data. Most countries requested derogations in some areas up to 2020. The transition to the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6) is also complete. The ECB's new data reporting requirements on external statistics under BPM6 are more detailed, particularly as regards the instrument breakdown within the various functional categories, and have full stock-flow reconciliation. The dissemination of these data will be completed in 2015 when their quality is sufficiently enhanced and large asymmetries coming from some euro area countries are addressed to reduce "errors and omissions". Eurostat and the ECB are working closely with all stakeholders on resolving outstanding issues regarding extending the availability of historical series. The methodology of monetary and financial statistics (e.g., interest rates, investment funds, financial vehicle corporations, securities issues) has also been adapted and new statistics will become available in the second half of 2015.

2. **A number of significant initiatives are underway to improve the quality and timeliness of statistical data.**

- *Flash quarterly GDP estimates at T+30 days*. The progress of the Task Force established by the National Accounts Working Group to assess the feasibility of producing a flash estimate of euro area and European Union quarterly GDP at T+30 days has been encouraging. Internal estimates of quarterly GDP have been produced at T+30 days and

[1] Prepared jointly by the European (EUR) and Statistics Departments (STA) of the IMF in consultation with Eurostat and the ECB. Florina Tanase acted as the STA coordinator.
[2] The ESS is defined by Article 4 of Regulation (EC) No. 223/2009 of the European Parliament and of the Council on European statistics. The ESCB performs its statistical function on the basis of Article 5 of the Statute of the ESCB and of the ECB.
[3] The transition to ESA 2010 is regulated by EU Regulation No. 549/2013 and the transition to BPM6 is regulated by EU Regulation No. 555/2012 and ECB Guideline ECB/2011/23, as amended. Changes to monetary and financial statistics are regulated by the ECB.

test calculations showed limited deviations from those produced at T+45 days. Faster flash quarterly GDP estimates could be published next year if a majority of Member States supports them in a decision foreseen towards the end of this year.

- *European level supply and use tables*. The FIGARO[4] project, foreseen by Eurostat in cooperation with the Joint Research Centre of the European Commission aims to establish an annual production of EU multi-country input-output tables and a five-yearly production of EU multi-country supply, use and input-output tables. The output of the project will support studies on competitiveness, growth, productivity, employment and international trade, and assessment of the position of the European Union and the euro area in the world.

- *Further harmonization of data on trade of goods and services* will benefit from the ongoing study of discrepancies between national accounts, balance of payments statistics, and international trade in goods and services statistics. The largest gaps are observed in data on imports and exports of goods reported in the international trade statistics compared with the national accounts and balance of payments. Eurostat and the ECB are working on resolving discrepancies (e.g., to include illegal activities in the balance of payments data).

3. **Significant progress has been made in government finance statistics (GFS) to enhance economic and fiscal governance.** Annual and quarterly ESA 2010-based GFS time series are available for all countries. The revisions to government deficit and debt levels due to the introduction of the ESA 2010 standard occurred in October 2014, largely due to reclassification of units in the general government sector. Progress has also been made in the national publication of monthly fiscal data based on public accounts, as required by the Enhanced Economic Governance Package (so called "Six Pack"). Further, in February 2015 and in the context of "Six Pack", Eurostat published for the first time the data on contingent liabilities and non-performing loans of the government. The contingent liabilities included government guarantees, liabilities related to public-private partnerships recorded off-balance sheet of government, and liabilities of government controlled entities classified outside general government (public corporations). Work is underway to encourage member states to improve comparability of data across countries. Technical work is also ongoing to harmonize and modernize public sector accounting standards by moving to accruals based accounting in the context of the EPSAS (European Public Sector Accounting Standards) project.

4. **The effect of the European Fund for Strategic Investments (EFSI) on GFS remains uncertain.** Eurostat is awaiting details on the operational arrangements and the pipeline of transactions, in particular, whether additional contributions will be made to EFSI by individual member states. It is possible that EFSI transactions will be added to government deficits, although this impact will be excluded by the European Commission for the purposes of the Excessive Deficit Procedure, in line with their communication on flexibility in the beginning of 2015.

[4] The acronym FIGARO stands for Full International and Global Accounts for Research in Input-Output Analysis.

5. **Ongoing efforts aim to enhance the statistics for the Macroeconomic Imbalances Procedure (MIP).** The ESS and the ESCB cooperate closely to assure the quality of MIP-relevant statistics. The main challenge is the availability of historical time series of necessary length based on the new statistical standards. This is addressed by statistical estimation methods in some cases. Eurostat, in cooperation with the ECB, is also developing a quality monitoring mechanism for data required for the MIP. A report on the quality of data is due to be published in the second half of 2015.

6. **The ECB is working on several projects to enhance over time the availability and quality of statistics on the basis of new granular databases.**

- *Money Market Statistical Reporting (MMSR).* An ECB Regulation (ECB/2014/48) adopted in November 2014 will require credit institutions to report daily their individual transactions relating to various segments of the money market as from April 2016 with full reporting commencing in July 2016. In particular, the transaction-by-transaction data collection will comprise: (i) daily unsecured borrowing transactions with maturity up to and including one year as well as interbank lending; (ii) daily secured lending and borrowing transactions data; and (iii) daily Foreign Exchange Swaps (FX Swaps) transactions and Overnight Index Swaps transactions denominated in euro (volume and rates). To ensure standardization, a common set of Reporting Instructions have been developed which are fully compliant with the ISO 20022 standard. Some aggregated indicators based on the different markets will be released at a later stage to the general public.

- *Securities holdings statistics.* Securities holdings statistics are being collected since end 2013. The data contain quarterly security-by-security information on holdings of individual securities by institutional sectors, collected after 70 days from euro area (and some other EU) national central banks and enriched with reference issuer and securities information by the Centralized Securities Database (CSDB). Additionally, a second module comprises security-by-security information on the holdings by some individual euro area banking groups identified as important for the stability and functioning of the financial system in the euro area. From 2016 the timeliness of the data collection will be enhanced to 55 days. The granularity of the data provides a vast range of breakdowns on both the issuer and holder sides, which are not available in other statistics. For instance, the holdings of government debt can now be monitored together with residual or original breakdown or even on an individual bond level (e.g., recently issued bonds).

- *Insurance corporations' statistics.* An ECB Regulation (ECB/2014/50) adopted in November 2014 will require insurance corporations to report quarterly their balance sheets from May 2016, referring to data as at 2016Q1. The granularity and the expected quality of these data will be comparable to balance sheet statistics of other types of financial institutions collected under ECB Regulations, such as MFIs and investment funds. In addition, annual data on premiums, claims and commissions will be reported. To limit the reporting burden, the national central banks may use harmonized European supervisory reports ("Solvency II") to compile the statistics. The new statistics will be released for the first time towards the end of 2016. They will replace the current, non-harmonized ECB insurance corporations' statistics, which will continue to be compiled until reference period 2016Q2.

- *Harmonized granular credit data*. This initiative aims to establish a long term framework governing the collection of harmonized granular credit and credit risk data to support many tasks of the ECB (and the ESCB), in particular monetary policy analysis and operations, risk management, financial stability surveillance and macro-prudential policy. Information will be provided by the Central Credit Registers, maintained by the NCBs or similar granular statistical databases. First reporting is foreseen to take place in early 2018 focusing on credit granted to non-financial and financial corporations, and general government.

7. **In 2014 the ECB set up the necessary structures and processes for collecting statistics relating to supervisory tasks.** A dedicated Supervisory Statistics Division was established within the ECB's Directorate General Statistics. The division's work covers the governance framework for the management of data from all supervised groups and individual institutions, including the coordination, receipt, quality management and reconciliation of these supervisory data. The entry into force of the EBA's Implementing Technical Standards (ITS) on supervisory reporting significantly increased the amount of comparable information. This framework now includes additional data on forbearance and non-performing loans (with uniform definitions), asset encumbrance, liquidity and leverage. In addition, the ECB published a decision to remove identified supervisory data gaps, mainly related to financial information under national accounting rules, rolling out from end-2015. Data collection follows a "sequential approach" whereby banks submit their data to national supervisors, who then report to the ECB who in turn disseminate selected data to stakeholders.

8. **Various components of the Survey on SME Access to Finance were reviewed.** The most recent survey included an ad hoc set of questions on collateral requirements, while the regular questionnaire was enriched with additional questions on export intensity, interest rates and sources of financing such as leasing and non-bank loans. The sample size was increased and over 11,000 enterprises were interviewed in the euro area in the most recent survey round. In cooperation with the European Commission, a larger version of the survey with an extended questionnaire covering all countries in the European Union as well as neighboring countries, has been conducted since 2013 on an annual basis (previously on a biennial basis). The next large survey will be conducted between September and October 2015 and the results will be published on 1st December 2015.

9. **The ECB supported the launch in November 2014 of the Special Data Dissemination Standard plus, the third and highest tier of the IMF's Data Standards Initiatives.** Seven of the eight countries in the first cluster of adherents to the Fund's initiative were EU Member States.

10. **The IMF Executive Board decided on December 22nd 2014[5] to change the interest rate for the euro component of the SDR interest basket.** The new rate is the three-month spot rate derived from a yield curve based on euro area central government bonds with a rating of AA and above, published daily by the ECB. It replaced the three-month Eurepo rate, following the discontinuation of the Eurepo rate as of 31 December 2014.

[5] See IMF Press Release 14/601.

Statement by the Staff Representative on the Euro Area
July 24, 2015

This statement provides information that has become available since the issuance of the staff report. The information does not alter the thrust of the staff appraisal.

The situation in Greece has been evolving rapidly. Since the issuance of the staff report, the Greek parliament passed a package of reforms as the basis for starting negotiations on a new ESM program. National parliaments in several euro area countries have endorsed these reforms. With the approval of bridge financing by the European Council, Greece met a July repayment to the ECB and cleared its arrears to the Fund. And the ECB last week increased its cap on emergency liquidity assistance (ELA) to Greek banks.

Market developments have been broadly positive, returning asset prices to the levels prior to the recent turbulence. Spreads on 10-year European sovereign bonds relative to the German Bund have declined, while European equities—led by bank stocks—have gained. The 10-year German Bund yield has also fallen to under 0.8 percent, reflecting expectations of continued sovereign asset purchases by the ECB. The euro is trading more than 3 percent lower relative to the U.S. dollar, partly reflecting expectations of earlier U.S. policy rate normalization.

The market reaction to both the initial deterioration and the subsequent improvement suggests that new policy instruments such as QE, as well as a stronger banking union have helped limit contagion. Nonetheless, further episodes of significant uncertainty and volatility arising from the situation in Greece cannot be ruled out. As noted in the staff report, policymakers should stand ready to deploy, and if necessary adapt, the full arsenal of available instruments to manage spillovers. Beyond the near term, steps should be taken to strengthen the monetary union and European firewalls. Fully severing bank-sovereign links would require a common deposit insurance scheme with a fiscal backstop, a larger and fully funded Single Resolution Fund, and easier access to direct bank recapitalization from the ESM. Such additional risk-sharing should be supported by a stronger fiscal and structural governance framework.

Statement by Menno Snel, Executive Director, on the Euro Area
July 24, 2015

In my capacity as President of EURIMF, I submit this Buff statement on the Article IV consultation with the euro area. It reflects the common view of the Member States of the euro area and the relevant European Union institutions in their respective fields of competence.
The authorities of the euro area Member States and EU institutions are grateful for open and fruitful consultations with staff and for their constructive policy advice.

The authorities are in broad agreement with staff findings and recommendations at the current juncture and the focus on medium-term growth challenges. A reinforced policy response to address the growth weakness is essential. Such a policy response needs to address in a comprehensive way both demand and supply side factors and should focus on the implementation of structural reforms, responsible and growth-friendly fiscal policy, and stronger investment via the European Investment Plan. In particular, structural reforms are needed not only to support the recovery in the short term and tackle the legacies of the crisis in terms of high debt levels but also to boost medium-term growth prospects, ensure social sustainability and decrease inequality.

Economic outlook, inflation and risks

The authorities broadly share staff's view on economic prospects. Supported by a number of structural reforms and tailwinds, the economic recovery has been strengthening and is expected to gain further momentum in 2015-16.

In the first quarter, real GDP increased by 0.4 percent (quarter-on-quarter), following an expansion of the same size in the fourth quarter of 2014 and thereby registering the highest 6-month growth rate since mid-2011. The favourable development reflects the positive growth impact of a number of tailwinds, which include low oil prices, a lower external value of the euro, and increased policy support, including the ECB’s non-standard monetary policy measures. Moreover, the cyclical recovery is supported by more durable factors such as the fruits of previously implemented reforms, in the context of a broadly neutral fiscal stance. Looking ahead, tailwinds should remain strong enough to mitigate the impact of a slightly weaker global growth outlook than earlier expected, less dynamic global trade, and a possible future rebound in oil prices. According to the Commission services' Spring 2015 forecast, real GDP should grow by 1.5 percent in 2015 and by 1.9 percent in 2016, with all domestic GDP components making positive contributions in both years. This outlook is also broadly in line with staff's forecast, which appears to remain slightly less optimistic for 2016 despite an upward revision in the WEO update of 9 July. This is mainly due to a more pessimistic view on the staff’s side on the rebound in investment in 2016. Accelerating economic activity should allow for further improvements in labour market conditions, from which private consumption will benefit. Increased demand and somewhat lower balance-sheet adjustment needs should support greater investment, helping the economic recovery to become more sustainable. Moreover, the Investment Plan for Europe should impact next year, lifting

both public and private investment. Exports too should benefit from the lagged competitive impulse stemming from the depreciation of the euro. Finally, GDP growth should continue benefitting from previously-implemented reforms and the lower fiscal drag. The strength in GDP growth will, however, continue to be restrained for some time by the impact of some adverse factors. These include high unemployment rates and still on-going deleveraging needs in some countries as well as geopolitical tensions.

After inflation dynamics weakened at the turn of the year, dragging inflation below zero, HICP inflation has moved up in the second quarter 2015. According to the Commission services' Spring 2015 forecast, inflation should come in at 0.1 percent in 2015 and move up to 1.5 percent in 2016 as the impact of the fall in oil prices fades, economic slack diminishes, and the depreciation of the euro raises import prices. The staff's outlook for a more moderate increase in inflation appears to reflect mainly the expected slower closing of the output gap.
The staff's assessment highlights that risks to the growth outlook are now more balanced than in recent years, but refrains from assessing the overall balance. The authorities regard this process as having brought overall risks by the time of their forecast releases already into a broadly balanced position. Deflation risks have declined in response to the ECB's non-standard monetary policy and risks to the inflation outlook appear now balanced.

The authorities share staff's view that timely and effective policy responses are essential to mitigate the near-term risks stemming from uncertainty surrounding Greece. While direct spillovers through financial links are generally limited, the increased uncertainty can have impact through indirect channels. The Member States as well as EU institutions are determined to use all the available tools to address the possible spillovers to the rest of the euro area. The implementation of proposals to strengthen the Economic and Monetary Union, as set out in the June Five Presidents Report, will be important to enhance the solidity and successful performance of the euro area as a currency union.

Supporting macro policies to boost demand

- **Monetary policy**

The ECB's monetary policy remains very supportive to the economic recovery. It contributes to economic growth, a reduction in economic slack, and money and credit expansion. The positive effects in financial markets are passed through to the cost and availability of credit for firms and households. Combined monthly purchases under the expanded asset purchase programme, amounting to €60 billion on average, are intended to run until end-September 2016, and in any case until the ECB's Governing Council sees a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to, 2 percent over the medium term. The ECB closely monitors the situation in financial markets as well as its potential implications for the monetary policy stance and for the outlook for price stability. If any factors were to lead to an unwarranted tightening of monetary policy, or if the outlook for price stability were to materially change, the ECB would respond to such a situation by using all the

instruments available within its mandate. To reap the full benefits of the latest monetary policy measures, the contribution of other policy areas is decisive.

- **Financial stability**

The authorities concur with the IMF's findings that over the past months financial markets and institutions in Europe have overall further stabilised. The impact of revised financial regulation in the EU and the start of operations of the SSM have been important contributing elements to this development. The main risks to financial stability stem from the eventuality of an abrupt reversal of global risk premia and weak profitability prospects for banks and insurers. Furthermore, despite progress over recent years, balance sheets of some financial institutions and some of their non-financial clients, private or public, remain much leveraged. Non-bank financial institutions also deserve close monitoring in order to defuse any emerging stability risk emanating from their part.

- **Fiscal policy**

On the fiscal policy side, the authorities broadly agree with the Fund's assessment that the current fiscal stance for the euro area is appropriate. Fiscal policies should reflect the economic conditions and sustainability risks at Member State level, while ensuring a good co-ordination of economic policies. One of the key policy challenges facing the euro area is to reduce government debt by pursuing fiscal responsibility. Thanks to the consolidation efforts of the past years, the euro area fiscal situation has improved but the coordination of fiscal policies remains sub-optimal. A number of euro area Member States still need to continue with fiscal adjustment to bring down very high levels of debt. Other countries have more room for manoeuvre and could use it to encourage domestic demand, with a particular emphasis on investment; along with structural reforms this would support domestic growth and the euro area as a whole. Euro area Member States will continue to closely monitor and discuss the aggregate fiscal situation of the euro area including the fiscal stance. Furthermore, more efforts will be made to prioritise investment and raise the quality of public expenditure as fiscal strategies are not yet sufficiently growth-friendly. On the revenue side, despite increased coordination in the Eurogroup, there is further scope for improving the efficiency of tax systems and reducing the tax wedge on labour. On the expenditure side, more focus is needed on public investment, backed by sound cost-benefit analysis, and other public expenditure with strong and positive growth effects. Spending reviews have emphasised the need for efficiency gains in public administration. Well-functioning national fiscal frameworks will support this process.

The flexibility embedded in the Stability and Growth Pact rules allows Member States to facilitate structural reforms and investment, while following the commonly agreed rules. The Commission Communication on the use of the flexibility within the existing rules, published in January 2015, provides clarifications on the way public investment and structural reforms will be assessed under SGP rules. Contrary to what could be understood from the staff’s report, it did not introduce any new elements concerning one-offs. As stated in the January Communication, the eligibility conditions required to

benefit from the investment and/or the structural reform clause aim at safeguarding against unsustainable deviations from MTOs. A distinction has to be made between the two clauses as the investment clause is linked to the condition that the Member State concerned is forecast to be in "economic bad times", while this condition does not apply to the structural reform clause. These eligibility conditions do not prevent Member States from using their fiscal capacity to engage in structural reform and investment. First, well-financed structural reforms and investments are more than encouraged and fully compatible with the SGP. Second, ensuring that deviations from MTOs are only temporary is a necessary condition for long-term fiscal sustainability, which in turn guarantees future fiscal capacity of the Member State to invest and engage in structural reforms.

On the windfall from lower interest payments, the authorities agree that notably countries with high debt should use windfalls gains to make further progress to consolidate public finances, while countries with low debt which are at or above their MTOs could use windfalls to support structural reforms and increase public investment.

- **The Investment Plan for Europe**

The authorities welcome staff's positive assessment of the Investment Plan for Europe in general and of the European Fund for Strategic Investments (EFSI) in particular. As for the EFSI, the authorities agree that careful project selection and swift implementation will indeed be key to the initiative's success. At the EU level, all elements have been put in place in order to ensure both. Importantly, projects will be selected by a committee of independent experts, strictly on the basis of a project's merit. This governance structure, complemented by a large but exhaustive list of strategic investments areas (e.g. energy, infrastructure, resource efficiency) ensures that a good balance is found between a market-based initiative and the rationale for public intervention. Importantly, several EU Member States have already committed significant sums to contribute to the financing of EFSI-supported projects, confirming the strong support for this approach and for investment in general. As staff correctly points out, the EFSI's activities will need to be complemented by further improvements of the EU's business environment going forward.

In addition to the EFSI, the so-called Third Pillar of the Investment Plan involves taking actions both at EU and country level to unlock the full potential of investment in Europe by removing barriers to investment and reinforcing the single market. Improving the regulatory framework will contribute to its greater transparency and predictability, which are of crucial importance in particular for long-term and large-scale investments such as in infrastructure and cross-border investment. Among the priorities of the 2015 work programme, the authorities and the EU Institutions are committed to develop the Capital Market Union, to further deepen the Single Market for goods and services, to develop a truly connected Digital Single Market and to make the most of the Single Market in energy (Energy Union) and transport. This comes in addition to pursuing an enhanced implementation of existing Internal Market rules, which is a shared responsibility of the EU and the Member States.

Stronger bank balance sheet repair to support lending

The authorities would like to recall the efforts undertaken in the last years to strengthen the banking sector, and highlight the landmark importance of the Comprehensive Assessment completed since the last year's consultation, prior to the entry into force of the SSM. In a context of moderate growth and crisis legacies, they broadly concur with staff's views on the need to continue repairing bank balance sheets. Indeed, balance sheets of many financial institutions, companies and households continue to be stretched. Non-performing loans (NPLs) of banks remain very high particularly in some countries, and have further risen in some cases. Addressing these high NPLs is a necessary, though not sufficient, condition to support lending to the private sector and, thereby, growth and jobs. Some of the euro area Member States, have already acquired good experience in significantly and rather rapidly reducing NPLs, for example by setting up Asset Management Companies.

The authorities would have to further explore how the incentives framework can be strong enough for banks to address their NPLs and how solutions could be found, considering also the applicable EU rules on state aids and on bank resolution (BRRD).

As rightly pointed out by the staff's report, the legal, institutional and market framework could also usefully be revisited in many Member States in order to support further and quicker balance sheet repair of banks. This includes foreclosure and bankruptcy laws and judicial procedures, markets for distressed loans and tax rules, as well as strengthened prudential supervision. Progress on these fronts is being made in several Member States.

Regarding the Capital Market Union, the authorities would like to point out that following the publication of the Commission's Green Paper, an action plan is under preparation. The objective is to set a single market for capital aimed at cost efficiency, enhanced competition and diversification of funding sources. The emphasis has been put in particular on: (1) SMEs, which are likely to be the most constrained by the absence of a well-developed and integrated capital market, and (2) on the need to carefully recalibrate the regulatory framework to enhance investment and access to finance. This is badly needed to improve market-based risk sharing in the euro area and make our economy more resilient to shocks.

Structural Reforms to boost productivity, employment and investment

In terms of structural reforms, the authorities agree that targeted and country-specific policy action is needed. Structural reforms, both in labour and product markets, will play a key role in the current context, not only to foster investment and boost employment and potential growth, but also to support the rebalancing process by facilitating the reallocation of resources between sectors, helping to regain competitiveness and improving the business environment in several euro area Member States. While there are encouraging signs showing that structural reforms are starting to bear fruit, the need to accelerate structural reforms has been further stressed by the Commission in its May 2015 surveillance package in the context of the European Semester. With regard to this,

the Council has adopted country-specific recommendations (CSR) that provide country-specific policy advice to the Member States.

Relevant reforms at national level cover a wide set of measures that aim to improve the functioning of labour and product markets and the business environment by removing barriers to financing and launching of investment projects, such as inefficient taxation system, low transparency and efficiency of the public administration, barriers to access to finance both for SMEs and for long-term projects, as well as more specific barriers to investment in infrastructure (in energy, transport and broadband). Reinforcing the Single Market will allow firms to operate on a bigger scale, thereby enhancing their capacity to innovate, invest, become more productive and create jobs. Efforts to further deepen the single market, notably for services, the digital economy and energy will play an important role in upholding the reform momentum. The authorities strongly believe that the ongoing recovery provides a window of opportunity to implement reforms that will lift the economy on a more solid medium-term growth path.

Better economic governance in the euro area

Regarding governance issues, the authorities agree that there is need to reflect on how to improve and streamline the surveillance system and, furthermore, complete the euro area architecture. The Report on “Completing Europe’s Economic and Monetary Union”, published in June under the personal authority of the Five Presidents, a result of numerous consultations between the authorities and the EU Institutions, sets the stage for the next steps on better economic governance in the euro area. It specifically recommends accelerating the completion of the Banking Union and reinforce Europe's governance framework to enhance convergence, competitiveness and stability.

The Five Presidents Report also mentioned the concept of benchmarking as an avenue to pursue stronger economic convergence within the Economic and Monetary Union. Regarding the use of outcome-based benchmarks for euro area-wide priorities in structural reforms, as recommended in the staff assessment, the authorities would like to signal that the approach would need to be studied further. On the one hand, outcome-based benchmarks could increase the specificity of the reform agenda, and improve transparency and accountability in the application of the current framework. On the other hand, identifying appropriate outcome-based benchmarks and finding indicators that meet the requirements in terms of measurability and timeliness and also sufficiently correlate with the final outcome desired by policymakers could be difficult.