



EURO AREA POLICIES

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR

July 2014

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 2014 Article IV consultation with the member countries, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 9, 2014 following discussions that ended on June 2, 2014 with the officials of the Euro Area on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 25, 2014.
- A **Press Release** on the Executive Board's discussion.
- A **Statement by the Executive Director** for the Netherlands.

The following document has been or will be separately released.

Selected Issues Paper

The publication policy for staff reports and other documents allows for the deletion of market-sensitive information.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



EURO AREA POLICIES

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

June 25, 2014

KEY ISSUES

Context. Real output has expanded for four consecutive quarters, and financial market sentiment has improved markedly. But the recovery is weak and uneven. Inflation has been too low for too long, financial markets are still fragmented, and structural gaps persist: these hinder rebalancing and substantial reductions in debt and unemployment.

Policies. The economic expansion is grounded in complementary policy actions at both the national and euro area levels, but more is needed to strengthen the recovery:

Supporting Demand. Recent ECB actions—including a rate cut, negative deposit rates and policy support for new bank lending to companies—should help address low inflation and financial fragmentation. But if inflation remains too low the ECB should consider a substantial balance sheet expansion, including through asset purchases. The broadly neutral overall fiscal stance is appropriate but any negative growth surprises should not trigger additional consolidation efforts as this would be self-defeating.

Mending balance sheets and completing the banking union. Successfully executing the ongoing asset quality review and stress tests should spur balance sheet repair and help reverse fragmentation. Agreement on a single resolution mechanism and bail-in rules comprise important milestones towards banking union, but a common fiscal backstop is still needed.

Advancing structural reforms. Alternative sources of funding through securitization, especially to credit-constrained SME's, should be promoted. A comprehensive strategy, which boosts demand and removes country-specific structural impediments, is needed to tackle high youth unemployment. Competitiveness-enhancing reforms in debtor countries and higher public investment in creditor countries would promote needed rebalancing.

Approved By
**Mahmood Pradhan
 and Hugh
 Bredenkamp**

Discussions took place during May 19–June 2, 2014. Mission members included M. Pradhan (head), P. Koeva Brooks, S. Aiyar, S. P. Berkmen, J. Bluedorn, A. Jobst, and S. Saksonovs (all EUR), L. Eyraud (FAD), and C. Mumssen, B. Barkbu, and H. Schoelermann (all IMF Office in Europe). Executive Director M. Snel and his advisor L. Piana, as well as ECB Observer at the IMF G. Pineau and his advisor G. Pula participated in some meetings. Support from headquarters was provided by A. Al-Eyd, A. Banerji, K. Cincotta, P. Lukyantsau, X. Shao, S. Wang, and T. Wu (all EUR).¹

CONTENTS

CONTEXT: FROM CRISIS TO RECOVERY	4
OUTLOOK: A LONG ROAD TO FULL RECOVERY	7
THE POLICY AGENDA: STRENGTHENING THE RECOVERY	8
THE AUTHORITIES' VIEWS	21
STAFF APPRAISAL	23
BOXES	
1. Investment in the Euro Area: Why has it been Weak?	6
2. Stability and Growth Pact—Design and Implementation Issues	12
3. Capital Market Development: SME Financing in the Euro Area	17
4. Youth Unemployment in the Euro Area: Okun's Law and Beyond	19
5. External Rebalancing in the Euro Area: Developments and Policies	20
FIGURES	
1. Euro Area: High Frequency Indicators	31
2. Financial Market Developments	32
3. Euro Area: Inflation Developments	33
4. Debt Overhang in the Euro Area	34
5. External Sector Developments	35
6. Japan's Deflation Episode and Current Euro Area Developments	36
7. Fiscal Developments and Policies	37
8. Euro Area: Banking Sector Developments	38

¹ The mission would also like to thank euro area authorities, in particular President M. Draghi (European Central Bank), Chairperson Danièle Nouy (Single Supervisory Board), Head of Secretariat F. Mazzaferro (European Systemic Risk Board), Managing Director K. Regling (European Stability Mechanism), 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.

TABLES

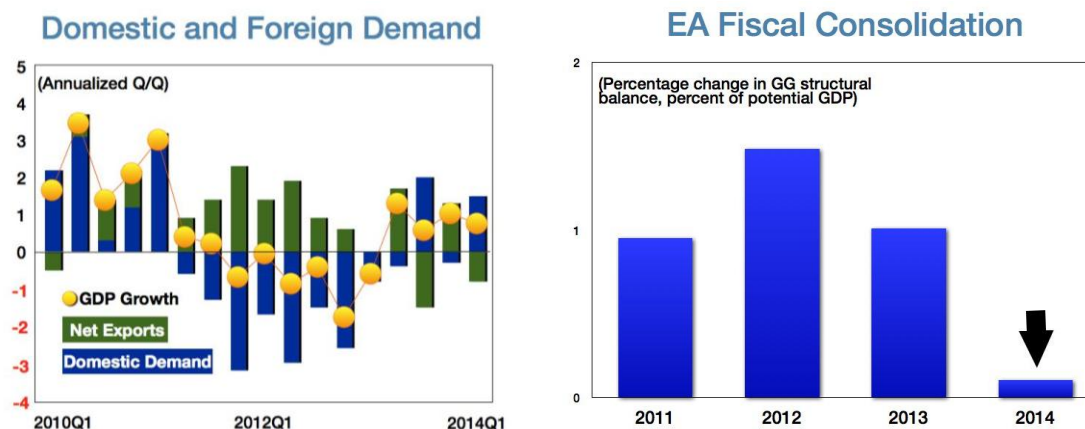
1. Euro Area: Main Economic Indicators _____	26
2. Risk Assessment Matrix _____	27
3. A Scorecard Approach to the Near-Term Fiscal Stance from April 2014 WEO _____	28
4. Structural Reform Plans and Progress in Selected Countries _____	29

APPENDIX

Statistical Issues _____	39
--------------------------	----

CONTEXT: FROM CRISIS TO RECOVERY

1. **The euro area recovery is taking hold** (Figure 1). Real activity has expanded for four consecutive quarters. An incipient revival in domestic demand, owing partly to reduced fiscal drag, is adding to the impetus from net exports.



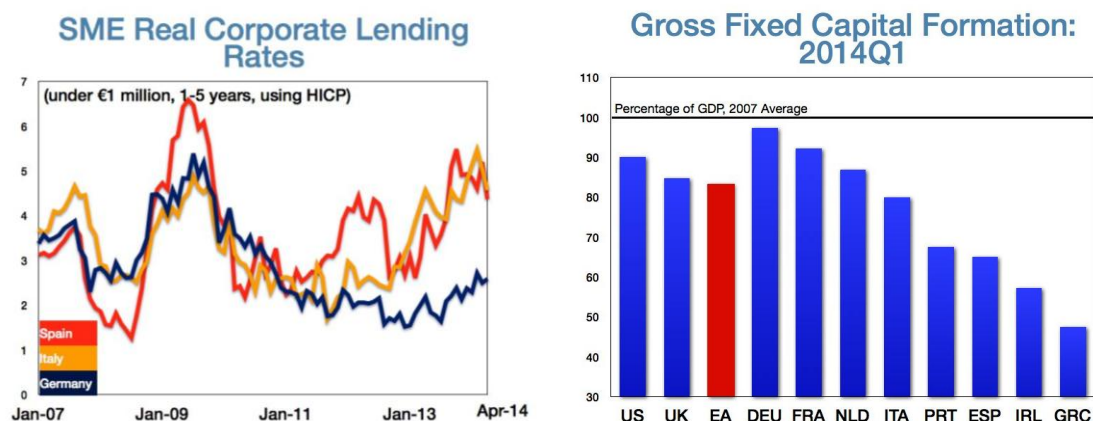
2. **Financial market sentiment has improved dramatically** (Figure 2). Sovereign and corporate yields have fallen markedly, benefiting from increasing foreign demand. This has narrowed sovereign spreads between stressed and core economies, and supported corporate bond issuance and equity markets across the region. Bank funding costs have also declined, helping banks to raise capital and deleverage their balance sheets.

3. **Strong policy actions have boosted investor confidence and laid the foundations for recovery.** At the national level, governments have made further progress repairing sovereign and bank balance sheets and implementing structural reforms to restore competitiveness. At the area-wide level, the ECB has taken a wide range of measures to support demand and address fragmentation. The Comprehensive Assessment of systemically important banks is on track to be completed in October 2014 before the ECB assumes supervisory responsibilities in November 2014. Further progress on building a banking union—such as the agreements on a Single Resolution Mechanism (SRM), backed by a Single Resolution Fund (SRF), the Bank Recovery and Resolution Directive (BRRD), and the deposit insurance harmonization directive—has demonstrated the collective commitment to EMU.

4. **But the appetite for further integration has diminished.** The euro-skeptic outcome of the European elections may pose risks to the single market (particularly the free flow of labor) and test the credibility of the nascent fiscal governance framework. With the economic recovery taking hold and financial markets rallying, additional progress on reforms may be prone to reform fatigue—both at the national and euro area level.

5. And lingering damage from the crisis has manifested itself in several ways.

- *Real activity and investment in the euro area have yet to reach pre-crisis levels.* In the first quarter of 2014, euro area growth was weaker than expected and unevenly distributed across countries. Investment continues to be constrained by limited access to credit in stressed countries (Box 1).



- *Financial markets are still fragmented.* Private borrowing costs remain too high in stressed economies. The flow of credit to the private sector in stressed economies is contracting at a faster rate than for the euro area as a whole, with SMEs in particular subject to credit rationing. Moreover, cross-border banking flows continue to shrink, suggesting that liquidity provision is becoming splintered along national lines.
- *Inflation remains worryingly low.* Both headline and underlying inflation rates are fluctuating below 1 percent—away from the ECB’s price stability objective of close to (but below) 2 percent for headline inflation (Figure 3). They remain low even in the core. Energy and food price developments, euro appreciation, and structural reforms have contributed to disinflationary pressures but cannot fully explain them. The still-sizeable output gap continues to pull down inflation. Although long-term inflation expectations remain anchored, short- and medium-term expectations have been drifting down.
- *Unemployment and debt are still stubbornly high.* The average unemployment rate for the euro area remains at 12 percent, although it is much higher in economies under stress. Youth unemployment is even more elevated, averaging 24 percent across the region, but with unprecedented highs in stressed economies (e.g., over 50 percent in Greece). Private and public debt levels remain elevated in many countries (Figure 4).

6. **For the euro area as a whole, the external position is assessed to be broadly in line with medium-term fundamentals and desired policies** (Figure 5). But this masks the asymmetry of past adjustments and some continued imbalances, viz. an undervaluation in some creditor economies and overvaluation in most debtor economies (see 2014 External Sector Report). In debtor countries, relative price adjustments have been proceeding gradually. While these efforts have contributed to a rebound in exports, slumping internal demand has accounted for much of the reduction in current account deficits in these economies. This has not been matched by stronger demand and lower external surpluses in the core. Hence, the current account surplus of the euro

area as a whole has grown further, putting upward pressure on the euro. Staff analysis indicates that further adjustments in relative prices are still needed for some countries to regain competitiveness. Such adjustments will be increasingly difficult to achieve, given nominal rigidities in these countries and low inflation in trading partners. A fall in the surpluses of creditor countries would allow debtor country surpluses to increase further without pressure for euro appreciation. In addition, although the euro is broadly in equilibrium in real terms, a weaker nominal exchange rate (and higher inflation) would help support the recovery by improving cyclical conditions.

Box 1. Investment in the Euro Area: Why has it been Weak? ^{1/}

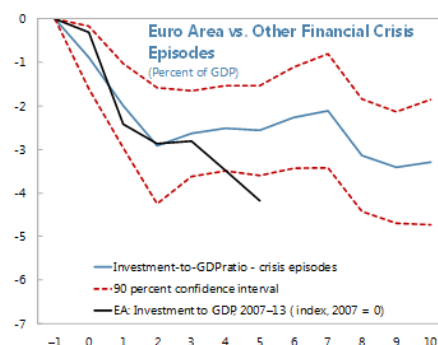
Investment has been hit hard since the onset of the crisis. It remains below its pre-crisis level, particularly in stressed countries and it has been weaker than in most previous recessions and financial crises

Staff analysis shows that output changes can explain broad trends in investment in the euro area and selected individual countries. But, in most cases and with the exception of Spain, a model controlling for output changes only does not fully account for the decline in real non-residential private investment after the European sovereign debt crisis.

The elevated cost of capital, greater financial constraints, high corporate leverage, and uncertainty have also weighed on investment across the euro area. The relative importance of different factors varies across countries. The real cost of capital is important in explaining investment in many cases.² In addition, financial constraints (from the EC consumer and business survey) have limited investment, particularly in stressed countries. High corporate sector leverage and uncertainty are additional impediments to investment in Italy, Spain, and to a lesser extent in Portugal and France.

Output changes and country specific impediments explain the weak investment performance well. While output dynamics play a dominant role in determining investment, the real cost of capital, credit rationing (proxied by a financial constraints variable), high corporate indebtedness, and uncertainty are additional factors pulling down investment across the euro area, particularly after the European sovereign debt crisis. For example, while investment in cumulative terms (since 2010Q2) has been below the levels that would have been predicted by controlling only for output changes (about 3 to 6 percent of GDP), once the other factors are controlled for the “missing” investment declines to about ½ to 2 percent of GDP.

Investment is expected to pick up as the recovery strengthens and uncertainty declines. However, a sustained recovery in investment will require dealing with the corporate debt overhang and financial fragmentation. Corporate debt-to-equity remains elevated in some stressed countries, and the deleveraging process is still at an early stage. At the same time, borrowing costs need to be substantially lower particularly for smaller firms.



Sources: WEO 2014, Chapter 3; and staff calculations.

Notes: Gross fixed capital formation in percent of GDP. The entire sample of advanced economy financial crises between 1970 and 2007 identified by Laeven and Valencia (2012). Dashed red lines denote 90 percent confidence bands; and black line denotes the actual evolution of the investment-to-GDP ratio in the euro area from 2007 to 2013. X-axis units are years; t = 0 denotes the year of the financial crisis.

¹ Prepared by Bergljot Barkbu, Pelin Berkmen, Pavel Lukyantsau, Sergejs Saksonovs, and Hanni Schoelermann.

² The real cost of capital is calculated as a weighted average of financing costs of bank loans, corporate bonds, and equities, adjusted for inflation and depreciation. In stressed economies it is currently higher than its historical average, while for Germany it is lower. See the accompanying Selected Issues Paper for further details.

OUTLOOK: A LONG ROAD TO FULL RECOVERY

7. **Despite recent improvements in financial markets and economic prospects, the obstacles to strong, sustained growth remain substantial.**

- *Insufficient aggregate demand* is weighing on real activity and pulling down inflation across the euro area, as corporates, households and banks all attempt to repair their balance sheets. Despite the reduced drag from fiscal policy, contracting credit and high borrowing costs are constraining investment in countries with large output gaps, large debt burdens, and high unemployment.
- *Impaired balance sheets* continue to inhibit monetary transmission and the flow of credit, particularly to SMEs. Weakness in banks' balance sheets and uncertainty about their quality are contributing to fragmentation, constraining the ability and willingness of banks to support credit and investment. Corporate and household debt overhangs in some countries are further reinforcing fragmentation along national borders.
- *Remaining structural gaps* in capital, labor, and product markets present hurdles to financing investment, deploying resources from non-tradable to tradable sectors, adjusting relative prices, raising productivity, and creating jobs.

8. **Against this backdrop, the outlook is for a modest recovery and subdued inflation (Table 1).**

- Growth is projected at a little over 1 percent this year and 1½ percent next year. This is predicated on a further pick-up in domestic demand, owing to limited fiscal drag, better lending conditions, and resilient external demand. In the medium run, the euro area economy is expected to expand at a moderate pace (1½ percent), reflecting the many constraints to growth bequeathed by the crisis. Thus, the output gap is not expected to close until 2019.
- Inflation is expected to remain below the ECB's primary price objective for a protracted period. Persistent output gaps, weak credit conditions, and an impaired monetary transmission mechanism—especially in stressed economies—will combine to contain prices. Annual inflation in the euro area is forecast at 0.7 percent this year, before picking up to 1.2 percent in 2015.
- The current account surplus of about 2¼ percent of GDP is forecast to persist, with the pick-up in domestic economic activity balanced by sustained external demand from major trading partners (e.g., the US and China).

9. **Risks are still tilted to the downside** (Table 2). With limited policy space in the near term, further negative shocks—either domestic or external—could sour financial market sentiment, halt the recovery, and push the economy into lower inflation and even deflation (see Risk Assessment Matrix). Bond market stresses could re-emerge if the AQR or stress tests uncovered unexpectedly large capital shortfalls in the absence of a common fiscal backstop. External risks could stem from a

slowdown in emerging market growth, escalation of geopolitical conflict, and an abrupt exit from unconventional monetary policies in the United States (see Spillover Report). Over the medium term, there is a high risk of stagnation, which could stem from persistently depressed domestic demand due to deleveraging, insufficient policy action, and stalled structural reforms. More positively, improved confidence could raise growth above forecast levels. For example, greater political and policy certainty could boost investment sentiment and create a virtuous cycle.

10. **A protracted stagnation could have significant spillovers on neighboring European countries through trade and financial channels.** Staff analysis suggests a 1 percentage point slowdown in the euro area could reduce growth in emerging European countries by an estimated $\frac{1}{2}$ - $\frac{3}{4}$ percentage points. Low inflation is already affecting countries in the region, especially those that peg their currencies to the euro, with core inflation in some of these countries in negative territory. In this context, further unconventional monetary easing in the euro area would generate positive spillovers for trade partners by supporting domestic growth and inflation, outweighing potentially adverse effects on balance sheets (due to possible currency depreciation).

THE POLICY AGENDA: STRENGTHENING THE RECOVERY

11. **To strengthen the recovery, policy efforts should focus on three priority areas:** (1) support demand (to reduce spare capacity and combat low inflation/deflation risks); (2) repair balance sheets and completing the banking union (to tackle fragmentation, revive credit supply, and ensure financial stability); and (3) advance structural reforms (to boost investment, employment, productivity, and foster rebalancing). Such policies would help mitigate risks to the recovery and reduce spillovers from low growth and low inflation to the rest of the world (see Spillover Report).

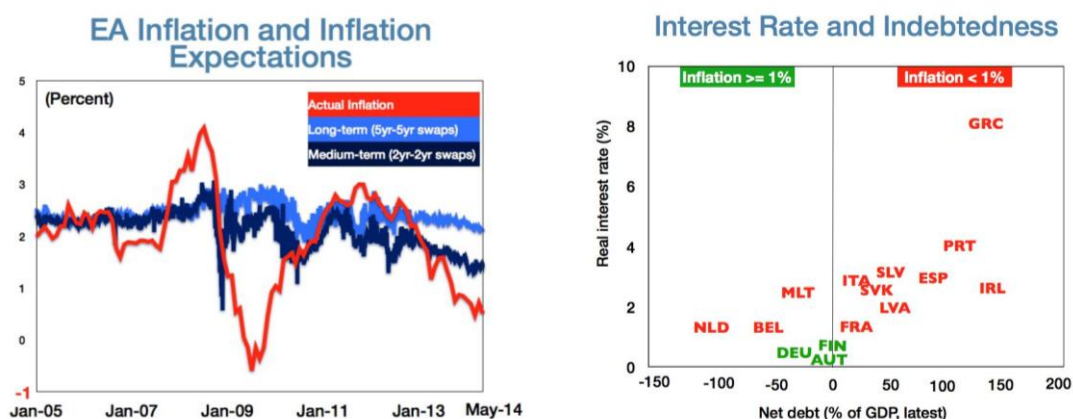
Providing more demand support to tackle low inflation and strengthen the recovery

12. **Further monetary policy easing would counteract the dangers posed by an extended period of low inflation.** Several considerations point in the same direction:

- *Damage from “low inflation”:* By keeping real interest rates and real debt burdens elevated, very low inflation stifles demand. Given significant downward nominal rigidities in debtor economies and low inflation in creditor economies, it also makes difficult the adjustment in relative prices and real wages that must occur for sustainable growth to take hold.
- *Deflation risk:* Negative external shocks and/or further euro appreciation could easily push inflation into negative territory.
- *Undershooting target:* A persistent failure to meet the inflation target could undermine central bank credibility and de-anchor inflation expectations. Staff analysis suggests that even a small

and temporary decline in inflation expectations could have sizeable output effects (see Spillover Report).

- *Expectations*: Past deflationary episodes illustrate that long-term expectations tend to adjust too little and too late to provide a useful signal for monetary policy (Figure 6). In this context, the recent downward movement in short- and medium-run inflation expectations could be worrisome.



- *Shrinking balance sheet*: The contraction of its balance sheet (in the context of LTRO repayments) has made it increasingly difficult for the ECB to credibly communicate that monetary conditions will be kept sufficiently accommodative, particularly when conventional policy space is almost exhausted. This puts upward pressure on the euro, pulling inflation down further.

13. **Most recently, the ECB announced a wide range of actions.** Fully in line with past staff recommendations,² these measures will help tackle low inflation and address fragmentation. Collectively, they should lead to a substantial expansion of liquidity.

- The *reductions in policy interest rates* (by 10 basis points for each the MRO and deposit rates, taking the latter to negative territory, and by 35 basis points for the MLF) will provide a credible signal of the ECB's accommodative stance, and will limit the level and volatility of money market rates. The broad application of the negative deposit rate will ensure that banks do not arbitrage their deposit holdings across other facilities.
- The *targeted credit easing (TLTROs)* will support term funding and ensure credit provision. The substantial tenor and successive operations of the TLTROs are likely to attract a wide range of banks, thereby helping to address both fragmentation and low inflation. While the initial TLTRO allocation may offset some of the repayment of the previous 3-year LTRO coming due, the new TLTRO offers significant incentives for banks to use the facility. Nevertheless, the ECB has only indirect control over the expansion of its balance sheet, as take up depends on banks' demand.
- The *extension of fixed rate full allotment* will strengthen the ECB's forward guidance and ensure the continued availability of liquidity.

² See the staff report for the 2013 Article IV consultation with member countries.

- The *suspension of sterilization of the SMP holdings* is warranted given low inflation and new measures to boost liquidity. It will help ease money market pressures by freeing up around €165 billion (current SMP holdings).
- The *extension of existing collateral eligibility* will enhance access to liquidity facilities for stressed banks.
- The preparatory work related to outright purchases of ABS is being intensified. If and when implemented, direct ABS purchases would circumvent the banking system, helping to address fragmentation and providing the ECB direct control over the expansion of its balance sheet. However, the ABS market is small, limiting its effectiveness to address low inflation.

		Monetary Policy Options 1/			
		Low inflation	Fragmentation	Effectiveness	Transmission channels
Recent Actions					
Policy rate cuts:	a) Lowered main policy rate (MRO) and narrowed the upper bound of the corridor (MLF)	√	√	Limited impact (10 bps decline of the MRO to 15 bps; and 35 bps decline in MLF to 40 bps)	Credit; Signaling
	b) Implemented negative deposit rate	√	√√	Limited impact; marginally negative (zero to -10 bps)	Credit; Signaling; Exchange rate
Targeted LTROs (TLTROs):	Targeted to net lending at a very low rate (MRO+10 bps) ; Up to €400 billion until March 2015; Additional quarterly operations until June 2016; All maturing in September 2018	√	√√	Supports term-funding and ensures credit provision; Substantial tenor and successive operations likely to attract a wide range of banks; but indirect control over the balance sheet	Bank lending; Signaling; Liquidity
Collateral Policy:	Extended existing eligibility of additional assets as collateral for all ECB liquidity facilities (additional credit claims), at least until September 2018	√	√	Enhances access to TLTROs and other liquidity facilities for stressed banks	Liquidity
Extension of fixed rate full allotment	Fixed rate full allotment for MROs to at least December 2016 and 3-month LTRO facility to December 2016.	√	√	Strengthens the forward guidance; ensures short-term liquidity	Liquidity
Halt SMP sterilization		√	√	Eases money market pressures, but limited impact (outstanding amount at about €165 billion)	Liquidity
Outright ABS purchases (Forthcoming)	Intensification of preparatory work related to outright purchases of ABS.	√	√√	If implemented, circumvent banking system; Direct control over the balance sheet; But limited size	Credit; Signaling
Additional Options					
Quantitative Easing (QE): Sovereign assets		√√√	√√	Broad based; Sustained; Direct control over the balance sheet	Portfolio rebalancing; Signaling; Asset prices & credit; Exchange rate
Credit easing:	Direct additional private asset purchases	√√	√√√	Small private asset pool; Circumvents banking system; Direct control over the balance sheet; More effective if implemented with QE	Asset prices and Credit; Signaling
New fixed rate LTROs: (of sufficient tenor)	V-LTRO for general liquidity (with a considerable tenor) to complement the targeted LTROs, facilitating a sizeable balancing sheet expansion	√√	√	Attractive for all banks; Indirect control over the balance sheet	Bank lending; Signaling; Liquidity
Money market support:	Direct intervention (forward MMRs or euro repo markets)	√	√	Useful in response to external shocks; but limited to periods of stress	Forward guidance; Signaling

1/ Check marks reflect subjective evaluation of relative importance of the measures in addressing low inflation and fragmentation.

14. **Also reassuring is that if inflation remains too low, the ECB has expressed willingness to do more.** In staff's view, this should involve a substantial balance sheet expansion, including through asset purchases.

- The deepest potential market for asset purchases—and therefore likely the most effective in significantly expanding the ECB's balance sheet—is the **sovereign bond market**. Buying sovereign assets, in proportion to ECB capital key, would reduce government bond yields, induce higher equity and corporate bond values, and ultimately raise demand and inflation expectations across the euro area. Such purchases can work even in a bank-centric system. Higher asset prices caused by ECB purchases would strengthen bank balance sheets and hence their *capacity* to lend, while stronger corporate balance sheets (from higher equity and bond values) would increase banks' *willingness* to lend to them.
- **Private asset purchases** may be preferable on many counts, but the volume of eligible securities appears small and yields on assets like covered bonds have already compressed sharply. Buying private assets would also entail very uneven help across the area and favor the banks that hold more marketable assets. Nonetheless, the ECB could allocate a portion of its interventions to these markets. A mix of purchases from highly rated private bond markets (including NFCs and securitized assets) would complement interventions in sovereign markets, directly transmitting lower interest rates to the real economy through the credit channel.
- A **large-scale, non-targeted LTRO** on a long-term, fixed-rate basis could also deliver a sizeable expansion of the ECB balance sheet and send a credible signal of the ECB's accommodative stance. Its impact would be especially powerful if the establishment of the SSM facilitates the cross-border flow of liquidity within and between banks.
- By signaling the ECB's commitment to its price stability objective, the above measures would likely have an important impact through expectations. They may also counter appreciation pressure on the euro, pushing up flagging inflation.

15. **The broadly neutral (area-wide) fiscal stance this year strikes a balance at the current juncture** (Table 3 and Figure 7). On the one hand, persistently high debt ratios continue to cast a shadow over the medium term, and risks to fiscal forecasts remain significant. On the other hand, the still-large output gap would argue for fiscal support. Against this background, the fiscal response has to remain flexible. Large negative growth surprises should not trigger additional consolidation efforts. Moreover, if deflation risks materialize and monetary policy options are depleted, the escape clauses in the fiscal framework may need to be used to respond in these circumstances.

16. **While significant progress has been made to strengthen the fiscal governance framework in recent years, critical gaps remain.** Successive reforms of the SGP have had many positive elements, including stronger economic underpinnings for the rules; a tighter link between fiscal targets and the debt objective; better enforcement; and greater flexibility and specificity. Nonetheless, these reforms have made the system increasingly complicated, creating risks of overlap and inconsistency between rules, as well as difficulties of public communication (Box 2). Staff advised examining the complexity of the framework over the medium term, and looking into the possibility of reducing the number of rules (e.g., by consolidating the preventive and corrective arms of the SGP and possibly focusing on some measure of the structural balance as the single

operational target). Another area is to enhance the credibility of the rules and foster compliance (e.g., by introducing administrative sanctions, accelerating procedures in predefined cases, and continuing to strengthen national fiscal frameworks).

Box 2. The Stability and Growth Pact—Design and Implementation Issues^{1/}

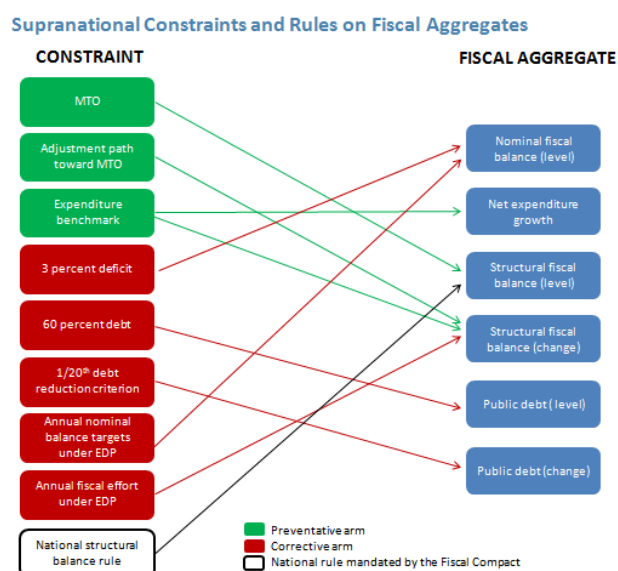
The implementation of the fiscal governance framework has revealed gaps in the design of rules and enforcement mechanisms:

- *The rules of the system have become exceedingly complex.* Successive legislative changes have added new constraints and procedures, creating possible inconsistencies and redundancies. Individual rules have also become more sophisticated, in particular those specified in cyclically-adjusted terms.

- *The structural budget balance is undermined by large measurement errors.* The structural balance indicator is now at the center of the fiscal surveillance system both in the preventive and the corrective arms. However, its calculation relies on output gap estimates, which are generally underestimated in real time, making the structural balance prone to significant downward revisions (on the order of 0.5 percent of potential GDP per year).

- *The SGP may reduce incentives to foster long-term growth.* Two issues feature prominently in current discussions. The first is that the SGP may limit the space to finance structural reforms that entail sizeable short-term budgetary costs. Although the 2005 reform explicitly recognized that these costs should be accommodated, the present framework has so far only been applied to some types of pension reforms. Going beyond pension reforms is proving contentious. A second question is whether the MTO and, to a lesser extent, the 3 percent deficit cap, discourages public investment by limiting the capacity to borrow to fund projects that increase long-term growth potential.

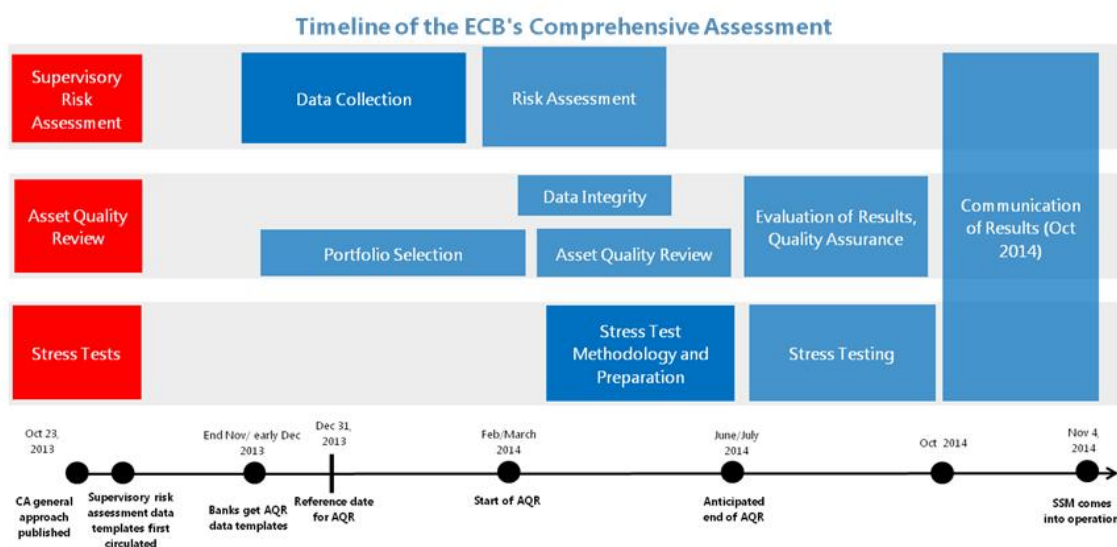
- *Enforcement mechanisms may need to be strengthened further.* Sanctions and corrective actions are mild compared to existing federations. In addition, the unique EU governance structure undermines the incentives for strict implementation (the Council has the final word on monitoring decisions, while the EC only makes recommendations), although recent changes to voting procedures may have partially mitigated this problem. Finally, supranational controls are not sufficient to ensure fiscal discipline at the national level, as credible enforcement has also to take place at the level where fiscal sovereignty is exerted.



^{1/} Prepared by Luc Eyraud (FAD) and Tao Wu (EUR).

Mending balance sheets and completing the banking union to reduce fragmentation and revive credit

17. **The ECB's Comprehensive Assessment of bank balance sheets is well underway, with results expected to be announced in October 2014.** Importantly, the asset quality review (AQR) establishes consistent definitions of capital and NPLs across national jurisdictions, and incorporates independent third party involvement in valuing bank assets, thereby ensuring cross-comparability of asset quality and providing transparency to the market.



18. **In general, the exercise is proceeding well (Figure 8).** Capital hurdle rates are appropriately set higher than the regulatory minimum under Basel III: an 8 percent Common Equity Tier 1 (CET1) ratio is required under the baseline and 5.5 percent under the stress scenario. However, the treatment of sovereign risk might be perceived as too lenient by markets.³ Staff recommended development of an effective and clear communications strategy for the test results—particularly in light of some national discretion over the treatment of sovereign holdings, the lack of an adverse scenario incorporating a complete assessment of deflation risks, and the heterogeneity in stress test parameters across national and EU-wide variants. Staff welcomed independent third-party involvement in the AQR, but urged that efforts be made to ensure uniformity in the level of such involvement across countries.

19. **Banks falling below the required capital ratios will be expected to remedy the shortfall speedily.** Banks falling below the AQR requirement will have 6 months to fill the gap, while banks falling below the stress test requirement in the adverse scenario will have 9 months. Moreover, banks will be asked to present a formal plan describing their recapitalization strategy to

³ Sovereign holdings in the trading book and available-for-sale (AFS) portfolios are to be marked to market. National supervisors may allow the use of prudential filters for unrealized losses in sovereign AFS holdings, while hold-to-maturity (HtM) holdings will only be subject to changes in risk weights arising from banks' internal models (and remain zero-rated under the standardized approach).

supervisors—for their approval—within two weeks of the results being announced. Staff welcomed the simplicity and clarity of this approach, but raised two issues:

- *Timetable*: Staff supported the ambitious recapitalization timetable. As noted earlier, many banks have been raising capital well in advance of the publication of the AQR and stress test results. This reduces the chances that they will need to raise capital after the exercise. However, if capital needs are high and the market environment unfavorable, it is reassuring that the framework has some flexibility to respond to such circumstances. But the authorities should continue to encourage banks potentially in need of capital to act pro-actively, taking advantage of current favorable market conditions.
- *Bail-ins*: If a bank proves unable to raise its minimum capital ratio to the desired level, the conversion of subordinated debt to capital must be applied before recourse to public support under EU state aid rules. Staff urged careful consideration of financial stability concerns when applying any capital conversion or bail-in provisions: if necessary, the systemic risk exception or proportionality principle should be invoked to mitigate risks.

20. **The credibility of the exercise would be markedly enhanced by a common fiscal backstop, which would help sever sovereign-bank links.** In particular, direct recapitalization of banks from the ESM should be an option in case private capital is insufficient. There has been recent political progress in making operational ESM direct recap. But the timetable remains uncertain and the proposed threshold to access the mechanism is very high: direct recap must be preceded by bail-ins of at least 8 percent of eligible bank liabilities (in line with the BRRD); and the country's fiscal position must rule out the possibility of indirect recapitalization (via the sovereign) from the ESM.

21. **There has been substantial progress toward a banking union along three dimensions: bank regulation, supervision, and resolution.** However, the design will not fully sever bank-sovereign links in the foreseeable future, possibly delaying financial reintegration.

- *Single Supervisory Mechanism (SSM)*: The SSM is on-track to become fully operational in November 2014. The transition to a single supervisor should increase the fungibility of liquidity within cross-border banking groups in the euro area, thereby reducing financial fragmentation. Joint supervisory teams are being created to oversee individual banks, with staff drawn mainly from national central banks and regulatory authorities, but also the ECB. Staff stressed the need to guard against implementation risks, including the treatment of home-host supervisory coordination and—for banks with relevant activities outside the euro area—the

Banking Union – A Qualitative Review

REGULATION Single Rulebook (CRD4/CRR) adopted	REGULATION
SUPERVISION ECB becomes pan-European bank supervisor from Nov 2014	SUPERVISION No EU-wide direct recapitalization provisions with ECB Comprehensive Assessment (AQR/ Stress Tests)
RESOLUTION Final directives on bail-in, resolution, and deposit guarantees ("BRRD and DGS") Agreement on procedures and funding to deal with failing banks ("SRM" and "SRF")	RESOLUTION No common fiscal backstop SRF phase-in remains too gradual SRM decision-making still cumbersome
Bottom line: Important progress but sovereign bank links not severed	

importance of reciprocal macro-prudential policies through supervisory colleges, as discussed in the 2013 FSAP.

- *Single Resolution Mechanism and Fund (SRM/SRF)*: Compared with earlier plans, the final agreement specifies a more streamlined decision-making process with faster mutualization. However, the SRM decision-making procedure remains cumbersome, the SRF transition period too long (8 years), and its financial capacity limited given the concentration and size of large financial institutions. This raises questions about the ability of the framework to deliver least-cost, effective, and timely resolution in a systemic banking crisis. The possibility of a credit line with the ESM will help, but such concerns could be more directly mitigated by making direct bank recapitalization via the ESM less stringent.
- *Backstop*: There remains a need for a common fiscal backstop that could be deployed quickly in the event of a systemic crisis, when industry-based funds and purely national deposit insurance schemes may be insufficient. By supporting confidence in the banking sector, the availability of such a backstop could reduce the likelihood it would be used. Moreover, potential support measures for systemically relevant non-bank activities, such as insurance and central counterparties may need to be considered.

22. **Macro-prudential authority will be shared between the SSM and national competent authorities (NCAs).** While the SSM will take over primary supervision of the largest banks from the NCAs, the ECB and the national central banks in the SSM area, via the Financial Stability Committee (FSC), will assess any system-wide vulnerabilities and the scope for macro-prudential policies. Staff urged the ECB to continue joint discussions with national authorities and the European Systemic Risk Board (ESRB) on macro-prudential coordination under the new dispensation (as highlighted in last year's FSAP recommendations), especially with respect to EU banking activities outside the euro area and policy measures related to non-banking sectors. Staff also encouraged effective cooperation with national authorities on anti-money laundering (AML) frameworks.

23. **Working out the corporate debt overhang will play an important role in repairing bank balance sheets and supporting investment.** Although many countries have taken steps to reform their insolvency regimes, continued progress is needed on harmonizing and strengthening national insolvency frameworks, encompassing terminology, definitions and processes. Measures should also be taken to: (1) facilitate out-of-court settlements; (2) reduce impediments to more efficient debt restructuring (e.g. incentives for creditor coordination in debt restructuring, and schemes to provide priority financing for restructured entities); (3) standardize debt restructuring contracts for SMEs; (4) strengthen liquidation procedures to enable rapid exit of non-viable firms; and (5) introduce guidance on tax incentives and debt resolution procedures in line with international best practice.

Advancing structural reforms to boost growth and address imbalances

24. **Structural reforms can play an important role in reviving investment, employment, and productivity, as well as resolving intra-euro area imbalances.** To this end, national reforms to improve labor market functioning and increase competition in product and service sectors need to progress further (Table 4 summarizes staff's country-specific recommendations and priorities). These would be helped by reform efforts at the euro area level to implement the Services Directive, negotiate free trade agreements, and further integrate energy markets to mitigate possible disruptions in global commodity markets due to geopolitical events. Specifically, an energy strategy aimed at increasing interconnections of national networks could help ensure security of gas and electricity supply by pooling and allocating energy reserves across countries more efficiently. In addition, some reforms, such as capital market development, youth unemployment, and rebalancing have both national and area-wide dimensions.

25. **Improving SMEs' access to finance is crucial to investment and growth.** SMEs account for around 80 percent of employment and 70 percent of value added in Italy, Spain, and Portugal. SMEs applying for loans are experiencing difficulties in obtaining credit from banks, particularly in Spain and Italy, where about a fifth of SMEs were credit rationed during the last 6 months, either because their applications were rejected or offers were prohibitively expensive.

26. **Developing diversified funding markets would help ensure lending to viable smaller firms and enhance financial system resilience** (Box 3). In particular, SME securitization could draw upon a large existing pool of assets and reduce the high reliance on bank-intermediated funding, while helping firms to rebalance their financial structure towards longer maturities and attracting new investors. Securitization would boost bank liquidity, free up regulatory capital, and allow banks to lend again. SME securitization could also improve the transmission of monetary policy, facilitate cross-border investment, and boost the growth of other funding markets. Staff recommended policy actions in the following areas:

- *Regulatory frameworks:* Capital regulations should appropriately differentiate between high- and low-quality SME-backed securities. Most securitization transactions in Europe showed remarkable resilience during the financial crisis. This was largely due to conservative loan origination standards; high equity participation and servicing being retained by the originator, together with issuer due diligence; and adequate post-issuance monitoring. Reducing the capital intensity of safer structures would encourage the supply of simpler (less capital intensive) transactions, with greater transparency of the underlying SME loans. This could also involve a more even capital treatment for different institutional investors (banks, insurance companies, and asset managers) and the use of SME loans as collateral in refinancing operations. Harmonization of reporting requirements would not only broaden the investor base but create scope for developing securitization instruments that pool SME loans on an EU-wide basis.
- *Public sector support:* The official sector should be a catalyst by creating institutional demand when markets are insufficiently developed. Area-wide and national initiatives—such as the joint

EC–EIB SME initiative, the EIB-EIF securitization program, or plans by several national central banks to support the bundling of SME-backed loans for ECB refinancing—move in the right direction, but should be broadened to have a significant impact.

Box 3. Capital Market Development: SME Financing in the Euro Area^{1/}

The corporate sector in Europe is highly dependent on bank-based financing, with only the largest firms able to directly access capital markets. Developing diversified funding for small- and medium-sized enterprises (SMEs), including through securitization, could help overcome the adverse effects of financial fragmentation and support cross-border investment.

But SME securitization faces several challenges.² Unfavorable economic terms (e.g., the high cost of issuance, a lack of uniform reporting standards, and cumbersome insolvency regimes) and adverse cyclical factors (e.g., cheap alternative funding sources for banks and rising SME loan default rates in stressed economies) reduce the incentives for issuance. In fact, most recent transactions have been arranged for funding purposes and do not offer any regulatory capital relief for issuing banks. In 2013, more than half of all issuances were “retained”—well in excess of the 5 percent “skin in the game” regulatory requirement under CRD2—for use as collateral for short-term funding from Eurosystem liquidity facilities (“securitization to repo”). Moreover, pending regulatory changes—Basel III for banks and Solvency II for insurance companies—have weakened the institutional investor base by adversely affecting the capital intensity of holding highly-rated securitization transactions and their eligibility for liquidity purposes.

Current initiatives to improve the economics of SME securitization are too small and too narrowly focused to have a broad impact. A joint EC-EIB SME lending program using EU structural funds will be operational by end-2014, and will complement the existing funding schemes for SMEs provided by the EIB/EIF. Both efforts provide greater official support to mostly bank-sponsored SME lending, but fall short of standardized mechanisms to entice non-banking funding sources and schemes that would allow direct capital market access. In April 2014, the EC issued recommendations on a new approach to business failure and insolvency, aimed at addressing some of the structural impediments to SME financing.³

Reforms in the following areas would facilitate development of the SME securitization market:⁴

- *The regulatory regime should appropriately differentiate between high- and low-quality securitization transactions.* Reducing the capital intensity of safer structures to reflect the resilience of European asset securitization markets during the financial crisis would encourage the supply of transactions that fund real economic activity. This could involve a revised capital treatment for transactions that meet higher standards of loan portfolio disclosure and performance monitoring.
- *Official sector involvement could help incubate market-based solutions for risk transfer.* The EIB/EIF could initially act as guarantors or strategic investors (risk sharing) while guarding against long-term distortionary effects by making any risk-sharing time-bound. In this regard, a targeted change to the ECB collateral framework could provide incentives for creating a viable structure for the entire transaction rather than only that part of it placed with the ECB (possibly in combination with an ECB liquidity facility and the option for outright asset purchases of SME transactions to establish a floor to market prices).
- *Structural improvements could further facilitate market development.* National insolvency frameworks should continue to be strengthened, with a view to cleaning up banks’ balance sheets and boosting the quality and transparency of collateral. Greater harmonization of SME lending standards and credit registries across countries would facilitate the establishment of a truly single market. Also, forms of non-bank intermediated securitization (such as trade receivables) and equity finance should be explored in areas where structural impediments to asset securitization are too high and cannot be overcome in the near term.

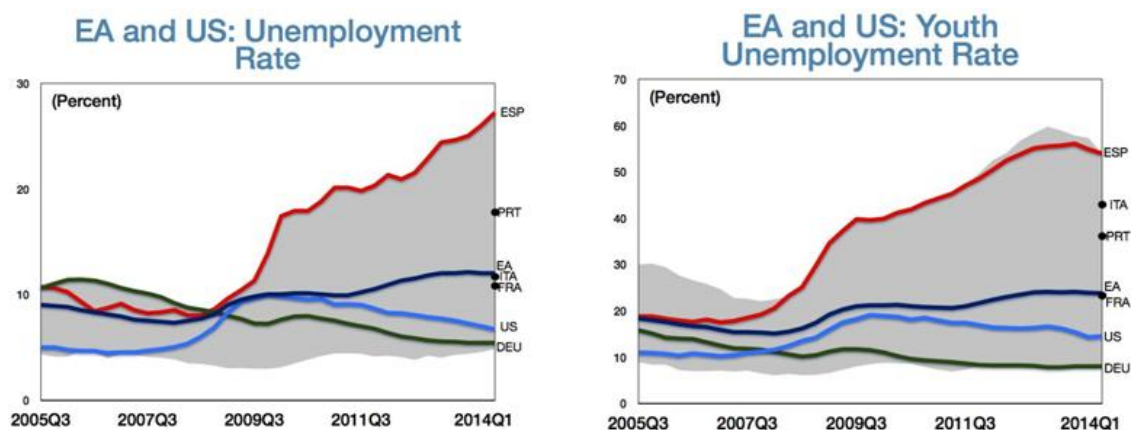
¹ Prepared by Ali Al-Eyd and Andy Jobst.

² The European securitization market is relatively small and has contracted by more than one-third since the start of the financial crisis to €1.4 trillion (roughly a quarter of the size of the U.S. market).

³ European Commission, 2014. *Commission Recommendation of 12 March 2014 on a New Approach to Business Failure and Insolvency* (2014/135/EU). See also European Commission, 2013, *Finance for Growth, Report of the High-Level Expert group on SME and Infrastructure Financing*.

⁴ In May 2014, the ECB and the Bank of England published a comprehensive review of existing obstacles to a better functioning of the securitization market in the European Union, which includes some arguments that are also reflected in these recommendations.

27. **The crisis has left a legacy of unacceptably high unemployment, especially in stressed economies.** For instance, euro area countries hit hardest by the crisis have had unprecedented increases in youth unemployment rates, ranging from 25 percent in Ireland to over 40 percent in Spain on average during 2007–13. Large and persistent youth and adult unemployment rates lower potential output due to skill attrition and depreciated human capital. Youth unemployment also leads to a lower probability of future employment and lower wages, and erodes social cohesion and institutions.

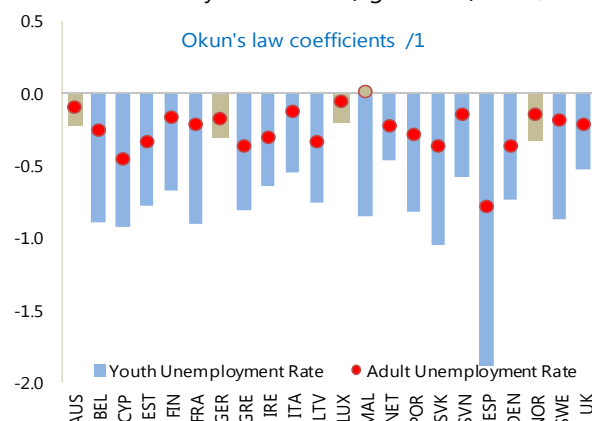


28. **A comprehensive and country-specific approach will be necessary for addressing high unemployment.** Staff analysis suggests that youth unemployment in the euro area has been especially sensitive to cyclical conditions (Box 4). Nonetheless, structural factors also make a difference: a larger tax wedge, higher minimum wage (relative to median wage), and lower spending on active labor market policies (ALMPs), especially on training, are associated with higher unemployment. Overall, a broad, comprehensive strategy to tackle youth unemployment is needed, which involves both measures to boost growth and remove country-specific structural impediments. The latter could include properly designed, cost-effective ALMPs, together with measures to lower hiring costs (by reducing the tax wedge and better aligning minimum wages to average labor costs) and improve skill levels (by providing work-related training).

29. **Further policy efforts in both creditor and debtor economies are necessary to prevent intra-euro area imbalances from re-emerging as the recovery takes hold.** In addition to supportive macroeconomic policies, product and labor market reforms are crucial to rebalance the euro area. Higher infrastructure investment in the creditor countries could improve disposable incomes in these economies and lead to higher external demand, thereby reducing excessive surpluses including vis-à-vis the rest of the world. Further improvements in competitiveness are particularly important for stressed economies, which need to lower costs, shift resources to tradable sectors, and reduce external debt. Staff analysis shows that in a “good” rebalancing scenario—with higher public investment in creditor countries and more structural reform progress across the euro area—would improve current account balances in debtor economies, while reducing the surpluses of creditor economies. The growth dividends under this scenario could be substantial, ranging from a ½ to ¾ percentage point rise in growth annually over a five year horizon (Box 5).

Box 4. Youth Unemployment in the Euro Area: Okun's Law and Beyond^{1/}

The business cycle is the most important driver of unemployment in the euro area. It explains up to 70 percent of changes in the youth (age 15–24) unemployment rates in stressed euro area countries. Youth unemployment rates are more than twice as sensitive to the business cycle as adult (age 25–64) rates, regardless of how the business cycle is measured (output growth or output gap). This may be because relatively more youth are employed in the cyclically sensitive industries (e.g. construction) as well as the concentration of employment in SMEs which have been severely affected by the crisis. Therefore, sustained growth is key to reducing youth unemployment, especially in stressed countries. For example, an additional percentage point of annual growth could lower the unemployment rate from 0.8 percentage points in Greece and Portugal to 1.9 percentage points per year in Spain.

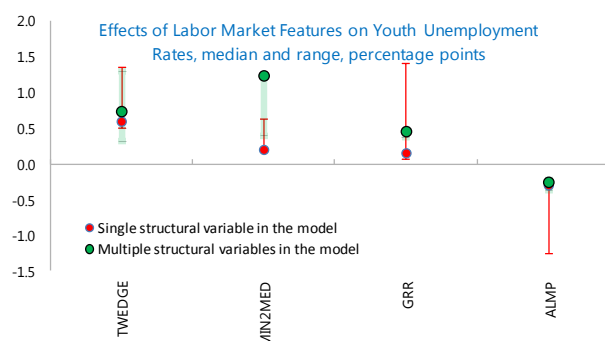


/1 Shaded bars and dots indicate results and are not significant.

Source: Eurostat and IMF Staff Estimates

Structural features of the labor market have significant effects on the size of unemployment.¹

A one percentage point increase in hiring costs (tax wedge, ratio of minimum to median wages) raises youth unemployment rates by 0.2 to 1.2 percentage points. A higher benefit replacement rate increases youth unemployment rates by up to 1.3 percentage points. An increase of 1000 euros in ALMP spending per unemployed person can lower youth unemployment rates by up to 0.3 percentage points. Skill levels also play a role, especially for long-term unemployment, while collective bargaining (e.g., union density), labor market duality (e.g., protection of regular workers) have more mixed effects, consistent with the literature. These estimates are robust to different empirical specifications.



TWEDGE – Tax wedge, MIN2MED – the ratio of minimum to median wages, GRR – gross replacement rate, ALMP – total spending on active labor market policies per unemployed.

Source: Eurostat and IMF Staff Estimates

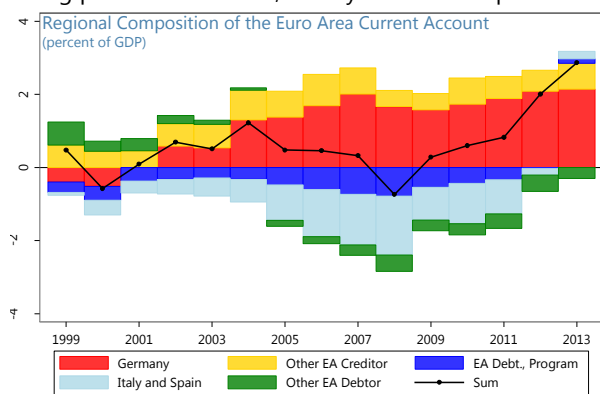
Structural characteristics also affect the responsiveness of unemployment to the business cycle. For example, in stressed economies such as Greece and Spain, a higher tax wedge makes unemployment rates more pro-cyclical.

These results are subject to important caveats. Given data limitations, the estimations assume that structural factors have the same effect across countries. Moreover, the variables do not capture every relevant detail of the labor market structure, e.g. eligibility requirements for unemployment benefits differ across countries, and the tax wedge may vary across income levels in a given country, and in progressivity across countries.

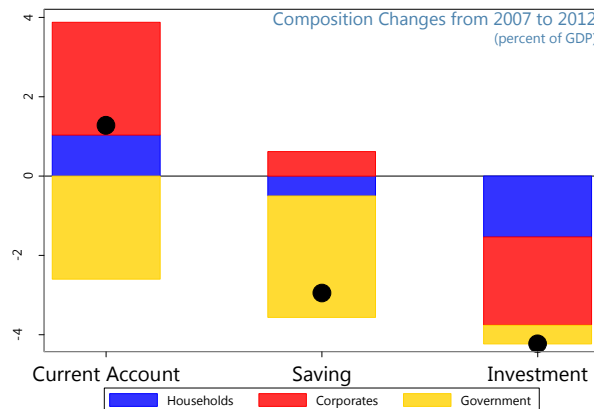
¹ Prepared by Angana Banerji, Huidan Lin and Sergejs Saksonovs. See companion SIP for other variables considered and methodological details.

Box 5. External Rebalancing in the Euro Area: Developments and Policies^{1/}

The euro area has shifted into strong surplus since the crisis. However, country-level developments underlying this shift have been highly asymmetric, with debtor economies (such as Greece, Ireland, Portugal, and Spain) seeing large improvements in their current accounts (sometimes into surplus), while creditor economies (like Germany and the Netherlands) have maintained their surpluses. At the sectoral level, the change in current accounts has been largely driven by falling private investment, mostly from the corporate sector.

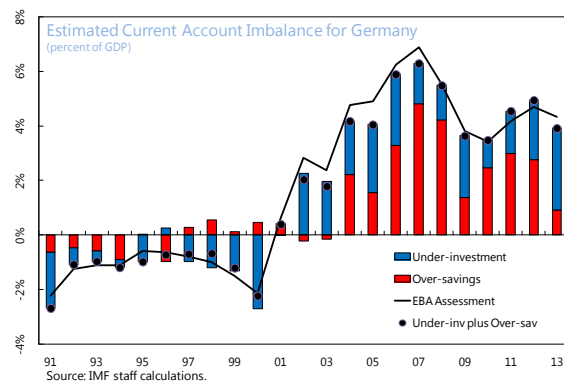


Source: IMF *World Economic Outlook* database and IMF staff calculations. Note: Italy and Spain do differ significantly in the magnitude of their net foreign liabilities. See Table 1 of the External Rebalancing Selected Issues Paper.



Source: Eurostat database and IMF staff calculations.

Statistical analysis indicates that euro area external imbalances can be traced to deviations in both saving and investment from model-based estimates. Creditor economies with large surpluses (such as Germany) have seen persistent under-investment and over-saving in recent years, compared to what would be predicted by a model incorporating fundamentals (see text figure). On the other hand, the analysis also points to persistent and substantial over-investment by some debtor economies prior to the crisis (such as Spain). The magnitude of over-investment in debtor economies has fallen since the crisis, but there is a risk that this reflects, at least in part, the large output gaps that remain in these economies and will unwind as they recover.



Source: IMF staff calculations.

Scenario analysis suggests that gains from further structural reforms and public investments by creditor economies would narrow external imbalances and boost output compared to the baseline. Simulations from the IMF’s EUROMOD general equilibrium model indicate that higher public investment in creditor economies and more structural reform progress across the euro area would improve current accounts in debtor economies, while reducing the surpluses of creditor economies. This would help reduce excessively high net external liabilities in some debtor economies (such as Greece) and temper the net

external assets of some creditor economies (such as the Netherlands). More importantly, potential growth and productivity would improve across the board, with growth dividends ranging from ½–¾ percentage points of real GDP over the medium term. This would be accompanied by faster closing of the output gaps and higher inflation (helping aid relative price adjustment).

The External Stability Report’s assessment suggests that the euro area as a whole exhibits an external position and real exchange rate that are broadly consistent with fundamentals. The 2013 real exchange rate gap is estimated to be somewhere between -5 and 0 percent, while the current account gap is estimated to be between -½ and 1 percent of GDP. However, this masks imbalances in constituent member economies, with some showing real exchange rate overvaluation (such as Spain) and others undervaluation (such as Germany). There is a need for continuing structural reforms in product and labor markets in both creditor and debtor economies to help rectify these imbalances. Moreover, in a few creditor economies, there is some scope to use fiscal space to boost public investment.

¹ Prepared by John Bluedorn, Shengzu Wang, and Tao Wu.

THE AUTHORITIES' VIEWS

30. **The authorities broadly agreed with the assessment of economic developments in the euro area and the downside risks to growth.** They noted that the recovery, despite showing signs of being sustained, was still too weak to make a significant impact on high unemployment and debt levels. They acknowledged strong headwinds to growth from persistently weak credit conditions, financial fragmentation, and private sector deleveraging.

31. **The ECB's recent package of policy measures demonstrates its resolve to raise inflation towards the price stability objective and counter financial fragmentation.** The authorities agreed with staff that low inflation makes adjustment difficult and emphasized that a prolonged undershooting of the inflation objective is not acceptable to the Governing Council of the ECB.

32. **The ECB considered this package sufficient to address low inflation and support greater bank lending.** But they are ready to respond swiftly if inflation remains unacceptably subdued including, potentially, asset purchases to expand the ECB's balance sheet. Despite their limited size, private asset purchases could address fragmentation by injecting liquidity and supporting credit. Quantitative easing (QE)—mainly through sovereign but also private asset purchases—is an option, particularly if external risks materialize and the inflation outlook worsens. Nevertheless, it should be acknowledged that QE is no panacea, and is subject—just like any other measure—to some limitations. Despite some uncertainty about standard transmission mechanisms in an environment of already very low sovereign yields, the expectations channel is expected to play a significant role in transmitting an ECB balance sheet expansion into higher inflation.

33. **The EC agreed that the broadly neutral fiscal stance at the euro area level is helping sustain the recovery, but cautioned against the risk of policy complacency.** Member states' 2014 consolidation plans are now based on more realistic macroeconomic assumptions, perhaps reflecting the role of the new fiscal councils. The composition has also improved with less reliance on capital spending cuts. But the EC argued that a premature relaxation of SGP targets to tackle weak aggregate demand would undermine the credibility of the recently-reformed framework. Nonetheless, if inflation remained subdued after the monetary policy arsenal had been exhausted, the escape clauses of fiscal rules could be activated.

34. **On fiscal governance, the authorities acknowledged that some revisions to the framework were necessary but emphasized legal and political constraints to introducing radical changes.** They noted that the complexity of the existing framework owed much to prior attempts to make the framework more flexible (and less pro-cyclical) in the face of large shocks. The EC also saw benefits in creating more incentives to foster long-term growth and fill the investment gap but warned that modifying the rules to accommodate structural reforms and higher public investment would create loopholes and make procedures even more complex. They also cautioned against an overly pessimistic view of existing enforcement mechanisms, pointing to the track record of several member countries successfully exiting the EDP.

35. **The authorities were optimistic that the ongoing AQR and associated stress tests would be successfully completed.** This will provide a major boost to confidence in the banking sector and facilitate balance sheet repair. The authorities pointed out that since the middle of 2013 there has already been a large improvement in European banks' capital positions. Total capital has risen almost €90 billion, nearly 4 percent, since May 2013. Coordination between the ECB and national competent authorities (NCAs) is so far proceeding smoothly, and independent third party involvement in asset valuations has been an integral part of the process. Clear and prompt recapitalization plans would be required of banks found to fall short of AQR or stress test hurdle rates. Recent improvements in the funding environment for banks should be conducive to banks' ability to fulfill the ambitious timetable for recapitalization. The timetable is expected to be strictly followed, in order to preserve the credibility of the exercise. That said, the authorities agreed with staff that banks may be granted some flexibility in extraordinary circumstances. They also concurred that financial stability concerns would be appropriately taken into account in all decisions.

36. **Major progress has been made on the banking union.** The authorities noted that the transition to a single supervisor is likely to facilitate cross-border liquidity provision within the euro area, which could help reduce financial fragmentation. The SSM is making institutional preparations—including hiring staff—to ensure that it will be ready to assume supervisory responsibilities in November. The authorities highlighted that recent agreements had made SRM decision making procedures less cumbersome—improving the prospects for quick resolution in a crisis—and the SRF transition period made shorter. Apart from a quicker overall mutualization of national compartments, they pointed to the front-loaded nature of the timetable, with 40 percent of the SRF funds being mutualized by the end of the first year of operation, and 60 percent by the end of the second year. They also noted that passage of the BRRD, which will become fully operational in 2016, has established tiered depositor preferences and a bail-in tool for creditors. Moreover, the Directive on Deposit Guarantee Schemes harmonizes the coverage and speed of payout of national deposit guarantee schemes across the EU.

37. **On a common fiscal backstop for the AQR and more generally for bank resolution, the authorities pointed to recent progress in enabling direct bank recapitalization from the ESM.** They agreed with staff that the threshold envisaged for direct recap is very high, but argued that this was broadly appropriate in light of the desire to minimize the chances that public aid would be deployed. The principle that creditors rather than taxpayers should be liable for payments in case of bank failures or capital shortfalls is firmly entrenched in the resolution framework.

38. **The authorities agreed that the ongoing rebalancing is incomplete.** Wages are adjusting and current account positions are improving in the debtor countries. But these developments are occurring against a backdrop of still-large output gaps and could be partially reversed as economic activity recovers. Further efforts in these countries should focus on microeconomic reforms to improve competitiveness. Meanwhile, there are limited signs of symmetric adjustment in surplus countries. The authorities agreed that higher infrastructure investment in these countries should contribute towards reducing intra-euro area imbalances.

39. **On structural reforms, the authorities agreed with staff that action was needed on both the national and regional levels.** The “Youth Guarantee Scheme” will provide EU structural funds to support country-specific programs, subject to an assessment by the EC. It will be targeted at countries where youth unemployment exceeds 25 percent. Progress was also being made on fostering a single market for energy, with wholesale prices for gas and electricity converging across countries. The most pressing challenges were to inter-connect national electricity grids, and harmonize country-specific climate change measures to achieve the common target for renewable by 2020. Negotiations continue on a free trade agreement with the US, and with other countries, although greater political uncertainty could slow the momentum.

40. **The authorities welcomed staff’s emphasis on capital market development.** They viewed this area as an integral part of the drive toward a Single Market. In this context, they supported proposals for facilitating greater SME access to finance. Widening the existing EIB-EIF program for SME securitization and exploring synergies with the EC-EIB SME Initiative would foster greater capital market integration. The authorities saw merit in pursuing a number of proposals: differentiated capital intensity of high- and low-quality securitization transactions; more equitable regulatory treatment of securitized and non-securitized SME loans; harmonization of loan reporting requirements, credit scoring, and credit registry information; and non-bank intermediated forms of structured finance, such as cash flow (receivables) securitization.

41. **The authorities generally agreed with staff’s risk assessment.** Surges in global financial market volatility due to revised expectations of US exit from UMP could complicate the ECB’s own policies to increase inflation expectations and support demand, if the ECB forward guidance proved less effective under such scenario. A protracted slowdown in emerging markets (EMs) could weigh on growth prospects through the trade channel, although such a channel is unlikely to be strong and there could be a potential offset from capital flow substitution from EMs to euro area periphery countries. An escalation of geopolitical tensions could have adverse—and uneven—consequences for several euro area countries, but the authorities observed that it was very difficult to attach meaningful probabilities to this event. They also noted that such risks seemed to have diminished recently. They agreed that internal risks arising from stagnation or a de-anchoring of long term inflation expectations remained germane. However, the authorities argued that some of these risks were interlinked, and the impact would be high only if they were all to be realized at the same time. Moreover, the probability of such scenarios materializing was reduced by the endogenous policy response that signs of stagnation would call forth, in particular as regards balance sheet repair. They attached a higher likelihood to the danger of reform fatigue setting in, especially in light of a more euro-skeptic configuration in the new European Parliament.

STAFF APPRAISAL

42. **The euro area’s economy has now expanded for four consecutive quarters, with varying strength across countries.** Financial market sentiment is buoyant, sovereign spreads have narrowed to pre-crisis levels and bank funding costs have declined sharply. These improvements have been grounded in vigorous policy actions. The ECB has provided demand support through

conventional monetary policy—including the recent rate cut and negative deposit rates—while the fiscal drag in 2014 has diminished. Rapid progress has been made with establishing a banking union, with the ECB ready to assume supervisory authority in November, soon after the results of the ongoing AQR are announced.

43. **But the recovery is neither robust nor sufficiently strong.** Investment remains well below pre-crisis levels, constrained, at least in part by the continuing contraction of bank credit. Credit conditions in periphery countries are particularly weak, with many SMEs—a major source of output and employment—being rationed. Unemployment, especially youth unemployment, remains unacceptably high, and the private debt burden remains elevated in many countries. Therefore, greater growth momentum is required to substantially repair the damage from the crisis.

44. **Inflation has been too low for too long.** This stifles demand by keeping real interest rates and real debt burdens too high, while making the unfinished task of rebalancing more difficult. A protracted period of inflation below the central bank's target could de-anchor expectations and undermine monetary policy credibility. And a negative external shock could tip the economy into deflation.

45. **Concerted policy efforts are needed to strengthen the recovery.** ECB actions have provided welcome demand support. Successful execution of the AQR and a common fiscal backstop are needed to facilitate balance sheet repair and sever bank-sovereign feedback links. And structural reforms are needed to tackle high unemployment and facilitate intra-euro area rebalancing.

46. **The ECB's recent policy package signals its determination to address low, below-target inflation and fulfill its mandate.** Collectively, the wide range of measures should lead to a substantial expansion of liquidity. The provision of targeted term funding for banks should encourage credit to SMEs, especially in stressed economies.

47. **But if low inflation and fragmentation are not reversed, a substantial expansion of the ECB's balance sheet may be necessary to complement the recent package.** This could be achieved through a large program of asset purchases—primarily sovereign assets for reasons of market depth—or a new non-targeted LTRO on a long-term, fixed-rate basis. Both asset purchases and a large-scale LTRO involve balance sheet risk for the ECB, strengthening the pre-commitment to accommodative policy, and thereby influencing inflation expectations.

48. **The overall broadly neutral fiscal stance of the euro area in 2014 strikes an appropriate balance between demand support and debt sustainability considerations.** Negative growth surprises should not trigger additional consolidation efforts.

49. **Successful completion of the AQR will facilitate bank balance sheet repair.** The ambitious timetable for recapitalization of banks should be feasible given markedly improved market conditions, but some flexibility might be necessary if several banks need to raise capital at the same time. Creditor bail-ins for systemically important banks, if necessary, would need to be

applied with due consideration given to financial stability concerns. Efforts are also needed to reduce the corporate debt overhang, by strengthening national insolvency frameworks and facilitating debt restructurings.

50. **There has been rapid progress towards a more complete banking union.** The transition to a single supervisor—the SSM—should facilitate cross-border liquidity provision, thereby reducing fragmentation. SRM decision-making procedures have been simplified, and the timetable for mutualization of the SRF has been shortened.

51. **Work needs to continue on establishing a common fiscal backstop to effectively sever sovereign-bank links.** While the proposal for ESM direct recap is a step in the right direction, as currently envisaged the thresholds for such support are too high.

52. **Capital market development should be encouraged to provide an alternative to bank lending.** Developing capital market financing alternatives, like greater securitization for corporate funding, would help ensure lending to viable smaller firms, enhance the resilience of the financial system, and improve monetary transmission. To bolster securitization markets, regulatory risk weights for high quality (simple and transparent) liquid asset-backed securities should be reduced. This would free up capital for further lending.

53. **More structural reforms are necessary to tackle high unemployment, burnish competitiveness, and facilitate rebalancing.** A comprehensive strategy to tackle youth unemployment would involve both measures to boost growth and remove country-specific structural impediments. The latter could include cost-effective ALMPs, measures to lower the opportunity cost of employment, and better-targeted training programs. Higher infrastructure investment in the creditor countries would help reduce excessive surpluses. Meanwhile, competitiveness-enhancing reforms to product and labor markets in debtor countries would aid further rebalancing, by boosting export growth as the recovery takes hold and import compression unwinds. Efforts should continue to implement the Services Directive, make progress with free trade agreements, and more closely integrate energy platforms and policies.

54. **Over the medium term, ideas to simplify and strengthen the fiscal governance framework should be explored.** Consideration should be given to a more parsimonious framework with a single objective and an economically sound operational lever. The credibility of the rules would be enhanced by much stronger enforcement mechanisms. Boosting the ability of the center to fund public infrastructure projects—such as cross-border investments in transportation, communications and energy networks—would help lay the foundations for sustained growth, while keeping countries within the bounds of the fiscal framework.

55. **Staff proposes that the next Article VI consultations on euro area policies follow the standard 12-month cycle.**

Table 1. Euro Area: Main Economic Indicators, 2011–19

	2011	2012	2013	Projections 1/					
				2014	2015	2016	2017	2018	2019
Demand and Supply									
Real GDP	1.6	-0.7	-0.4	1.1	1.5	1.7	1.6	1.6	1.6
Private consumption	0.3	-1.3	-0.7	0.6	1.1	1.3	1.4	1.4	1.4
Public consumption	-0.1	-0.6	0.1	0.3	0.3	0.4	0.5	0.6	0.7
Gross fixed investment	1.6	-4.0	-2.9	1.6	2.7	2.8	2.7	2.7	2.6
Final domestic demand	0.5	-1.7	-0.9	0.7	1.2	1.4	1.5	1.5	1.5
Stockbuilding 2/	0.3	-0.5	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand	0.7	-2.2	-1.0	0.8	1.2	1.4	1.4	1.5	1.5
Foreign balance 2/	0.9	1.5	0.5	0.3	0.3	0.2	0.2	0.2	0.2
Exports 3/	6.5	2.5	1.4	3.9	4.5	4.9	4.9	4.9	4.8
Imports 3/	4.5	-0.9	0.4	3.4	4.1	4.7	4.9	4.9	4.9
Resource Utilization									
Potential GDP	0.6	0.4	0.6	0.8	1.0	1.1	1.2	1.2	1.3
Output gap	-0.8	-1.8	-2.8	-2.5	-2.0	-1.4	-1.0	-0.6	-0.3
Employment	0.3	-0.6	-0.8	0.3	0.7	0.9	0.8	0.8	0.8
Unemployment rate 4/	10.1	11.3	12.0	11.7	11.4	10.8	10.3	9.8	9.4
Prices									
GDP deflator	1.2	1.3	1.5	1.1	1.4	1.4	1.5	1.5	1.6
Consumer prices	2.7	2.5	1.3	0.7	1.2	1.3	1.5	1.5	1.6
Public Finance 5/									
General government balance	-4.1	-3.7	-3.0	-2.7	-2.1	-1.5	-1.1	-0.7	-0.4
General government structural balance	-3.7	-2.3	-1.3	-1.2	-0.9	-0.6	-0.5	-0.3	-0.1
General government gross debt	88.2	92.9	95.2	95.9	94.9	93.2	91.2	89.0	86.3
External Sector 5/, 7/									
Current account balance	0.1	1.3	2.2	2.3	2.5	2.5	2.4	2.4	2.4
Interest Rates 4/, 6/									
EURIBOR 3-month offered rate	1.4	0.2	0.3	0.3	...	...	...	...	...
10-year government benchmark bond yield	4.3	2.3	3.3	2.6	...	...	...	...	...
Exchange Rates 6/									
U.S. dollar per euro	1.39	1.30	1.37	1.37	...	...	...	...	...
Nominal effective rate (2000=100)	104.2	99.8	108.5	108.6	...	...	...	...	...
Real effective rate (2000=100) 6/	95.0	90.2	96.1	95.3	...	...	...	...	...

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.

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ In percent.

5/ In percent of GDP.

6/ Latest monthly available data for 2014.

7/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

Table 2. Risk Assessment Matrix^{1/}

Sources of Risk	Likelihood of Risk (high, medium, or low)	Expected Impact of Risk (high, medium, low)	Policy Recommendations
Protracted period of slower growth in advanced economies	<p>High</p> <ul style="list-style-type: none"> Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis, leading to secular stagnation 	<p>High</p> <ul style="list-style-type: none"> Deanchoring of inflation expectations Debt-deflation dynamics (complicates public debt sustainability, balance sheet repair, rebalancing) Low investment and high unemployment lead to increased output gaps Lower growth potential 	<ul style="list-style-type: none"> Use monetary policy and ECB balance sheet expansion to support demand Repair bank, corporate, and household balance sheets to improve credit, support domestic demand On the supply side, implement structural policies to spur investment, productivity and competitiveness, and advance rebalancing
Reform fatigue at national and euro area levels			
Protracted period of slower growth in emerging economies	<p>High</p> <ul style="list-style-type: none"> Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth 	<p>High</p> <ul style="list-style-type: none"> Slower growth (primarily export-led so far), higher output gaps, lower growth potential Undermine market confidence in euro area growth prospects, increase in sovereign spreads 	
Growth slowdown in China	<p>Medium</p> <ul style="list-style-type: none"> Continued buildup and eventual unwinding of financial excess capacity eventually, resulting in a sharp growth slowdown and large financial and fiscal losses (medium term) 		
Bond market stress from a reassessment in sovereign risk	<p>Low</p> <ul style="list-style-type: none"> Stalled or incomplete delivery of bank reforms and policy commitments (national and euro-area wide) due to reform fatigue, political and social pressures Unanticipated outcomes from asset quality review and stress tests, absent common fiscal backstop 	<p>Medium</p> <ul style="list-style-type: none"> Financial stress could re-emerge Bank-sovereign-real economy links could re-intensify via worsening financial fragmentation and credit transmission, loss of market confidence (sovereign refinancing risks could reemerge) Procyclical fiscal policies may become unavoidable Negative shocks to growth, worsening an already weak growth outlook 	<ul style="list-style-type: none"> Undertake sound implementation of asset quality review and stress tests with clear plan for recapitalization Proper communication about process and results Complete banking union, in particular single resolution mechanism and a common safety net and fiscal backstop Maintain appropriate pace of fiscal consolidation and debt reduction
Surges in global financial market volatility	<p>High</p> <ul style="list-style-type: none"> Geopolitical tensions Revised market expectations on UMP exit/emerging market fundamentals 	<p>Medium</p> <ul style="list-style-type: none"> Tightening of financial conditions Uncertainty could hamper growth 	<ul style="list-style-type: none"> Ease monetary policy to support demand Keep national and euro area-wide reforms on track to preserve market confidence, reduce uncertainty Establish sufficient common backstops to help bank reform, break sovereign-bank links Revisiting euro area's energy strategy may become necessary
A sharp increase in geopolitical tensions surrounding Russia/Ukraine	<p>Medium</p> <ul style="list-style-type: none"> Significant disruptions in global financial, trade and commodity markets 		
Sustained decline in commodity prices	<p>Medium</p> <ul style="list-style-type: none"> Deceleration of global demand Coming on-stream of excess capacity (medium-term) 	<p>High</p> <ul style="list-style-type: none"> Further decline in inflation due to a decline in inflation expectations 	<ul style="list-style-type: none"> Tackle further declines in persistently low inflation (see above)
<p>^{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).</p>			

Table 3. A Scorecard Approach to the Near-Term Fiscal Stance from April 2014 WEO

	1 - Cyclical Conditions				2 - Monetary Policy Space		3 - Sustainability Conditions					4 - Fiscal Stance								
	Output gap %	Unemployment %	Real GDP growth %	Inflation %	Overall	Independent Mon. policy? Y/N	If yes: Overall Space	Debt sustainability		External sustainability		Credibility (CDS) Overall	Cyclical conditions 4/	Sustainability 4/	Change in CAPB					
								stock	flow	stock	flow				Govt. plan	WEO proj.	Staff Report advice			
								GG debt % GDP	MT primary gap 2/ % GDP	IIP % GDP	Current account % GDP	bpts Last 6 months			Weighted average 3/ (Cyc,Sus) =(25,75)	(Cyc,Sus) =(50,50)	% GDP	% GDP	% GDP	
	2014	2014	2014	2014			2014	2013	Latest	2014						2014 5/	2014	2014		
Germany	-0.1	5.2	1.7	1.4	2.8	N	75	-3.2	48	7.3	35.8	1.8	2.8	1.8	2.0	2.3	-0.2	-0.2	-0.5 6/	
France	-2.4	11.0	1.0	1.0	2.0	N	96	-0.1	-21	-1.7	80.7	3.8	2.0	3.8	3.4	2.9	0.8 7/	0.5	0.4	
Italy	-3.5	12.4	0.6	0.7	1.5	N	135	1.4	-30	1.1	271.6	3.8	1.5	3.8	3.2	2.7	-0.1	-0.1	0.3	
Spain	-3.1	25.5	0.9	0.3	1.3	N	99	-1.1	-98	0.8	286.4	4.4	1.3	4.4	3.6	2.8	0.6	0.6	0.6	
Netherlands	-4.7	7.3	0.8	0.8	1.8	N	75	1.7	53	10.1	47.5	2.2	1.8	2.2	2.1	2.0	0.1	0.2	0.2	
Euro area	-2.2	11.9	1.2	0.9	2.0	Y	Limited	96	1.4	-13	2.4	...	3.0	2.0	3.0	2.8	2.6	...	0.1	...
Memo																				
UK	-1.7	6.9	2.9	1.9	3.0	Y	Limited	92	-1.1	-1	-2.7	39.1	4	3.0	3.6	3.5	3.4	0.6	0.6	0.5 8/
US	-3.3	6.4	2.8	1.4	2.8	Y	Limited	106	-0.1	-27	-2.2	37.3	4	2.8	3.6	3.4	3.3	...	0.4 9/	...
Thresholds 4/																				
Strong tighten	Above 3	Under 3	Above 3	Above 4	5		Above 90	Below -3	Below -50	Below -5	Above 100	5	5	5	5	5	Above 2	5	5	
Modest tighten	1 to 3	3 - 5	2-3	3 - 4	4		60-90	- 1- to -3	-20 to -50	-2 to -5	80-100	4	4	4	4	4	0.5-2	4	4	
Neutral	+/-1	5-7	1-2	1 - 3	3		50-60	+/-1	+/- 20	+/- 2	40-80	3	3	3	3	3	+/- 0.5	3	3	
Modest stimulus	-1 to -3	7-10	-1 to 1	0.5- 1	2		40-50	1 to 3	20 to 50	2 to 5	20-40	2	2	2	2	2	-0.5 to -2	2	2	
Strong stimulus	Below -3	Above 10	Below -1	Below 0.5	1		Below 40	Above 3	Above 50	Above 5	Below 20	1	1	1	1	1	Below - 2	1	1	

1/ Includes large scale purchase of government securities, and credit easing measures.

2/ Primary gap defined as P-P*, P is the structural primary balance as % GDP in 2013. P* is the debt stabilizing primary balance in the medium term defined as $(r-g)*d$, where r is a weighted average (by average maturity) of the 2013 effective interest rate and the average 10-year yield over the last 6 months minus 2%, g is av. potential growth in 2016-2018 and d is the debt ratio in 2013.

3/ Weighted average of subcategories (red = 5, yellow = 4, grey = 3, light green = 2, dark green = 1). Monetary policy space modifies the weight on the cycle: i.e., if full monetary policy space, fiscal policy is determined by sustainability concerns. If zero monetary space, then fiscal policy determined by the weighted average of cyclical and sustainability factors. The weight for cyclical conditions are reduced by: "Limited" = 25% adjustment, "significant" = 50%, "substantial" = 75%, "full" = 100%.

4/ The values for each variable are colored depending on their signal for the fiscal stance based on the thresholds.

5/ Staff estimated structural headline adjustment from Authorities' budget plans submitted to EC under the Six Pack, as percent of potential GDP, slightly different from change in CAPB.

6/ Staff advice for Germany is to consider an additional deficit of -0.5 percent of GDP, with the caveat that spending should be tilted towards public investment.

7/ France Stability Program 2014-15, April 2014.

8/ U.K. Fiscal year, and public sector.

9/ Fiscal Monitor April 2014, IMF.

Table 4. Structural Reform Plans and Progress in Selected Countries

	Reform priorities	Recent progress	Staff recommendations
Germany	<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • Progress in extending the provision of child care. • 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 to force in 2012. The EU blue card facilitates immigration of skilled workers. • Additional allocation to research and development in the 2012–2014 budgets. 	<ul style="list-style-type: none"> • A framework (legal, tax, financial) that encourages larger investor base. • Lower tax wedge, in particular for the low skilled and women. • Further facilitation of immigration by creating new pathways for immigration of medium skilled workers in addition to supporting immigration of the high skilled. • Review the family policy to improve its efficiency. • Adjustments in the minimum wage should be tied to the recommendations of a council with independent expert representation. • Accelerate the integration of pan-European transportation and energy networks and increase competition in network industries. • Increased competition in services sector.
France	<ul style="list-style-type: none"> • Improve functioning of labor markets to re-absorb the unemployed, with a focus on youth unemployment. • Increase competition in service sectors with high economic impact. • Pursue a business-friendly environment for enterprises. • Increase labor mobility by reducing constraints on geographic and professional mobility. 	<ul style="list-style-type: none"> • Approval of measures to accelerate pension reform implementation in 2011. Additional pension reforms (2013) expected to close the deficit of the private sector pension system regime by 2020 and increase the effective retirement age. • The government has subsidized firms' permanent hiring of young workers (a €4000 subsidy for the first three years). • The government has committed EUR 30 billion of labor tax cuts over 2013–16. • The reform of training (Dec. 2013) is a positive step towards better skills matching and labor mobility. • The latest reform of unemployment insurance (March 2014) does not change the benefit structure. • Implementation of the Services Directive has strengthened competition, but some sectors remain protected. 	<ul style="list-style-type: none"> • Additional unemployment benefit reforms could aim for more degressivity and stricter activation measures. • Open up distribution, some transportation services, and professional services to competition. Strengthen competition authority to review anti-competitive practices more effectively. • Regulatory simplification. • Simplify employment protection legislation and labor code and reduce judicial uncertainty • Remove obstacles to labor mobility (unification of pension schemes, tax and cost distortions to selling a house etc.)
Italy	<ul style="list-style-type: none"> • Improve the efficiency of civil justice. • Reduce costs in regulated network sectors. • Improve competition in product markets and services. • Address very high unemployment (all age groups) and ineffective active labor market policies. 	<ul style="list-style-type: none"> • New mandatory mediation scheme, measures to deal with backlog of pending cases and speed up case processing (2013). • Packages on wage bargaining decentralization and labor contracts agreed in 2011 but implementation has stalled. • Measures to support youth employment announced in July 2013 (tax breaks for employers hiring under-30s on permanent contracts, increase in training, apprentice and internship schemes). • Fornero labor market reform (April 2012), reduced cost of individual dismissals. • Liberalization of gas sector; establishment of transport authority. 	<ul style="list-style-type: none"> • Promote the use of out-of-court mediation, comprehensive review of court fees; strengthen court organization and management, fully open up the legal profession. • Remove structural bottlenecks that push up average production cost. Enhance competition in supply and distribution of electricity. • Improve coordination and efficiency of ALMPs and employment services at the local level to support the youth guarantee program starting in 2014. Shift to more flexible, single contracts for new workers that gradually increase job protection with seniority to lower the hiring cost and support apprenticeships. • Decentralize wage setting. • Link unemployment support to employability: redesign wage-supplementation scheme to turn it into universal support system conditional on job search and training. • Faster implementation of plans to open up professional services and privatization of local services.

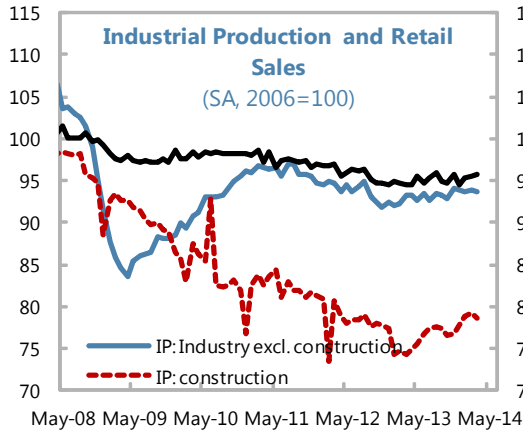
Table 4. Structural Reform Plans and Progress in Selected Countries (Concluded)

Spain	<ul style="list-style-type: none"> • Improve labor market functioning; reduce high unemployment among the youth and unskilled. • Address low revenue collection especially from indirect taxes. • Raise TFP growth to improve productivity. • Improve competitiveness (excessive regulatory burden of trading and protected professions). 	<ul style="list-style-type: none"> • The labor reform reduced severance payments and eased the use of fair dismissals, and facilitated firm-level agreements (February 2012). • Reduction of the replacement rate for unemployment insurance and hiring subsidies in July 2012. • In February 2013, the government announced a strategy for youth employment and entrepreneurship. • Approved Market Unity law (2013). 	<ul style="list-style-type: none"> • Build on the 2012 labor reform law already enacted, and seek to reduce duality and ensure wage flexibility. • Strengthen active labor market policies and training; reduce the labor cost (including tax cost) of unskilled employment. • Adopt a comprehensive tax reform that boosts jobs and growth, while increasing revenue. • Fully implement the programs for Market Unity and the draft law on liberalization of professional services.
Greece	<ul style="list-style-type: none"> • Improve labor market flexibility. • Foster competition in service and product markets • Improve the business environment. 	<ul style="list-style-type: none"> • Major labor market reforms were undertaken since 2010, including reduction of the severance pay; promotion of firm-level bargaining; lowering the tax wedge by 5 percentage points. • Legislation was adopted liberalizing restricted professions, transportation services and energy. • Legislation to improve the business environment including reduction of regulatory barriers to competition in 4 key sectors—retail trade, construction materials, tourism, food processing—with OECD assistance. 	<ul style="list-style-type: none"> • Bring rules on collective dismissals and industrial action in line with the EU best practice. • Continue opening up regulated professions. Continue to reduce regulatory barriers to competition in 4 additional sectors (possibly with OECD assistance). Lower the administrative burden. • Continue overhauling the licensing system while reducing, in the short-term, the costs for establishing new businesses under the existing system. Simplify custom procedures in line with EU practices, and finalize the electronic submission system for trade declarations in 2014.
Ireland	<ul style="list-style-type: none"> • Address high long-term unemployment. • Increase efficiency and competitiveness of the overall economy. 	<ul style="list-style-type: none"> • Increased staffing for employment services in 2013, tendered for private provision of these services. • Identified priorities to improve further education and training to meet labor market needs. • Completed sale of Bord Gais Energy for €1.125 billion. 	<ul style="list-style-type: none"> • Further improve engagement with the long-term unemployed. • Implement reforms of further education and training. • Introduce charging for water usage. • Finalize the reform of legal services to improve transparency of legal costs and regulation of the sector. • Implement further state assets disposals through an orderly process.
Portugal	<ul style="list-style-type: none"> • Improve the functioning of the labor market. • Enhance competition and tackle rents in the product markets. 	<ul style="list-style-type: none"> • Implemented "organized decentralization" on collective agreements and introduced representation threshold for extension of sectoral agreements. • Severance payment was reduced. • New Labor Code, effective as of August 1, 2012, aligned the accumulation rate of severance payments for existing contracts with those of new hires. • Authorities are investigating options to reduce upward pressures on electricity prices, including by addressing rents. They have recently announced the introduction of an energy levy to claw back part of the rents. 	<ul style="list-style-type: none"> • Need to follow up on plans to further ease EPL, foster more effective wage bargaining (including by encouraging firm-level agreements and reducing survival periods), and strengthen activation policies. • Maintain energy levy and apply proceeds toward reducing upward pressures on electricity prices. Implement measures to reduce electricity system costs. • Complete ongoing negotiations with port concessionaires with a view to passing on labor cost reductions generated by the new Ports Work Law to end-users.

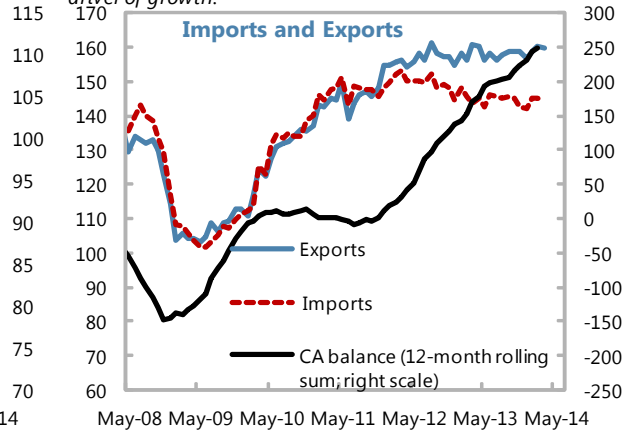
Source: IMF country teams

Figure 1. Euro Area: High Frequency Indicators

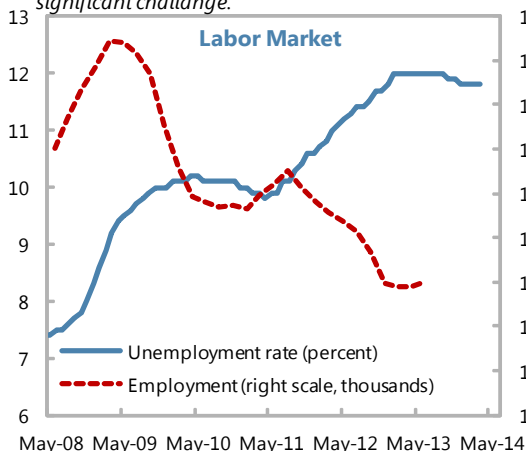
Activity has been gradually picking up...



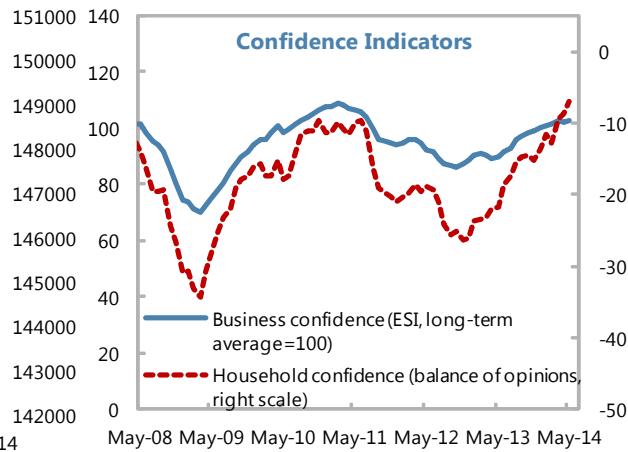
...with net exports remaining the most important driver of growth.



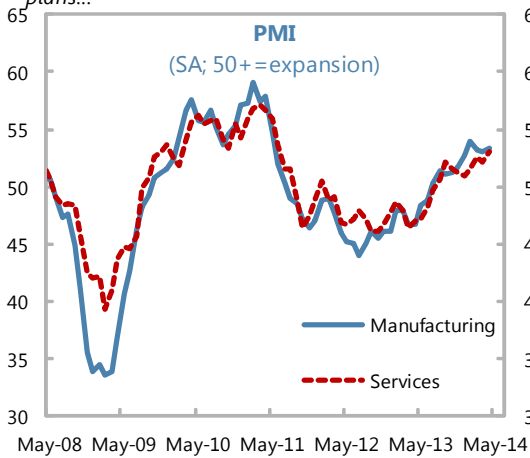
Persistently high unemployment continues to present a significant challenge.



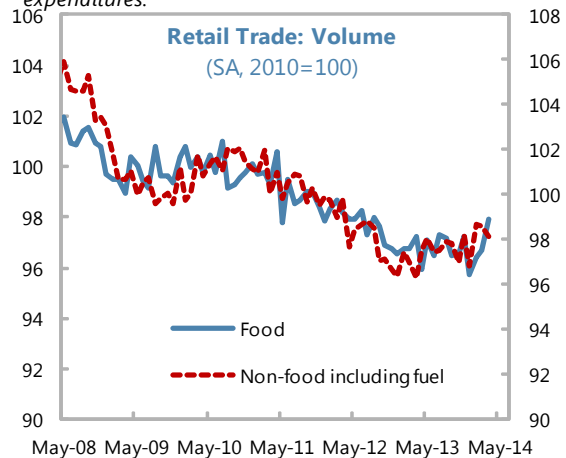
Business confidence has improved...



but firms are still cautious about their investment plans...



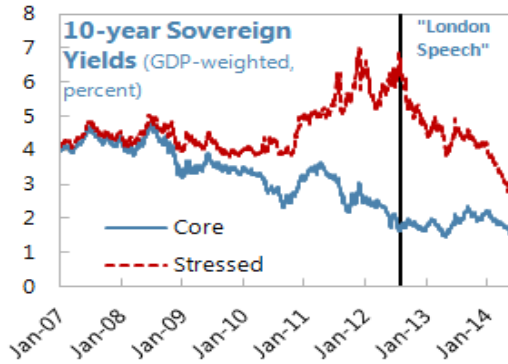
...and households about their consumption expenditures.



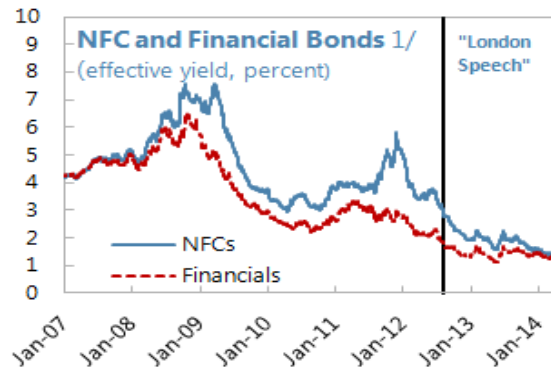
Sources: Haver Analytics and Eurostat.

Figure 2. Financial Market Developments

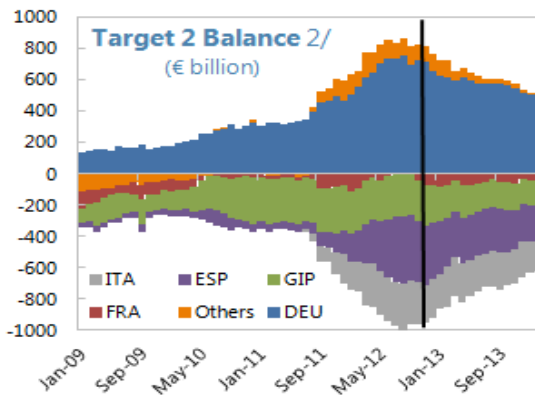
Sovereign yields, particularly in stressed countries, narrowed markedly following the London Speech.



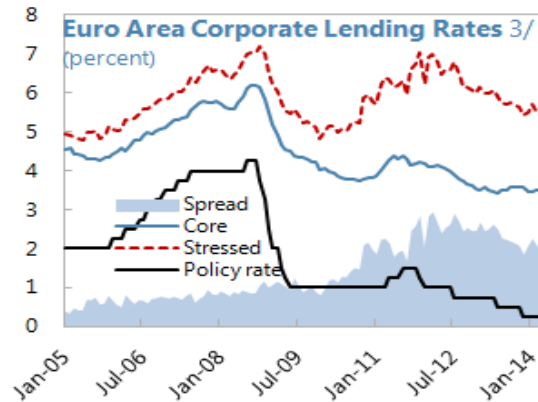
Corporate and financial borrowing costs have also compressed well below pre-crisis levels.



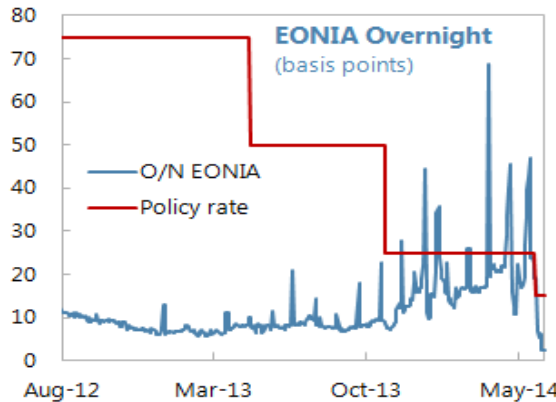
But financial market fragmentation persists. Despite initial improvements, Target 2 imbalances are large...



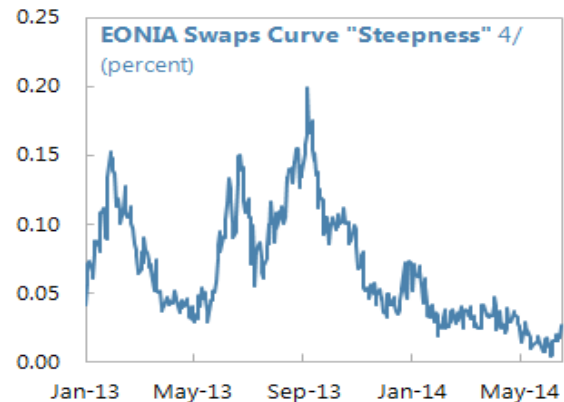
...while the spread between borrowing rates in core and stressed countries remains significant.



The overnight interbank rate has declined to historic lows in response to the ECB's latest policy measures...



...which have also helped to further anchor forward money market rates.



Sources: Bloomberg; Bank of America Merrill Lynch; ECB; National Central Banks; IMF WEO and IFS; and staff calculations.

1/ EUR-denominated NFC and Financial bonds, 1-5 year tenor.

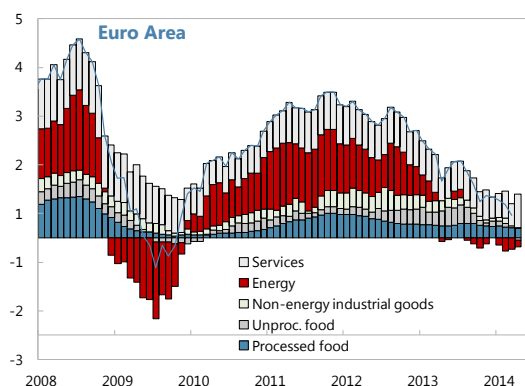
2/ GIP: Greece, Ireland, and Portugal. Others: Austria, Belgium, Finland, and the Netherlands.

3/ Loans < €1 million, maturity 1-5 years, new business. Loans are an unweighted average. Core: Germany, France, Belgium, the Netherlands. Stressed: Greece, Ireland (excluded from May 2011 onwards), Italy, Portugal, Spain.

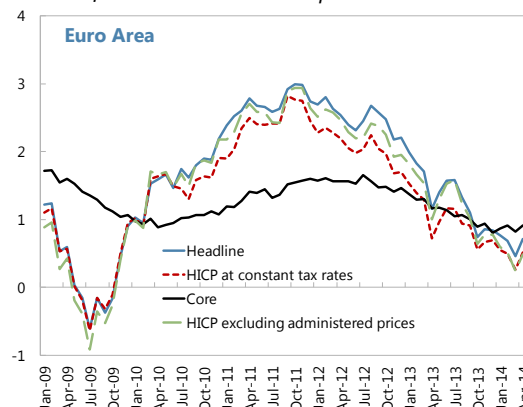
4/ Spread between 24 and 12 month tenors.

Figure 3. Euro Area Inflation Developments

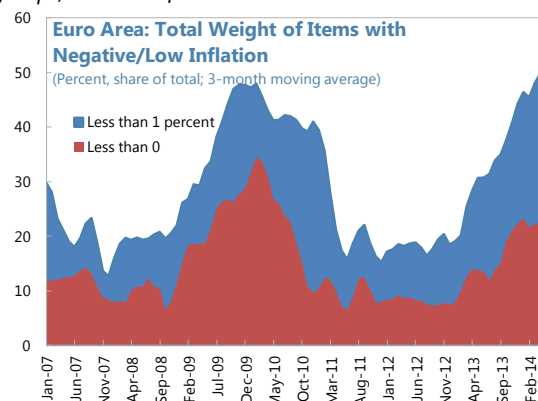
Inflation has been declining since 2013, driven partly by energy prices and appreciation of the euro...



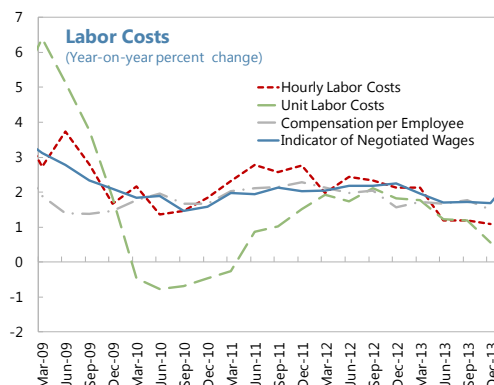
...but underlying inflation-excluding commodity, administered prices, and VAT effects- is also trending down and fluctuate at or below 1 percent.



Negative inflation is not broad-based across product groups, but low inflation is.



Labor costs have moderated gradually in 2013.



The impact from the structural reforms is still limited, estimated at around 0.1pps.

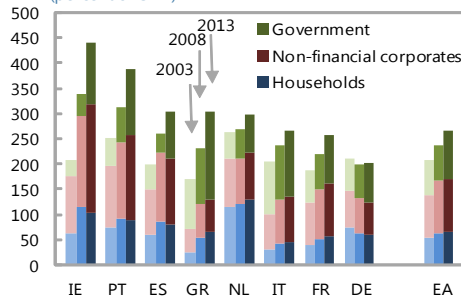
Country	Reforms	Estimated price impact
Belgium	Gas and electricity. Limiting indexations to international oil prices; increased competition (2013). Telecommunications. A new telecommunications law improving pricing and good customer service (2012).	- Estimated impact from gas and electricity reforms is about 0.6 pps and from telecommunication reforms is about 0.1 pps in 2013
France	Telecommunications. Increased competition (2011-2012).	- Estimated annual impact is about 0.3 pps in 2013.
Italy	Gas. Introduction of a futures market started trading; liberalization of the storage; progress towards building a trans-Adriatic pipeline;	- Gas price declined by 4.2 percent in 2013.
Greece	Minimum wage cut. Effective in the second half of 2012, the minimum wage is lowered by 22 percent (by 32 percent for youth), and frozen for the next three years.	- Restaurant and canteens prices: the estimated impact is about 1/4 pps.

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

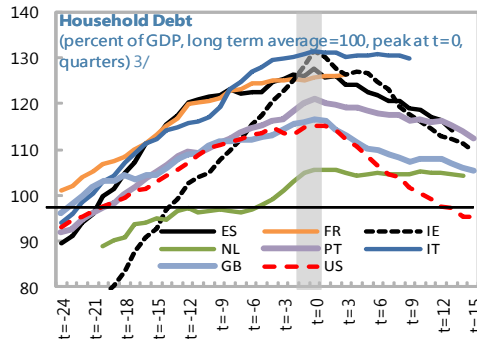
Figure 4. Debt Overhang in the Euro Area

Public and private sector debt increased rapidly in the last decade in the stressed countries....

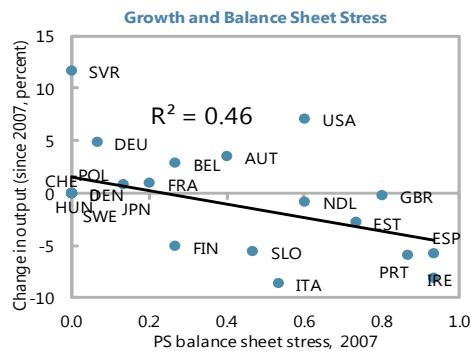
Indebtedness in the Euro Area 1/
(percent of GDP)



Household deleveraging has begun but has some way to go...

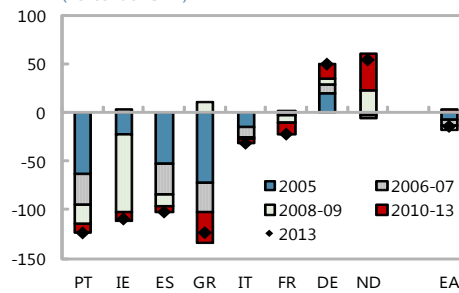


Private sector balance sheet stress is weighing on output...

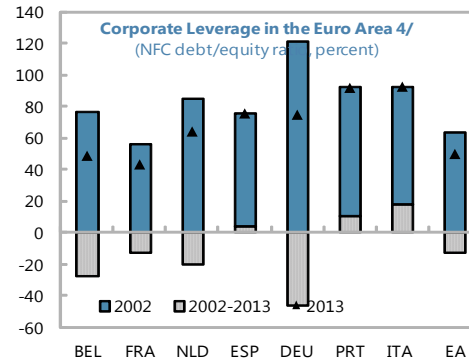


...and the external position worsened.

Net International Investment Position
(Percent of GDP)

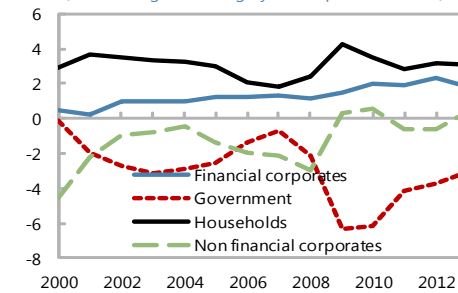


...while corporate leverage is high in countries where financing conditions are procyclical



...as all sectors de-lever simultaneously

Financial Surplus in the Euro Area
(Net lending/borrowing by sector, percent of GDP)



Sources: ECB, OECD, IMF IFS and staff calculations.

1/ For the Netherlands, first observation is 2005. Corporate debt includes intercompany loans which can differ significantly across countries.

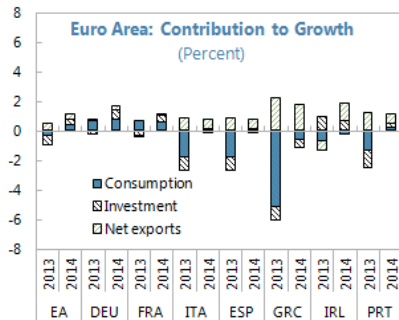
2/ France and EA are 2012 data.

3/ Long term average since 1999 but varies with data availability.

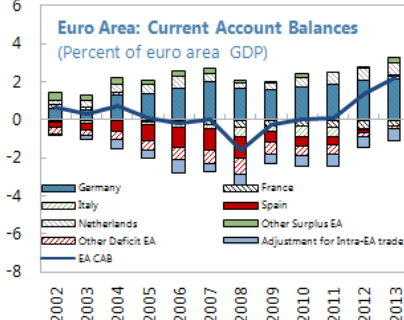
4/ First observation for Netherlands is 2005. Country data are not consolidated, EA is consolidated.

Figure 5. External Sector Developments

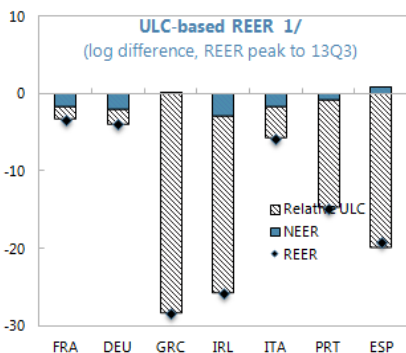
Net exports are expected to boost growth, while domestic demand stabilizes...



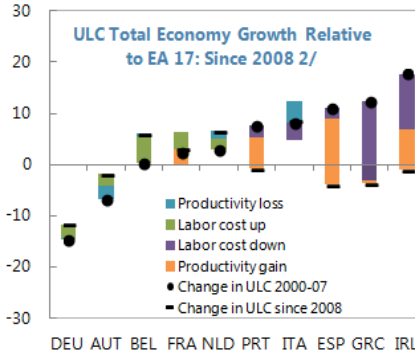
...helping to explain current account improvements across countries.



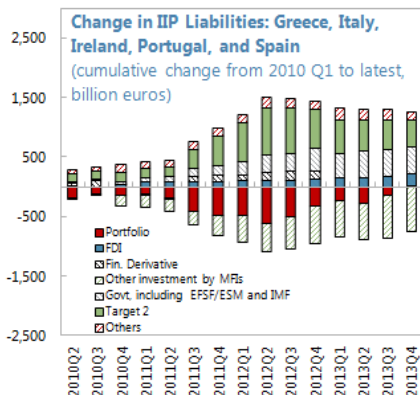
Substantial REER adjustments have been largely driven by falling unit labor costs...



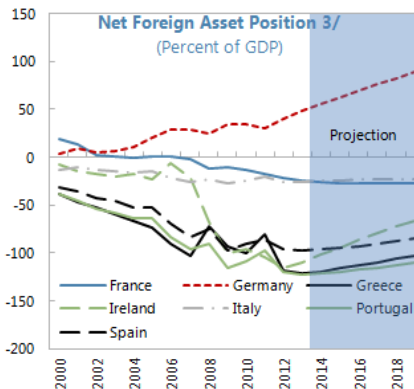
... which reflect both wage adjustments and labor shedding across countries.



Private capital is starting to flow back into stressed economies...



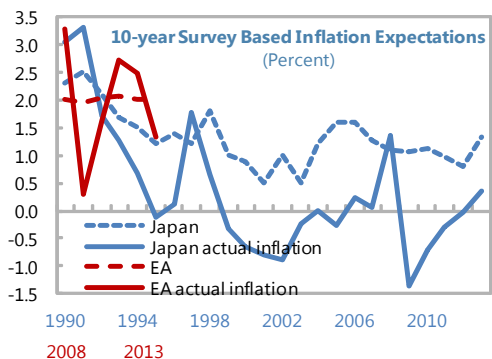
... and their net foreign asset positions should stabilize or improve slightly.



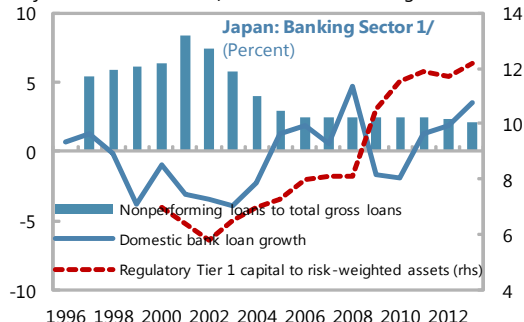
Sources: Eurostat; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
 1/ Peaks: 08Q1 for IRL and PRT, 09Q4 for GRC, DEU, FRA, and ITA.
 2/ The distance between the dots and bars represents changes from 2008 to the latest available data, in general 2013Q3.
 3/ NFA/GDP implied by WEO projections, assuming no stock-flow adjustments or valuation effects going forward.

Figure 6. Japan’s Deflation Episode and Current Euro Area Developments

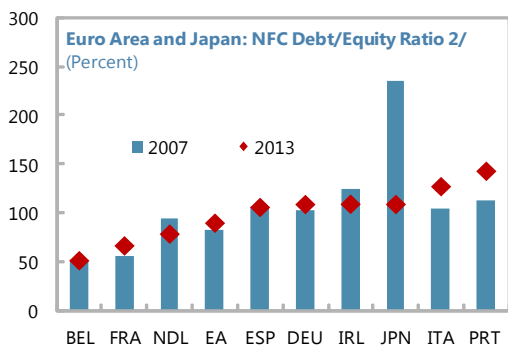
In Japan, long-term inflation expectations declined only gradually. In the euro area, they have remained anchored so far.



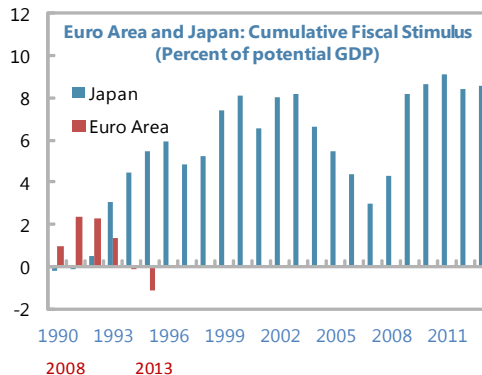
In Japan, banking reforms started late; credit picked up a few years later. In the euro area, banking sector reforms started earlier, but NPLs remain high.



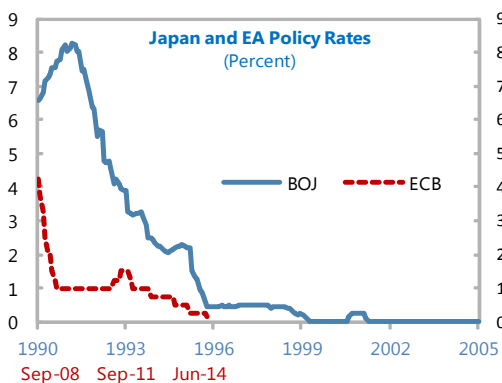
In Japan, investment recovered only after balance sheets were repaired. In the euro area, corporate leverage is lower, but incomplete and ongoing.



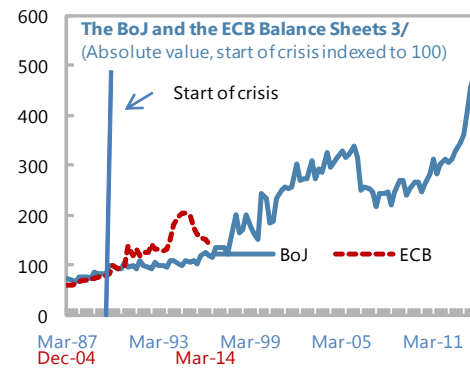
In the euro area, the initial fiscal stimulus was stronger, but there is less room going forward.



In the euro area, policy rates were cut swiftly, but conventional space is now exhausted.



In Japan, the BOJ started a substantial balance sheet expansion once expectations de-anchored. The ECB’s balance sheet has been shrinking.



Source: Consensus Forecasts; ECB; FSA, Bank of Japan, Ministry of Finance; Haver Analytics; National central banks; and WEO.

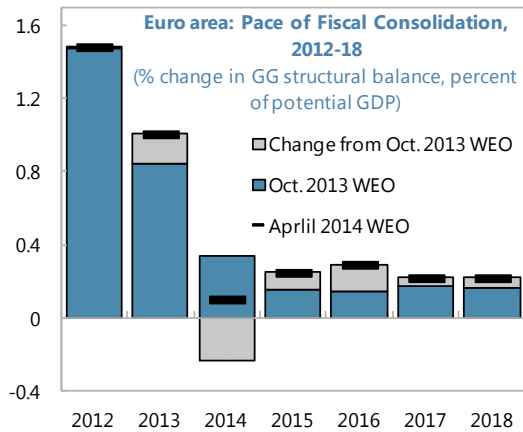
1/ At end-fiscal year (i.e. end-March of following year) except for FY2013 refers to half-year ending September 2012. Credit is based on calendar year. All banks but Shinkin banks included.

2/ JPN: leverage in 2002 (beginning of deleveraging) and in 2013. Debt at EA level is non-consolidated.

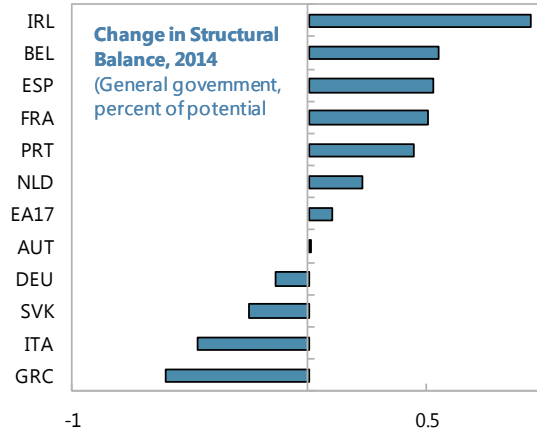
3/ The BoJ is indexed to 1990Q1=100, and the ECB is indexed to 2007Q4=100.

Figure 7. Fiscal Developments and Policies

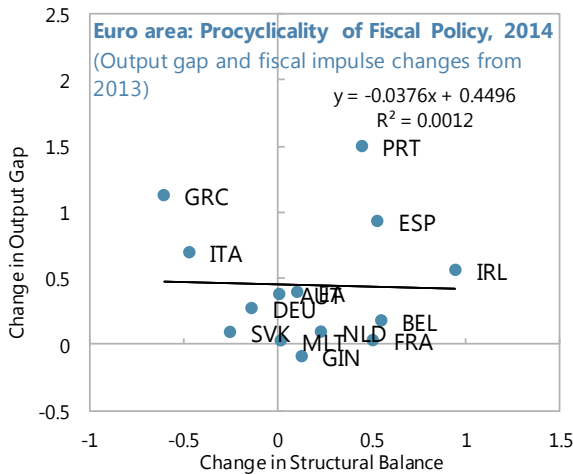
Fiscal consolidation will slow down in 2014 ...



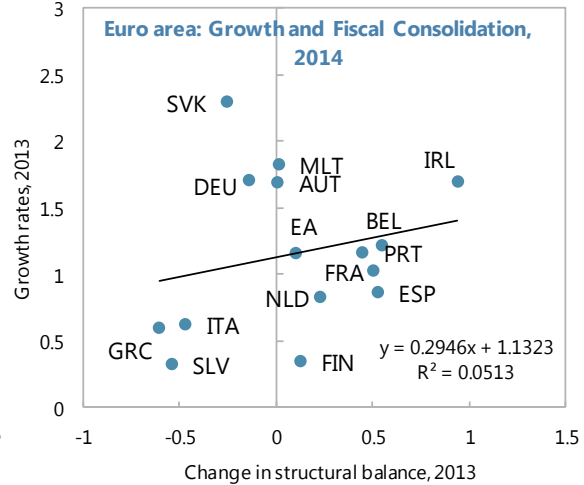
... with moderated adjustment envisaged in both core and periphery.



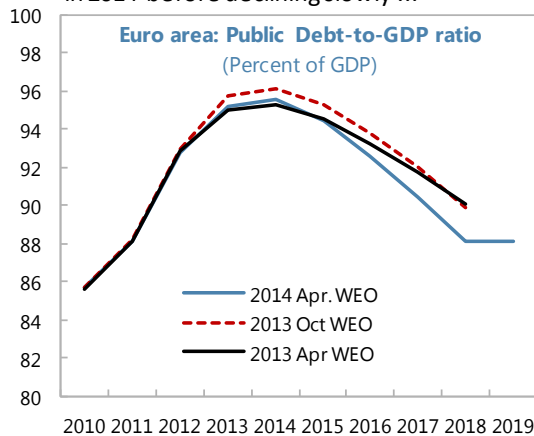
The pro-cyclicality of fiscal policies has largely diminished ...



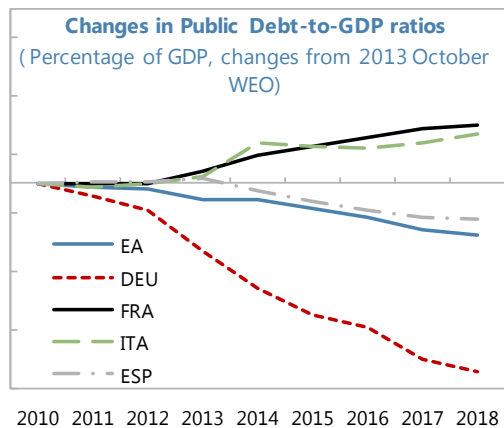
... and fiscal drag on growth is waning.



However, public debt is still expected to peak in 2014 before declining slowly ...



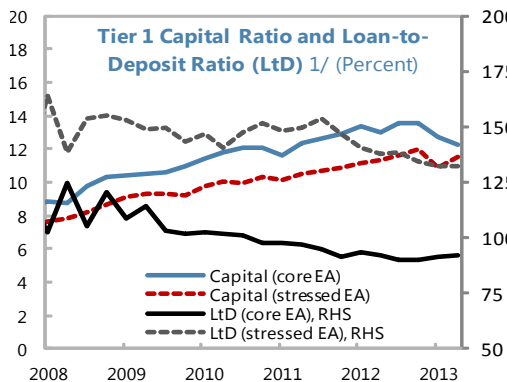
... while remaining elevated in many countries.



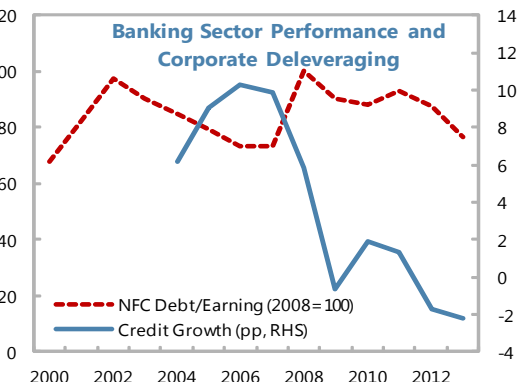
Sources: WEO and IMF staff calculations.

Figure 8. Euro Area: Banking Sector Developments

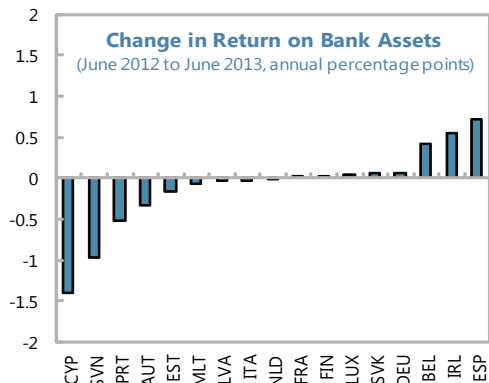
Capital ratios have been rising and loan-to-deposit ratios falling across the euro area, but differences remain between the core and stressed economies.



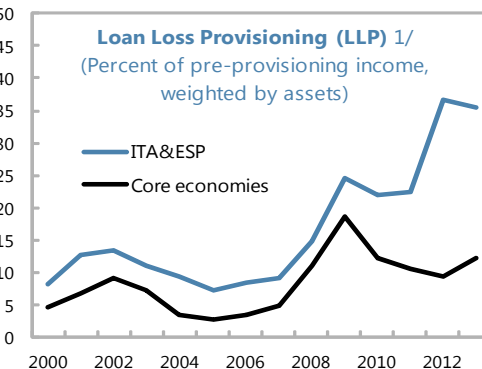
Credit supply is still contracting, and corporates have yet to begin deleveraging.



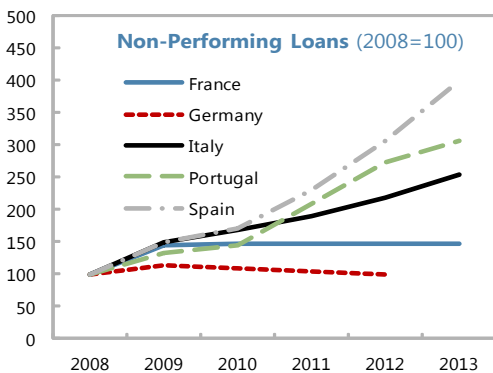
Bank profitability has shown wide variability, improving in some core economies and Ireland and Spain, while deteriorating elsewhere.



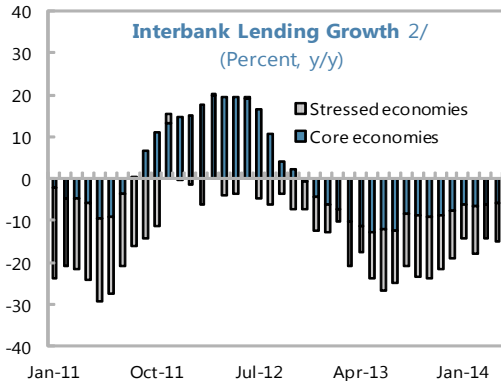
Loan loss provisioning rates have picked up across the euro area recently, with stressed economies like Italy and Spain showing a marked rise.



Non-performing loans have also risen across the euro area, but more in stressed economies, acting as a drag on profitability.



NPLs, profitability, and counterparty risk concerns may be contributing to falling interbank lending, which is seen across the euro area.



Sources: Bloomberg LP; Dealogic; ECB, World Bank, World Development Indicators database, and IMF staff calculations.

1/ Core economies = AUT, BEL, DEU, FRA, NLD; stressed economies = ESP, GRC, IRL, ITA, and PRT.

2/ Core economies = BEL, DEU, FRA, and NLD; stressed economies = ESP, IRL, ITA, and PRT.

Appendix. Statistical Issues¹

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 of the euro area.

1. **Significant progress has been made in implementation of the new international statistical standards.** The shifts to the new European System of National and Regional Accounts (ESA 2010) and to the Sixth Edition of the IMF's Balance of Payments International Investment Position Manual (BPM6) are well on track.³ Eurostat and ECB are working closely with all stakeholders on preparing the new data compilation and transmission, as well as methodological and statistical revisions. According to the current schedule, the new set of national accounts under ESA 2010 will be compiled and disseminated from September 2014, and the new euro area BOP statistics in line with the BPM6 will be published from Q4 2014. Monetary and financial statistics (e.g. interest rate, investment funds, financial vehicle corporations, securities issues) have also been adapted and new statistics will become available in 2015.

2. **These new changes are to bring remarkable benefits to economic surveillance and analysis.** The new statistical standards would allow economics data for the euro area to be disseminated in a timely manner with broadened coverage. In particular,

- *Broadened data coverage and shorter transmission periods.* ESA 2010 comes with a modified transmission program to Eurostat from the member states, with extended coverage (e.g. of non-financial assets and pension schemes) and advancement of transmission deadlines. Under the new schedule, national account aggregates are now to be transmitted at t+60 days (rather than t+70 days). The quarterly non-financial accounts by sector intended for euro area aggregates will be transmitted by the euro area countries at t+85 days (instead of t+90 days).
- *Flash quarterly GDP estimates at T+30 days.* In parallel to the adoption of ESA 2010, a Task Force (TF) is established by the National Accounts Working Group to assess the feasibility to

¹ Prepared jointly by the European (EUR) and Statistics Department (STA) of the IMF in consultation with the Eurostat and ECB. Claudia H. Dziobek 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."

produce a flash estimate of the euro area and European Union quarterly GDP at T+30 days. The TF started its work in June 2013 and intends to finalize the work by the end of 2015. Provided that the compilation of reliable T+30 days estimates is deemed to be feasible by the TF, a first T+30 flash estimate for the euro area and EU quarterly GDP could be published for Q1 2016.

- *More detailed analysis and presentation of pension schemes.* A compulsory supplementary table on pension entitlements will be required from 2017 to show the liabilities of all pension schemes, including those of government, whether they are unfunded or funded. This will improve comparability across countries and quantify the accrued-to-date pension entitlements of private households. Under ESA 2010, unfunded pension obligations of general government will not be reported in the core financial accounts and will not impact the Maastricht debt.
- *Improved statistics and coverage of balance of payments data under BPM6.* The ECB's data reporting requirements on external statistics under the BPM6 are more detailed, particularly as regard the instrument detail within the various functional categories of financial transactions. The first dissemination of BPM6 data will also be accompanied by comprehensive back-data, whose length will depend on national data availability and quality. In addition, a more detailed geographical breakdown of the euro area international investment position will be available on a quarterly basis, instead of the current annual frequency.

3. **The implementation of the new international statistical standards, combined with improved national data collections, will result in revisions to the economic statistics.** Revisions of historical GDP components are expected to raise GDP estimates for most EU members, partially due to the capitalization of research and development (R&D) expenditure and military weapons. The methodological revisions will for most countries coincide with regular benchmark revisions in which new data sources and methods will be introduced. While the exact impact on GDP levels varies across countries and they are not available until the data compilation is fully completed, the average impact of *methodological changes* (leaving aside statistical changes) on nominal EU GDP is expected to be an increase of 2.4 percent. In addition, the inclusion of part of illegal activities is likely to raise GDP estimates for some countries. Overall, as these re-categorized expenditures are relatively stable as share of GDP over time, most of methodological revisions are expected to affect GDP levels backwards with a limited impact on growth profile.

4. **There are remarkable improvements in government finance statistics to enhance economic and fiscal governance.** The Enhanced Economic Governance Package (so called "Six Pack") adopted in 2011 required adoption of measures for the collection and dissemination of monthly and quarterly fiscal data based on public accounts, and data on contingent liabilities for all

general government subsectors.⁴ Eurostat established a Task Force on the implications of the Directive under the “Six Pack” on the collection and dissemination of fiscal data. Important progress has been achieved up to date.

- *Enhanced fiscal data reporting.* By the end of 2013, countries brought into force the provisions necessary to comply with these requirements. Since February 2014, monthly fiscal data⁵ for central and state government and social security funds are publicly accessible for almost all countries on their national websites. A complete set of the general government accounts (including also local government) is available on a quarterly basis since end June 2014.
- *Planned publication of general government contingent liabilities.* In parallel to the new ESA transmission program, national publication of annual data on contingent liabilities and other indicators with potential impact on fiscal deficit and/or debt will start from October 2014. Eurostat will collect and disseminate new comparable sets of data regarding contingent liabilities and potential obligations of general government, such as the amounts of guarantees, the debt of public corporations, nonperforming loans, and potential obligations under Public Private Partnerships.

5. **Important steps are taken at the European level to support the ECB’s role as a single supervisor and monetary policy.** In October 2013 a new EU regulation conferred to the ECB the sole responsibility for supervision of large banks in the euro area and in those EU member states that voluntarily adhere to the Single Supervisory Mechanism (SSM).⁶

- *Expanded data collection and collaboration.* The ECB will collect supervisory data for the banking groups based on the harmonized Implementing Technical Standards (ITS) of the European Banking Authority, which has six parts: financial reporting, consolidated reporting, asset encumbrance, large exposures, liquidity ratios, and leverage ratios. Additional ad hoc datasets, including but not limited to those required for stress-testing purposes, may also be requested. Data is also to be transmitted directly from national supervisory authorities when the national central bank is not the supervisory authority.
- *Financial sector surveillance supporting SSM and monetary policy.* Since 2013 balance sheets of 246 monetary financial institutions (MFIs) are transmitted to the ECB on a monthly basis. This supports the analysis of deposit and lending decisions of the financial sector, and provides insights into the sources of bank funding. Quarterly data on the activities of non-bank financial institutions, including investment funds other than money market funds and including hedge funds, financial vehicles engaged in securitization and insurance companies and pension funds, are now collected by the ECB, complementing existing data relating to

⁴ See Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

⁵ The monthly fiscal data are cash based in the majority of countries, but the link with the accrual ESA 95 accounts is explained in the explanatory notes and a reconciliation table.

⁶ See EU regulation No. 1024/2013.

money market funds. Analytical results based on these data are regularly transmitted to the ECB decision-making bodies to support monetary policy.

- *Securities holdings statistics.* A new dataset on securities holdings statistics is being collected by the ECB since end 2013 on the basis of the ECB Regulation concerning statistics on holdings of securities. The new data contains security-by-security information on holdings of individual securities by institutional sectors. Additionally, a second module comprises security-by-security information on the holdings by each of the largest euro area banking groups (i.e. also including the securities held by their subsidiaries and branches, both inside and outside the euro area) identified as important for the stability and functioning of the financial system in the euro area and in each euro area country.
- *The survey on the access to finance of SMEs in the euro area (SAFE).*⁷ ECB conducted the tenth semiannual survey on SME financing conditions, which provides evidence mainly on changes in the financial situation, financing needs, and access to financing from October 2013 to March 2014. The survey results suggest that financing conditions for SMEs continue to differ significantly across euro area countries and are in general more difficult than those of larger companies. Increasing quantitative coverage are to be expected in future surveys on firm characteristics including investment, export intensity, employees, and lending conditions such as interest rates, payment delays, and sources of financing. Moreover, from 2014, a larger version of the survey which is conducted every second year together with the Commission will become annual.
- *Further improvements in data reporting.* The ECB and the IMF Statistics Department are finalizing the migration of the balance sheet data for depository corporations to the IMF's Standardized Report Forms (SRFs) for monetary statistics. Work continues on mapping data for Other Financial Corporations.

6. **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. In July 2013 the Commission submitted a draft proposal for a regulation on the provision and quality of statistics for the MIP to the European Parliament. The aim of this proposal is to develop a robust quality monitoring procedure in order to ensure the highest quality of the MIP relevant data. The proposal is currently under discussion at working party meetings of the Council.

⁷ The total euro area sample size was 7,520 firms, of which 6,969 (93 percent) had fewer than 250 employees.



INTERNATIONAL MONETARY FUND



Press Release No. 14/341
FOR IMMEDIATE RELEASE
July 14, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation on Euro Area Policies

On July 9, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Euro Area.

The euro area recovery is taking hold. Real output has expanded for four consecutive quarters, and financial market sentiment has improved markedly. Complementary policy actions have supported demand, boosted investor confidence, and eased financial conditions. At the national level, governments have made further progress repairing sovereign and bank balance sheets and implementing structure reforms to restore competitiveness. At the area-wide level, the ECB has taken a wider range of measures to support demand and address fragmentation. Progress on building a banking union continues, with the ECB set to assume supervisory responsibilities in November 2014, following the planned completion of the Comprehensive Assessment of systemically important banks. Additional steps—such as agreements on a Single Resolution Mechanism (SRM), backed by Single Resolution Fund (SRF), the Bank Recovery and Resolution Directive (BRRD), and the deposit insurance harmonization directive—demonstrate collective commitment to EMU.

But the recovery is neither robust nor sufficiently strong. Weak aggregate demand is weighing on real activity and pulling down inflation across the euro area, as corporates, households and banks continue to repair their balance sheets. Financial markets are still fragmented, with contracting credit and high borrowing costs constraining investment in countries with large output gaps, large debt burdens, and high unemployment. In this context, euro area GDP is expected to grow by just over 1 percent this year, before expanding by 1.5 percent in 2015. Headline inflation is expected to remain below the ECB's primary price objective for a protracted period, underscoring the risks from low inflation. And there are remaining structural gaps in capital, labor, and product markets, presenting hurdles to financing investment, intra-euro area rebalancing, and raising productivity.

Risks to growth are still tilted to the downside. With limited policy space in the near term,

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.

further negative shocks—either domestic or external—could undermine financial market sentiment, halt the recovery, and push the economy into lower inflation and even deflation. A common fiscal backstop would strengthen the credibility of the asset quality review (AQR) and stress tests. The recovery is also subject to external risks, including a slowdown in emerging market growth, escalation of geopolitical conflict, and an abrupt exit from unconventional monetary policies in the United States. Over the medium term, there is a risk of stagnation, which could result from persistently depressed domestic demand due to deleveraging, insufficient policy action, and stalled structural reforms. More positively, improved confidence could raise growth above forecast levels.

Executive Board Assessment²

Executive Directors welcomed the strong policy actions taken at the euro area and national levels to prop up demand and ease financial conditions, which have improved market sentiment and recovery prospects. Directors emphasized that sustained, higher growth is needed to reduce unemployment and debt burdens in the euro area while also generating positive spillovers to the rest of the world. This requires concerted efforts that focus on additional demand support, completion of bank balance sheet repair and of a banking union, and further advancement of structural reforms. Directors underscored the importance of continued collective commitment to completing the architecture of the Economic and Monetary Union.

Directors welcomed the exceptional measures recently taken by the European Central Bank (ECB) to address low inflation and strengthen demand, as well as its intention to use further unconventional instruments if necessary. They agreed that if inflation remains too low, consideration could be given to a large-scale asset purchase program, primarily of sovereign assets. Directors noted that the signaling of the ECB's commitment to its price objective would eventually raise inflation expectations across the euro area.

Directors acknowledged that the neutral area-wide fiscal stance is broadly appropriate, balancing growth with debt sustainability considerations. They stressed, however, that national fiscal policies should be carefully calibrated to support growth where space permits, making use of the flexibility under the fiscal framework and avoiding further consolidation in the event of large negative growth surprises, while adhering to the medium-term objective of reducing public debt-to-GDP ratios. Directors also recommended using the escape clauses in the fiscal framework if deflation risks materialize and monetary policy options are depleted. They saw scope for streamlining the governance framework over the medium term with a view to improving its clarity and compliance.

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>.

Directors underlined the urgency of repairing bank balance sheets and reducing financial fragmentation. While supporting the broad strategy and the ambitious timetable for bank recapitalization, they saw merit in maintaining some flexibility to take account of market conditions and financial stability concerns. They also considered that a common fiscal backstop would decisively sever bank-sovereign links and enhance the credibility of the ECB's Comprehensive Assessment of bank balance sheets. Directors were encouraged by the substantial progress toward a banking union, and looked forward to further advancement at the national level to facilitate corporate debt resolution, including by strengthening insolvency and debt restructuring frameworks.

Directors stressed the need to step up structural reforms with a view to promoting employment, competitiveness, and intra-euro area rebalancing. Priority areas include: (i) diversifying funding markets through securitization, especially to credit-constrained smaller firms; (ii) removing country-specific structural impediments to tackle high youth unemployment; and (iii) higher public investment in creditor countries and continued competitiveness-enhancing reforms in debtor countries. Directors also encouraged steps to improve labor market functioning and increase competition in product and services sectors, which would support efforts at the euro area level to implement the Services Directive, negotiate free trade agreements, and further integrate energy markets.

Euro Area: Main Economic Indicators, 2011-2016

	(Percent change)					
	2011	2012	2013	Projections 1/		
				2014	2015	2016
Demand and Supply						
Real GDP	1.6	-0.7	-0.4	1.1	1.5	1.7
Private consumption	0.3	-1.3	-0.7	0.6	1.1	1.3
Public consumption	-0.1	-0.6	0.1	0.3	0.3	0.4
Gross fixed investment	1.6	-4.0	-2.9	1.6	2.7	2.8
Final domestic demand	0.5	-1.7	-0.9	0.7	1.2	1.4
Stockbuilding 2/	0.3	-0.5	0.0	0.1	0.0	0.0
Domestic Demand	0.7	-2.2	-1.0	0.8	1.2	1.4
Foreign balance 2/	0.9	1.5	0.5	0.3	0.3	0.2
Exports 3/	6.5	2.5	1.4	3.9	4.5	4.9
Imports 3/	4.5	-0.9	0.4	3.4	4.1	4.7
Resource Utilization						
Potential GDP	0.6	0.4	0.6	0.8	1.0	1.1
Output gap	-0.8	-1.8	-2.8	-2.5	-2.0	-1.4
Employment	0.3	-0.6	-0.8	0.3	0.7	0.9
Unemployment rate 4/	10.1	11.3	12.0	11.7	11.4	10.8
Prices						
GDP deflator	1.2	1.3	1.5	1.1	1.4	1.4
Consumer prices	2.7	2.5	1.3	0.7	1.2	1.3
Public Finance 5/						
General government balance	-4.1	-3.7	-3.0	-2.7	-2.1	-1.5
General government structural balance	-3.7	-2.3	-1.3	-1.2	-0.9	-0.6
General government gross debt	88.2	92.9	95.2	95.9	94.9	93.2
External Sector 5/, 7/						
Current account balance	0.1	1.3	2.2	2.3	2.5	2.5
Interest Rates 4/, 6/						
EURIBOR 3-month offered rate	1.4	0.2	0.3	0.3	...	...
10-year government benchmark bond yield	4.3	2.3	3.3	2.6	...	...
Exchange Rates 6/						
U.S. dollar per euro	1.39	1.30	1.37	1.37	...	...
Nominal effective rate (2000=100)	104.2	99.8	108.5	108.6	...	...
Real effective rate (2000=100) 6/	95.0	90.2	96.1	95.3	...	...

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.

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ In percent.

5/ In percent of GDP.

6/ Latest monthly available data for 2014.

7/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

**Statement by Menno Snel, Executive Director, on the Euro Area
July 9, 2014**

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 generally in broad agreement with staff findings and recommendations. Policy actions over the past year have laid the foundations for recovery and boosted investor confidence. However, policy action is still needed to strengthen the recovery by supporting domestic sources of growth, pursuing differentiated, growth friendly fiscal consolidation, addressing financial fragmentation and facilitating the balance sheet repair in the private sector as well as advancing structural reforms.

The authorities are making continued efforts to ensure deeper structural reforms throughout the euro area in order to boost potential growth, to create jobs and to ensure that the intra euro area rebalancing observed in recent years will continue. The analysis undertaken within the economic surveillance framework under the European Semester leads to country specific policy advice on fiscal and structural policies. The authorities reiterate their commitment to take all necessary actions to strengthen the recovery in the euro area and ensure medium-term growth and sustainability of public debt.

Economic outlook and risks

The authorities broadly share staff's view on economic prospects. Despite recent improvements, the ongoing economic recovery remains moderate and is expected to gain momentum only slowly in 2014-15, while job creation is still lagging behind.

In the first quarter, real GDP increased by 0.2% (quarter-on-quarter), following an expansion by 0.3% in the fourth quarter of 2013. After four quarters of economic expansion, the real economy has not yet fully recovered from the impact of the European sovereign-debt crisis. Despite significant improvements in financial market sentiment, in the first half of 2014, credit dynamics remain weak, which can only partially be attributed to the usual lagged response of credit during a cyclical upturn. For instance, bank lending to the euro-area private sector continued to decline over the last couple of months, at an annual rate of -1.4% in May (adjusted for sales and securitisation). Lending volumes to the non-financial corporate sector continued to be weaker with -2.5% annual growth in May (adjusted for sales and securitisation), with market fragmentation still persisting, while the annual growth rate of loans to households remained slightly positive, mainly supported by lending for house purchases. Heterogeneity in lending volumes and interest rates across euro-area countries has slightly receded but remains high. Financial fragmentation has reduced but is still hampering the transmission of financial conditions to productive activity in some countries.

Looking ahead, the economic recovery is expected to continue, gradually gaining momentum and broadening across countries, as domestic demand strengthens in the course of this year. This includes fixed investment, which, as staff also emphasises, has been hit hard since the beginning of the crisis in 2007-08. Fixed investment is expected to continue its expansion as financing conditions remain favourable (on average), uncertainty declines further and the recovery gains momentum. According to the Commission services' Spring 2014 forecast, real GDP should grow by 1.2% in 2014 and by 1.7% in 2015, with all domestic GDP components and net exports making positive contributions in both years. The mechanical impact of the weaker-than expected first quarter on the annual figure for 2014 should be small. This outlook is also broadly in line with staff's forecast, which appears to be marginally less optimistic for output growth but comprises an identical outlook for employment growth. The on-going balance-sheet repair in the private sector as well as the residual fragmentation of financial markets are the main factors constraining growth in 2014. The expected uptick in growth in 2015 reflects not only stronger global growth, but also higher growth of private consumption and gross fixed capital formation. Further progress with structural reforms, with the banking union and with the repair of banks' balance sheets is expected to support the strengthening of domestic demand and thus the recovery. In both years, the moderate pace of expansion implies that unemployment rates should fall only slowly from current levels.

The staff's assessment highlights that risks to the growth outlook remain tilted to the downside with downside risks having recently increased on the external side. The authorities are less pessimistic than the staff's report regarding their potential impact on the euro area. On the domestic side, one of the main risks to growth remains the stalling or only partial implementation of structural, fiscal and institutional reforms at the Member States and the EU level.

Supporting domestic demand and strengthening the recovery

The authorities underline that the Fund's concern of a protracted period of slow growth and even stagnation is not a central scenario.

- ***Monetary policy and the outlook for price stability***

The authorities broadly share staff's view on euro area inflation dynamics and outlook. At present, inflation is very low at 0.5% both in May and, according to the flash estimate, also in June 2014. Looking ahead, inflation is expected to remain at low levels over the coming months, before increasing only gradually during 2015 and 2016. Inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with the ECB's aim to maintain inflation rates at levels below, but close to, 2% over the medium term. Both upside and downside risks to the outlook for price developments remain limited and broadly balanced over the medium term. The ECB is strongly determined to keep inflation expectations solidly anchored over the medium term.

Over the past year, the ECB forcefully responded to the risks to price stability, which at the current juncture are associated with the risks of too prolonged a period of low inflation. To address those risks, the ECB has lowered its key ECB interest rates in November and announced a comprehensive monetary policy package in early June. All these measures provide additional monetary policy accommodation and support lending to the real economy. Taken together, these measures should contribute to a return of inflation to levels closer to 2%.

Specifically, the ECB measures of early June included a cut in the key ECB interest rates, including, for the first time, a negative rate on the deposit facility now standing at -0.10%. Moreover, the ECB has announced to conduct longer-term refinancing operations targeted to support bank lending to the non-financial private sector and it is intensifying its preparatory work related to outright purchases in the ABS market. To maintain a high degree of monetary accommodation and to contain volatility in money markets all refinancing operations will be conducted as fixed rate tender procedures with full allotment at least until end 2016, and the weekly operations sterilising the liquidity injected under the SMP have been suspended.

The ECB has also announced to maintain a high degree of monetary accommodation. The key ECB interest rates will remain at present levels for an extended period of time in view of the current outlook for inflation. If necessary, the ECB stands ready to use further unconventional instruments within its mandate to address further risks of a too prolonged period of low inflation. At the same time, the combination of monetary policy measures decided last month has already led to a measurable easing of the monetary policy stance and is likely to provide impetus to an expansion of loans to the real economy which in turn will support and reinforce the on-going economic recovery.

- *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 and believe that, if needed, the possibilities offered by the EU's existing fiscal framework to balance fiscal discipline with the need to support growth should be used. Given the persistently high debt and unemployment levels and the low nominal GDP growth, as well as the challenges of an ageing society and of supporting job-creation, particularly for the young, fiscal consolidation must continue in a growth-friendly and differentiated manner. Structural reforms that enhance growth and improve fiscal sustainability should be given particular attention, including through an appropriate assessment of fiscal measures and structural reforms, while making best use of the flexibility that is built into the existing Stability and Growth Pact (SGP) rules.

On the fiscal governance framework, the authorities believe that the Fund should take into account the legal requirements of the Treaty, when assessing possible changes to the current governance framework. Substantial progress has been achieved in improving the SGP, and in improving the methodology to interpret fiscal effort and the structural indicators. In addition, the composition of fiscal consolidation is important to ensure a growth-friendly fiscal adjustment. In the authorities' view, it is essential that the SGP is supported by credible implementation and enforcement in Member States.

Financial markets, fragmentation and balance sheet repair

The authorities agree with the Staff Report that the financial crisis led to unwarranted fragmentation of financial markets in the euro area and revealed the shortcomings of the strong reliance of the euro area economy on bank lending. The progress made in the establishment of the banking union will undoubtedly help further reduce financial fragmentation by contributing to overcoming home bias among banks, leading to better diversification of risk and a rekindling of cross-border lending. Agreeing that the debt overhang in the private sector is a major force constraining growth in the euro area, authorities welcome the Staff Report's recommendation to improve national insolvency regimes.

The authorities recognise that a more diversified and accessible funding market of non-financial corporations could reduce the bank dependency of the euro area economy. They therefore welcome the Staff Report's emphasis on the development of capital markets options for corporate financing, in particular for SMEs, which are likely to be the most constrained and the need to carefully recalibrate the regulatory framework, as suggested in the Bank of England-ECB joint papers on EU securitisation market. They welcome the calls for the EIB and EIF to support efforts in order to reduce market fragmentation, including through the European Commission-EIB SME Initiative. A number of proposals could be explored such as the creation of a European High Quality Securitisation market, enhancing data transparency for SMEs in order to facilitate direct or indirect capital markets access, or enhancing the market for corporate private placements on a European scale or widening the existing EIB-EIF program for SME securitisation.

The authorities confirm that the ECB Comprehensive Assessment, including the asset quality review (AQR) and the subsequent EBA stress test, is well on track and should lead to a reinforcement of the euro area's banking system's soundness. The ESM's instruments including a new direct recapitalisation instrument will be in place when needed and will allow for an effective approach for those Member States that meet the eligibility criteria.

The fragmentation of financial markets will be further reduced and the soundness and resilience of the euro area banking sector enhanced by the establishment of a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). The Union has agreed on the SRM Regulation, which introduces a centralised system of decision making for resolution, endowed with the adequate financing means through the establishment of the Single Resolution Fund (SRF). Situations may arise when the SRF is not sufficiently funded by the banking sector, especially in the initial period but also in the steady state. In the transition period (1 January 2016 to 31 December 2023), bridge financing will be available either from national sources, backed by bank levies, or from the ESM in line with agreed procedures. A common backstop will be developed during the transition period. However, the ability to implement bail-in fundamentally alters the dynamic for future resolution cases. Resolution funds can only be used after a minimum bail-in of no less than 8% of the total liabilities, including own funds, of the institution under resolution has taken place and are not meant to be a financing mechanism for the capital of the bank.

Advancing Structural Reforms

The authorities believe that structural reforms are needed to address weak medium-term prospects and foster job creation, in particular to tackle youth unemployment, but also to

boost potential growth. As financing conditions improve, structural drivers will become more important in the medium-term. Sustained efforts need to be made for the adequate implementation of structural reform measures in both labour and product market to strengthen potential growth and ensure that the external rebalancing observed in recent years continues. Most of the debtor countries still need to either further improve their current account balances or sustain their existing surpluses to reduce risks to their external sustainability. Further measures to boost competitiveness and facilitate the reallocation of resources to the tradable sector are key in this respect. Creditor countries with large current account surpluses need to foster appropriate policies to contribute to positive spill-overs. In line with the views expressed in the staff report, creditor countries could adopt reforms that increase demand and potential growth, particularly those aiming to support investment.

The authorities have taken a number of initiatives to tackle youth unemployment with targeted policies (for example, reformed vocational education training, revised apprenticeship frameworks, targeted hiring incentives, reformed public employment services, and reformed EPL systems). The policy action has been better integrated into the European Semester implementation over the last year, while financing of country-specific programmes has been provided through EU structural funds (the "Youth Guarantee Scheme"), subject to an assessment by the European Commission.

The completion of the Single Market is a continuous exercise and it is a central element of the European growth agenda. According to the European Commission estimates, full implementation of the Services Directive would significantly improve the functioning of the single Market for Services and could lead to an additional economic gain of about 2.6% EU GDP in the long term. The authorities agree with the Staff Report that further integration of energy markets is important to mitigate possible disruptions in global commodity markets due to geopolitical events. In this regard, connecting national electricity grids should not be singled out as the most pressing challenge as improving the interconnection of national gas networks is also crucial in the current geopolitical context.

Policy advice under the European Semester includes country-specific policy recommendations in the structural domain for each Member State and the euro area as a whole. In particular, for many Member States recommendations highlight the need to further liberalise the services sector and to reduce the tax wedge on labour, and more generally, to improve framework conditions for growth and jobs, including by completing the single market, notably in the ICT industries, and by reinforcing an efficient competition framework. Moreover, benefits can also be obtained from improvements in the quality of research and innovation systems and from a prioritisation of R&D efforts. Further R&D investments should be accompanied by in-depth reforms to modernise the public-private research and innovation system and to improve the broader framework conditions for companies to become more knowledge-intensive. It is clear that Europe as a whole needs to invest more in R&D, innovation, education, skills and active labour market policies, as well as in energy, transport and the digital economy. The authorities are committed to respect the country-specific policy recommendations as endorsed in June under the European Semester.