



EURO AREA POLICIES

July 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

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 2018 Article IV consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 16, 2018 consideration of the staff report that concluded the Article IV consultation with member countries.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 16, 2018, following discussions that ended on May 24, 2018, with the officials at EU institutions on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 27, 2018.
- A **Statement by the Executive Director** for Germany, on behalf of the euro area Member States and the European community.

The documents listed below have been or will be separately released.

Selected Issues
Financial System Stability Assessment

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July 19, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation on Euro Area Policies

On July 16, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ on euro area policies with member countries. This year, the consultation also included a discussion of the findings of the Financial Sector Assessment Program (FSAP) exercise for the euro area.²

The euro area expansion, while still vigorous, is slowing to a more moderate pace. The main engine remains domestic demand, underpinned by solid job creation. Growth is projected to remain above potential in 2018 and 2019, at 2.2 percent and 1.9 percent, respectively, before easing to an annual rate near 1½ percent. In the medium term, demographic changes, weak productivity growth, and crisis legacies will continue to exert drag. While headline inflation has exhibited some volatility lately, core inflation has remained subdued. Inflation is still expected to take a few years to durably converge to the European Central Bank (ECB)'s objective of below, but close to 2 percent.

An array of global and domestic risks hangs over the outlook. Trade tensions have risen with the recent U.S. imposition of tariffs on steel and aluminum imports. Policy inaction and political shocks at the national level are important domestic risks, especially with regard to rebuilding fiscal buffers in countries with high public debt and implementing structural reforms while growth remains strong. And the lack of progress in Brexit negotiations raises the risk of a disruptive exit.

The FSAP finds significant progress on the banking union. The size and quality of banks' buffers are higher than before, and nonperforming loans have declined, but low profitability remains a serious challenge for many banks. Banking supervision has undergone a step improvement with the creation of the Single Supervisory Mechanism, and the handling of bank resolution is better under the Single Resolution Mechanism, although the fragmentation of rules along national lines remain an issue. The FSAP lays out detailed recommendations for further improvement.

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.

² Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion.

Executive Board Assessment³

Executive Directors welcomed the continued broad-based economic expansion and strong job creation, underpinned by solid domestic demand and accommodative monetary policy, noting that this is the fruit of many years of sustained policy effort. Core inflation and wage growth remain subdued, however, despite a closing output gap and a recent energy price driven spike in headline inflation.

Directors cautioned that risks are skewed to the downside, stemming from domestic policy inactions and political shocks, as well as a less favorable external environment, underpinned by escalating trade tensions and Brexit-related uncertainties. Moreover, policy reversals could risk sending borrowing costs abruptly higher, derailing the ongoing expansion.

Directors agreed that monetary policy should remain supportive until inflation is convincingly converging to the ECB's objective. They welcomed the ECB's intention to keep interest rates low well beyond the end of net asset purchases this year. In this respect, clear communication remains essential to anchor interest rate expectations.

Directors agreed that decisive policy efforts should support external rebalancing and promote trade openness and the rules-based global trading system. With respect to staff's assessment that the euro area current account surplus is moderately stronger than warranted by fundamentals, they underlined that the policy remedies lie primarily at the national level.

Directors were concerned that national budgetary plans did not adequately address country specific challenges. High-debt countries should increase their fiscal adjustment efforts while conditions remain supportive. Directors generally also encouraged countries with ample fiscal space to pursue additional investment that will lift potential growth and contribute to necessary external rebalancing. Directors stressed the importance of better compliance with and enforcement of the fiscal rules, along with a plan to simplify the fiscal framework. They also called for internationally coordinated efforts to address new taxation challenges arising from globalization of corporate activities and digitalization.

Directors recognized that deep structural issues continued to impede medium-term growth prospects and hamper income convergence. They urged countries to step up structural reform efforts to boost productivity and employment, and supported initiatives to link EU financial support to reform implementation.

Directors welcomed the improvement in overall banking health, as documented in the FSAP review. They urged further efforts to strengthen the resilience of the system, in particular in terms of profitability, and encouraged vigilance against financial stability risks. They appreciated the strengthening of banking supervision under the Single Supervisory Mechanism, while noting remaining challenges. Directors encouraged ongoing supervisory and other actions to clean up legacy assets. They recognized that bank crisis preparedness and management have been

³ 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>.

upgraded, yet saw the need to address certain transitional and structural issues. They agreed on the importance of building up “bail-in-able” debt in banks, and gradually reducing financial intermediaries’ exposures to home sovereign debt, both of which will help attenuate sovereign bank feedback loops. Further progress on building the capital markets union and enhancing the supervision of nonbanks were viewed as valuable in themselves, and all the more so in the context of Brexit.

Directors considered architectural reforms a necessary complement to national action. They urged swift progress on reducing the legal fragmentation across national lines, creating a credit line from the European Stability Mechanism to backstop the Single Resolution Fund, and establishing a common deposit insurance scheme. Most Directors saw merit in developing over time a central fiscal capacity to support macro stabilization, embedding strong safeguards against permanent transfers and moral hazard.

Euro Area: Main Economic Indicators, 2015–23									
	2015	2016	2017	Projections 1/					
				2018	2019	2020	2021	2022	2023
Demand and Supply									
Real GDP	2.1	1.8	2.4	2.2	1.9	1.7	1.5	1.5	1.4
Private consumption	1.8	2.0	1.6	1.5	1.7	1.5	1.5	1.4	1.3
Public consumption	1.3	1.8	1.2	1.4	1.2	1.0	1.0	1.0	1.0
Gross fixed investment	3.3	4.6	3.2	3.9	3.6	2.9	2.5	2.3	2.2
Final domestic demand	2.0	2.5	1.8	2.0	2.0	1.7	1.6	1.5	1.5
Stockbuilding 2/	0.0	-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand	2.0	2.3	1.9	2.1	2.0	1.7	1.6	1.5	1.5
Foreign balance 2/	0.1	-0.4	0.6	0.2	0.0	0.0	0.0	0.0	0.0
Exports 3/	6.4	3.3	5.3	4.7	4.4	3.8	3.6	3.4	3.3
Imports 3/	6.7	4.6	4.3	4.6	4.7	4.2	3.9	3.6	3.6
Resource Utilization									
Potential GDP	1.5	1.3	1.4	1.6	1.6	1.6	1.6	1.5	1.5
Output gap	-1.6	-1.2	-0.2	0.4	0.8	0.8	0.8	0.7	0.6
Employment	1.0	1.4	1.6	1.0	0.7	0.6	0.4	0.3	0.2
Unemployment rate 4/	10.9	10.0	9.1	8.4	8.0	7.8	7.6	7.5	7.4
Prices									
GDP deflator	1.4	0.8	1.1	1.5	1.6	1.8	1.9	2.0	2.0
Consumer prices	0.0	0.2	1.5	1.7	1.7	1.8	2.0	2.1	2.1
Public Finance 5/									
General government balance	-2.0	-1.5	-0.9	-0.6	-0.6	-0.5	-0.7	-0.7	-0.8
General government structural balance	-1.0	-0.8	-0.7	-0.8	-1.0	-0.9	-1.1	-1.1	-1.2
General government gross debt	89.9	89.0	86.7	84.3	81.8	79.8	77.9	76.1	74.5
External Sector 5/, 6/									
Current account balance	3.2	3.6	3.5	3.2	3.1	3.1	3.0	3.0	2.9
Interest Rates (end of period) 4/, 7/									
EURIBOR 3-month offered rate	-0.1	-0.3	-0.3	-0.3	...	...	...	...	...
10-year government benchmark bond yield	1.2	1.3	0.9	1.2	...	...	...	...	...
Exchange Rates (end of period) 7/									
U.S. dollar per euro	1.09	1.05	1.18	1.18	...	...	...	...	...
Nominal effective rate (2005=100)	101.2	102.6	110.0	110.2	...	...	...	...	...
Real effective rate (2005=100, ULC based)	90.7	90.6	96.3	96.7	...	...	...	...	...
Sources: IMF, <i>World Economic Outlook</i> , Global Data Source; Reuters Group; and Eurostat.									
1/ Projections are based on aggregation of WEO April 2018 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/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.									
7/ Latest monthly available data for 2018.									

EURO AREA POLICIES

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

June 27, 2018

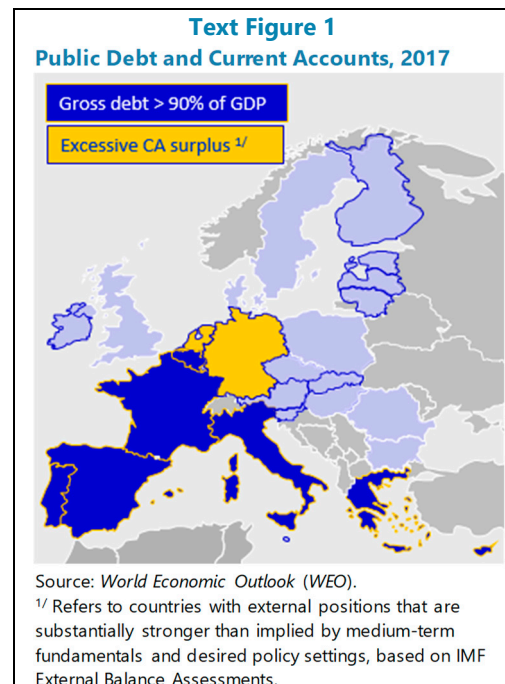
KEY ISSUES

This is a time to strengthen the resilience of the euro area and raise its long-term growth potential. Despite the recent slowdown and coming end of quantitative easing, growth remains strong and monetary conditions accommodative. Member countries should grasp the opportunity to address deep structural challenges, rebuild thin policy buffers, and rebalance externally. Mounting downside risks add urgency.

The supportive monetary stance should be maintained until inflation is convincingly converging to objective. As net asset purchases draw to a close, clear forward guidance will become even more important.

Much is needed at the national level. In the high-debt countries, public debt loads have barely fallen despite strong growth, leaving insufficient fiscal space to respond to the next shock, while productivity gaps remain wide, retarding per capita income convergence. In the large net external creditor countries, current account surpluses are excessive. Actions must include: (i) adjusting to rebuild fiscal buffers in the high-debt countries, while pursuing structural reforms to lift productivity; (ii) using fiscal space to increase spending in well-targeted ways in the large creditor countries to lift potential growth and incentivize private investment at home, while also taking steps to encourage faster wage growth; and (iii) maintaining risk reduction momentum in banking and finance everywhere.

Risk reduction and risk sharing should advance together. Architectural reforms would help increase the euro area's resilience to future shocks. Completing the banking union, with common rules and backstops, and advancing the capital markets union, with careful management of the Brexit transition, would support private cross border risk diversification. Equally, there is a pressing need for fiscal institutional reforms: a central fiscal capacity to support macroeconomic stabilization, embedding strong safeguards against permanent transfers and moral hazard.



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CONJUNCTURE

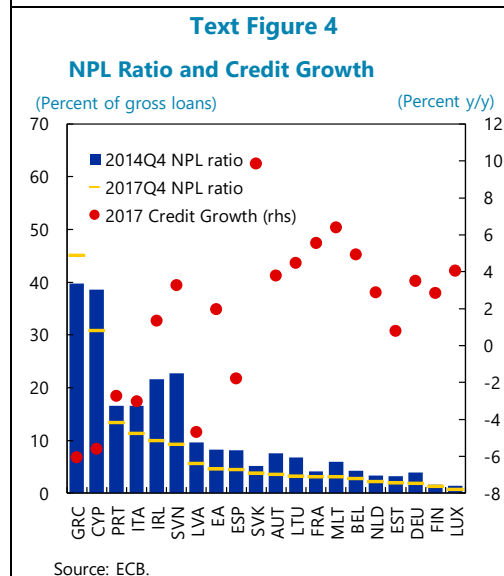
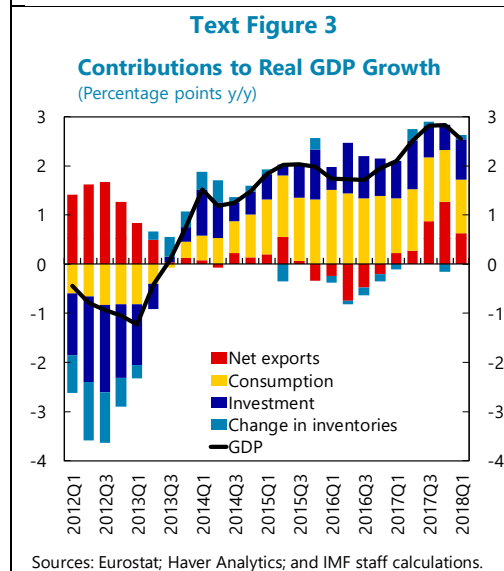
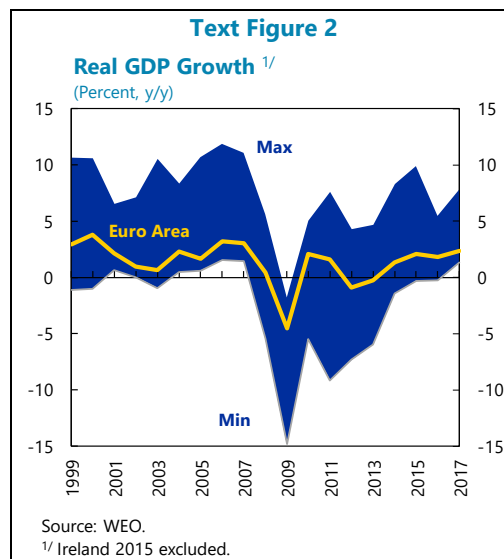
The euro area is enjoying a strong expansion, despite the recent slowdown. Solid job creation is helping propel domestic demand, a dynamic that should enjoy increasing support from wage growth going forward. But medium-term growth prospects remain lackluster, and risks—including of rising trade tensions, policy complacency, and political shocks—are particularly serious at this time.

A. Recent Developments

1. Six years after the depths of its crisis, the euro area is still reaping the fruits of wide ranging policy efforts. Bold actions by the European Central Bank (ECB) and major architectural projects—creating the European Stability Mechanism (ESM), the Single Supervisory Mechanism (SSM), and the Single Resolution Mechanism (SRM)—demonstrated resolve and cohesion under duress. This was important for the economic recovery.

2. Growth remains strong, broad-based, and job friendly, but has likely passed its peak. All euro area countries are growing, with the dispersion of growth rates at its narrowest since the launch of the single currency. The main engine is domestic demand—including investment—although net exports played an increasingly complementary role in 2017. Steady job creation underpins the robustness of the recovery. Joblessness has declined across age and gender groups, with the overall unemployment rate falling to 8½ percent in April 2018, the lowest level since early 2009. Youth unemployment remains above 20 percent in several countries, however, and net job creation for young adults has been much slower than the overall rate.

3. Macroeconomic conditions are helping mend the banks, with credit beginning to grow again. Bank profits and capital ratios are improving and non-performing loan (NPL) ratios are coming down—to an average of about 5 percent at present. As of Q4 2017, the aggregate euro area risk-based tier 1 capital ratio was 15.8 percent, and the average return on equity was



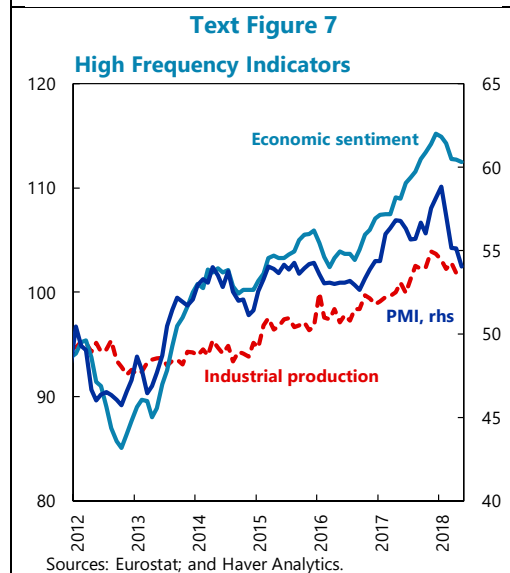
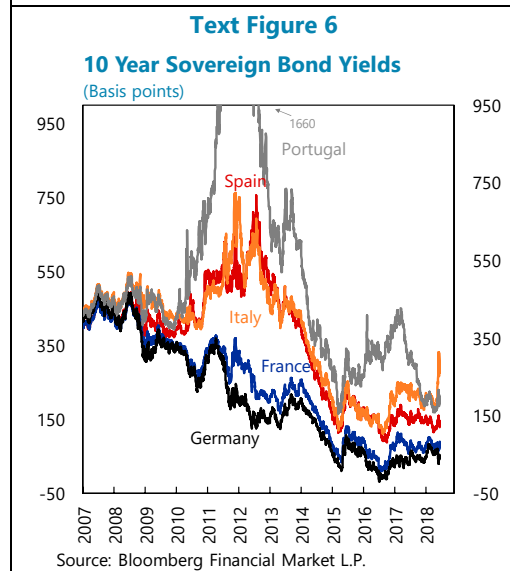
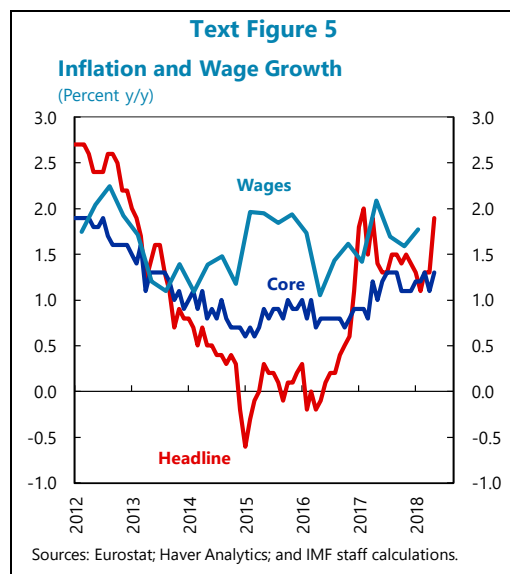
5.6 percent. But there is a large dispersion in NPL ratios—which remain in double digits in Greece, Cyprus, Portugal, and Italy—and a similar dispersion in returns, where staff analysis shows that for many banks growth alone will not be enough (see Financial Sector Policies). The ECB’s survey of lending standards shows bank credit terms to nonfinancial firms and households easing amid rising credit demand. Bank credit growth picked up to 1.7 percent in 2017, still considerably below nominal GDP growth.

4. Wage growth and underlying inflation have remained subdued. Headline inflation has been volatile, spiking to 1.9 percent in May 2018 on the back of rising world oil prices. Core inflation crept from 0.9 percent in early 2017 to 1.3 percent in May 2018. Wage growth has been stuck below 2 percent for most of the last six years, with the latest reading still at only 1.8 percent, in Q1 2018. Across the four largest economies, Germany registered the fastest wage growth in 2017, at 2.2 percent, and Italy the slowest, at 0.4 percent.

5. National political developments have shown a continued propensity to roil financial markets. The recent difficulties with forming a government in Italy triggered a sharp spread widening accompanied by a drop in secondary market liquidity. There were also some price spillovers to the Spanish and Portuguese bond markets, although these were relatively minor, with yields remaining below their 2017 averages.

B. Baseline Outlook

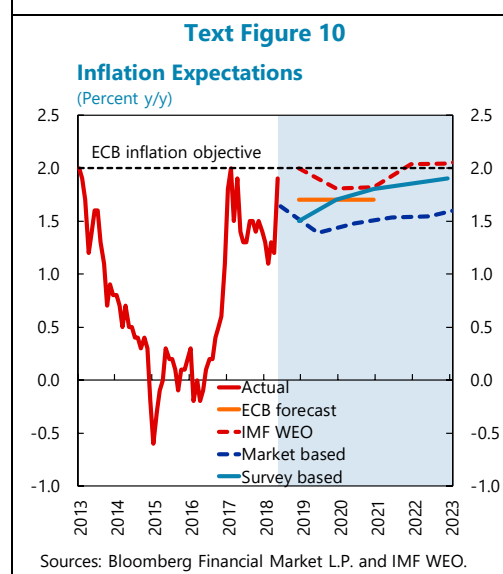
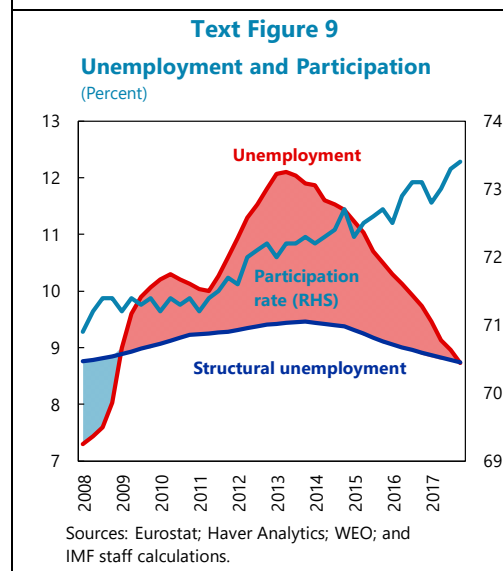
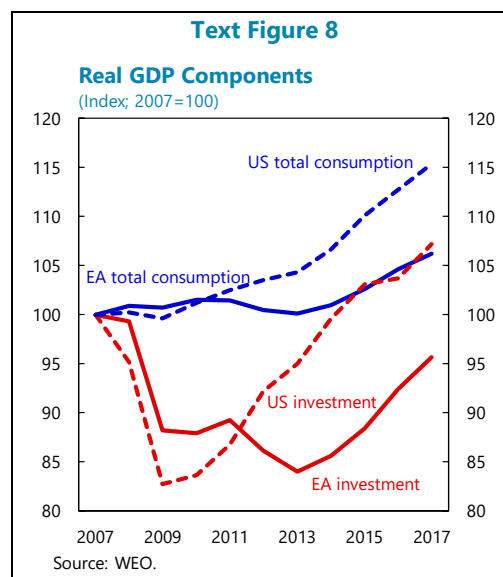
6. The most recent readings suggest the recovery has passed its peak. Growth slipped to a provisional 0.4 percent q/q in Q1 2018 compared with an average quarterly rate of 0.7 percent in 2017. To some extent, the weak growth number for Q1 reflected temporary factors related to winter weather, strikes, and the timing of the Easter holidays. But several high-frequency indicators, including industrial production, the European Commission’s survey of economic sentiment, and the purchasing managers’ index, suggest reduced momentum in Q2 also. Some modest deceleration of



growth is consistent with the well-advanced recovery—now in its fifth year—and a closing output gap.

7. There are good reasons, still, to expect a soft landing. Staff's growth projection for 2018 was revised down by 0.2 percentage points, to 2.2 percent, between the April and July 2018 *World Economic Outlooks (WEOs)*, and that for 2019 by 0.1 percentage points, to 1.9 percent. Even after its run of strong growth, total investment remains well below its pre-crisis level. This—and a comparison with the U.S. recovery path—suggests some further room to run over the next couple of years. Consumption is expected to remain firm, supported by solid job creation and a gradual pick-up in wage growth. Importantly, monetary policy is expected to continue to provide strong demand support for some time yet. Conversely, the increasing impulse from net exports seen in 2017 could fade given past euro appreciation and moderating world trade growth. On balance, the aggregate output gap is projected to close in 2018 and turn positive in 2019, with the dispersion in national output gaps expected to keep narrowing.

8. Inflation is expected to converge to objective, slowly. With the remaining unemployment assessed to be structural—and with the pace of increase of the participation rate unlikely to be sustained—hiring plans by firms will likely spur wage growth; the recent German wage agreements may be a bellwether (see *Europe: Regional Economic Outlook*, April 2018). Higher oil prices, coupled with rising labor costs and a likely unwinding of past profit compression by firms, will tend to lift inflation. Recent Phillips curve analysis by staff, on the other hand, indicates a strong backward-looking element in the euro area inflation process, suggesting significant sluggishness in the face of what will be a positive euro area output gap (see Monetary Policy). On balance, staff's inflation projections are up slightly relative to the April 2018 *WEO*—but inflation is still not expected to reach the ECB's objective of below, but close to, 2 percent for a few years yet.

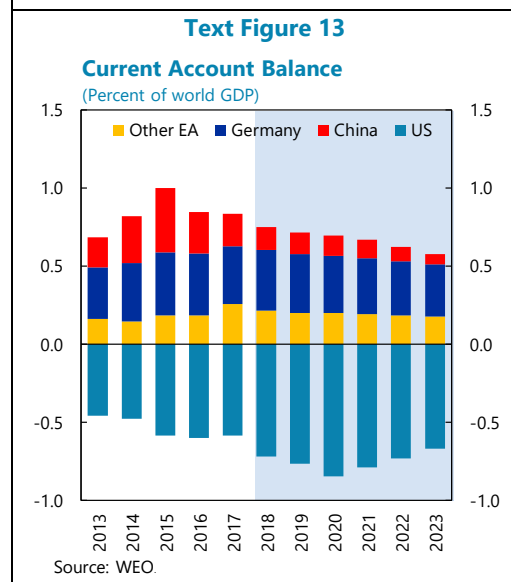
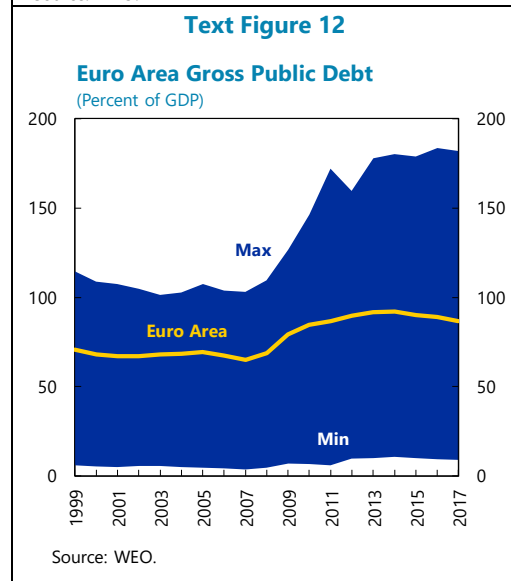
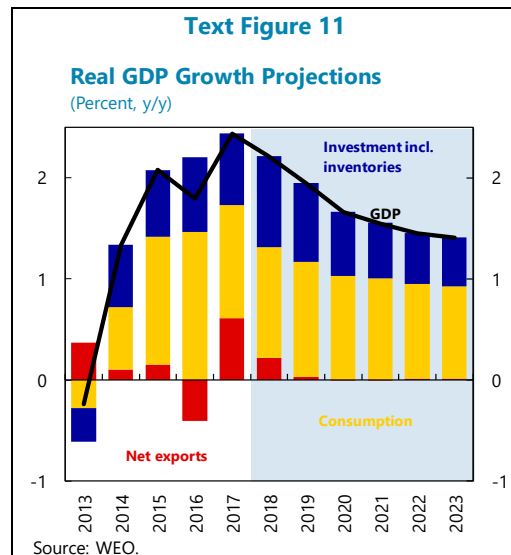


9. Medium-term growth prospects remain lackluster. Once the cyclical upswing has run its course, growth is expected to ease to an annual rate near 1½ percent. Demographic changes, weak productivity growth, and crisis legacies—including ongoing private sector deleveraging in some countries—will continue to exert drag. Productivity enhancing infrastructure investment is likely to be held back by too little fiscal space in the countries with heavy debt loads and by too much caution in the countries with strong balance sheets. Brexit-related dislocations will cause some output and job losses for both the U.K. and EU-27 economies. In the EU-27, these losses will likely be disproportionately concentrated in a few countries with strong direct and indirect economic ties to the United Kingdom, including Ireland, the Netherlands, and Belgium (Box 1).

C. Risks Around the Baseline

10. Risks are particularly serious at this time. Recent events have skewed the balance of risks downward, reflecting both domestic and global factors. If these were to materialize, the economy could yet be tipped into a hard landing.

11. Policy inaction and political shocks at the national level are the main domestic risks. Brisk growth and easy financing conditions have fostered complacency on needed fiscal adjustment and structural reforms, despite the approaching end of the period of extraordinary monetary accommodation. If monetary normalization were to coincide with a perception that vulnerable countries are not doing enough to address their underlying problems—or indeed are considering reversing reforms or implementing policies that would harm debt sustainability—sovereign spreads could again increase abruptly, with possible contagion effects, imposing valuation losses on investors across the euro area. Persistently wider spreads would hurt growth and could force sharp fiscal adjustments, making a bad situation worse. Meanwhile, the lack of progress in Brexit negotiations raises the risk of a disruptive exit, which would weigh on confidence and investment.



Box 1. Macroeconomic Impacts of Brexit ^{1/}

Bonds between the euro area and the United Kingdom run deep. First, the United Kingdom ranks among the euro area's three largest trading partners, accounting for 13 percent of euro area trade in goods and nonfactor services. Second, supply-chain linkages imply substantial indirect trade links through third countries. Third, financial linkages are tight, with bilateral capital flows, spanning FDI, portfolio investments, and bank claims, amounting to some 55 percent of euro area GDP in 2016. Finally, bilateral migration is particularly important for some euro area countries, including Cyprus, Ireland, and Malta. A synthetic multidimensional index of EU–U.K. integration indicates growing links over the past 30 years.

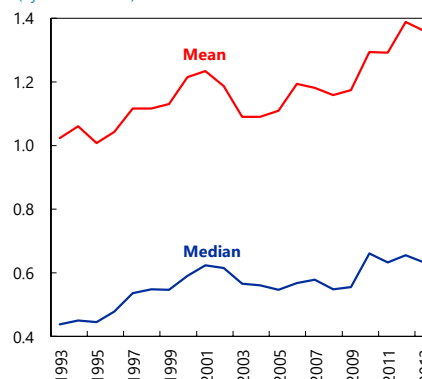
Weaker integration post-Brexit will hurt the EU-27. Empirical analysis by staff estimates that EU-27 real GDP would fall by up to 0.8 percent or 1.5 percent in the long run relative to the baseline, in the event of a standard free trade agreement or a default to World Trade Organization (WTO) rules, respectively. Under a relatively benign “Norway” scenario where access to the single market is preserved while membership in the customs union is lost, the estimated loss of output is negligible.

Impacts vary widely across countries. Detailed simulations from a multi-country general equilibrium model that mainly isolates direct and indirect trade effects suggest euro area real output would decline by 0.3 percent in the long run in the event of a standard free trade agreement, with Ireland's income level falling the most in the EU-27 by about 2 percent, followed by other countries such as Belgium, Luxembourg, Malta, and the Netherlands. These estimated impacts increase in a “hard Brexit” scenario, reaching an output loss of 0.5 percent for the EU-27, in which the estimated output loss for Ireland reaches 4 percent.

There will be no winners from Brexit. Integration between the EU and the United Kingdom has strengthened significantly over time, reflecting shared gains from the EU single market. It follows that the departure of the United Kingdom from the EU will represent a loss not only for the United Kingdom but also for the EU-27. Staff's analysis corroborates that higher barriers to trade, capital, and labor mobility will have a negative long-term effect on output and jobs throughout the EU-27.

^{1/} See companion selected issues chapter, “Long-Term Impact of Brexit on the EU.”

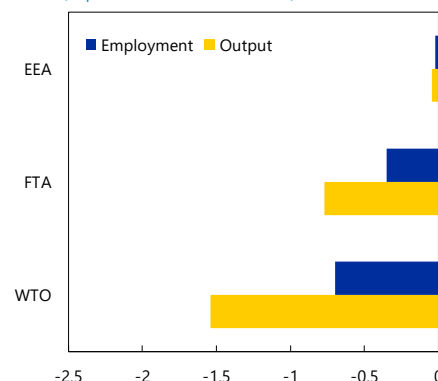
Euro Area Index of Integration with the U.K.
(Synthetic index)



Source: IMF staff estimates.

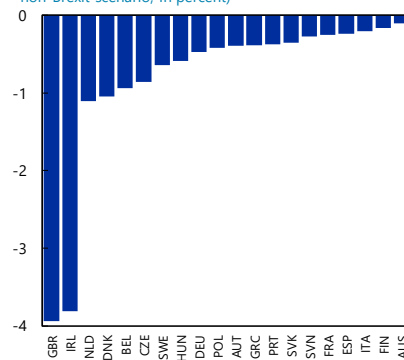
EU27: Long-Run Decline in Output and Employment

(In percent; losses due to Brexit)



Source: IMF staff estimates.

Long-Term Impact of Brexit: WTO scenario
(Decline in the level of output compared to a non-Brexit scenario; In percent)



Source: IMF staff estimates.

12. Rising protectionism stands out as a major global concern. Uncertainties around U.S. trade policy and tensions among the big global players risk weakening the rules-based global trading system. As a tail risk, protectionist measures could trigger a full-blown trade war, seriously disrupting cross border commerce and damaging the recovery.

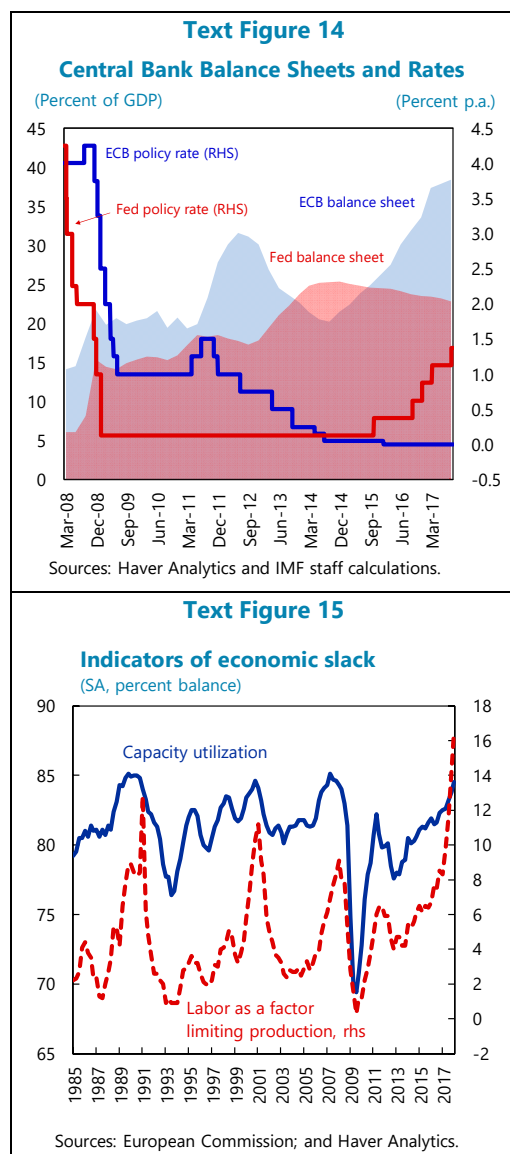
13. Leads and lags between U.S. and euro area policy cycles could create complications. By itself, faster-than-expected monetary policy normalization by the Federal Reserve triggered by strong U.S. growth would tend to depreciate the euro, helping the ECB to gradually reduce its accommodation. If, however, there were to be an abrupt change in global risk appetite—triggered by, say, a U.S. inflation surprise—the result could be sharply tighter global financial conditions and surging spreads for the euro area’s high-debt countries. The looser U.S. fiscal stance could also affect the exchange rate independently.

14. Against these downside risks, there is still the possibility that growth could surprise positively in the next year or two. The global economic setting could yet improve, including—in the short run—in response to the U.S. fiscal stimulus, driving a positive feedback process between euro area exports, investment, and consumption. As always, there is considerable uncertainty around estimates of economic slack in the euro area. High capacity utilization and emerging labor shortages suggest that the euro area’s cyclical position may be further advanced than baseline estimates. Conversely, other indicators such as a broader measure of underemployment suggest that labor market slack might be greater than estimated (*European Commission Annual Review of Labor Market Conditions in Europe, 2017*, and *WEO*, October 2017).

Authorities’ Views¹

15. The authorities agreed the most likely path over the next two years will be for moderating but still-strong growth. Healthy job and wage growth, higher corporate earnings, and improving credit conditions will continue to support domestic demand. But the pace of expansion will probably decelerate, reflecting supply constraints, past euro appreciation, and gradual monetary normalization. The Commission sees risks to growth tilted firmly downward, dominated by the effects of procyclical policies in the United States, the global protectionist threat, and financial market dislocations such as those experienced around the recent government formation in Italy.

16. Inflation is expected to rise gradually. Headline inflation has exhibited considerable volatility of late, mainly driven by energy prices, which led to the spike in May, but also partly by temporary factors such as university fee exemptions in Italy and lower transport insurance costs in Germany, which had a moderating effect. With further absorption of labor market slack, the ECB



¹ Authorities refers to the ECB, the European Commission, and other central institutions.

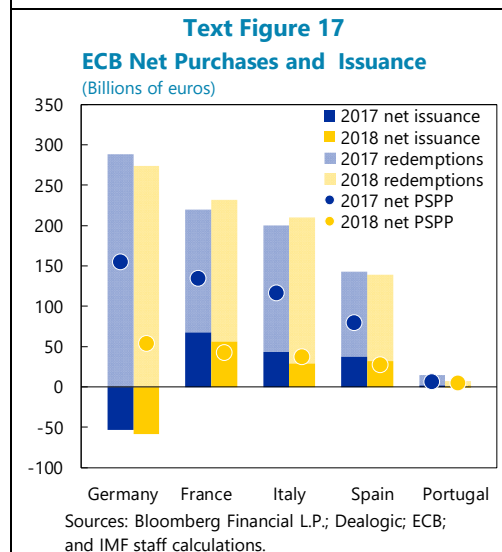
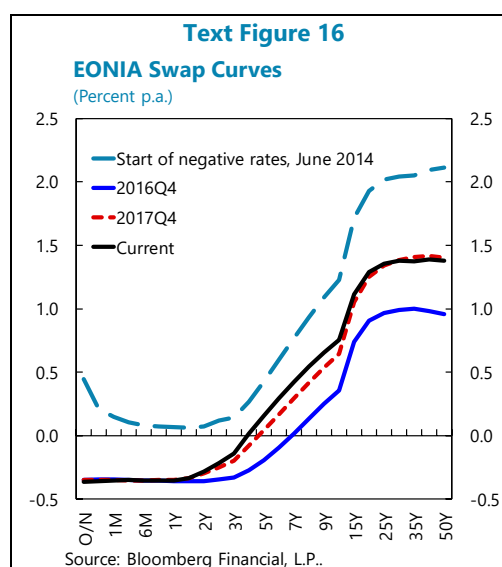
expects positive demand developments and stronger labor compensation to assert themselves going forward, with core inflation rising to 1.9 percent by 2020. The Commission anticipates an impact from the recent German wage agreements, but points to some remaining labor market slack area-wide, for instance, in the form of involuntary part-time work.

17. Potential growth is seen settling at around 1½ percent, down from about 2 percent pre-crisis. The authorities see weaker contributions from labor supply and capital formation as the main culprits. They also emphasize drag from population aging, despite rising labor force participation among the older segments, and see technological developments such as digitalization and automation adding uncertainty to medium-term growth prospects.

MONETARY POLICY

Strong monetary accommodation should be maintained until inflation is convincingly converging to objective, which could take time given a strong backward-looking element in the euro area inflation process; premature interest rate hikes would be damaging. Clear communication will be central. And vigilance is needed to ensure that financial stability risks do not begin to take root.

18. The ECB’s commitment to keep policy rates at their current, extraordinarily low levels at least through next summer is vital. Ending net asset purchases at the end of 2018—subject to incoming data confirming the medium-term inflation outlook—is warranted given strong demand conditions and the dissipation of deflation risks; other tools exist to address country-specific issues. Nonetheless, slow progress toward a self-sustaining convergence of inflation to the medium-term objective underscores the need for patience, persistence, and prudence. Raising rates too early could be a costly error—for the euro area, and for the rest of the world, through unwanted demand spillovers. The need for caution in policy setting is corroborated by staff research which finds that the Phillips curve still holds in the euro area, but also that the euro area inflation process is relatively backward looking (Box 2). Positive output gaps and tightening labor markets will lift inflation, but this will take time—especially if potential rises with actual output, including as a result of “reverse hysteresis” as previously marginalized workers regain skills with re-employment (see [Cœuré, 2018](#)).



Box 2. Understanding Euro Area Inflation Dynamics ^{1/}

From afar, it may look as if core inflation in the euro area has decoupled from its traditional relationship with employment.

First there was a “missing disinflation” episode over the two years starting late 2011, despite a high unemployment rate. Thereafter followed a “missing inflation” period, with inflation remarkably stable despite considerable declines in the unemployment rate. Among other explanations, some attribute this low euro area inflation to a broken Phillips curve and low global inflation.

Using a Phillips curve framework, staff has sought to explain the inflation puzzle.

The domestic Phillips curves were augmented with global factors so as to assess their relevance in explaining past inflation and improving inflation forecast performance. The preferred model specification—including domestic slack, lagged inflation, and long-term inflation expectations—resulted from the general-to-specific model selection procedure^{2/} and the assessment of both the out-of-sample forecast performance of different models and the power of each factor.

Domestic factors are found to dominate global factors in explaining recent inflation dynamics.

Even though some global factors can improve the inflation forecast, they do not clearly enhance the model’s in-sample goodness of fit. Besides, a decomposition of inflation drivers shows that global factors contribute to inflation developments to a lesser extent than domestic factors. Moreover, global factors did not push inflation consistently down during the “missing inflation” episode (sometimes also feeding inflation pressures via higher import prices or exchange rate depreciation).

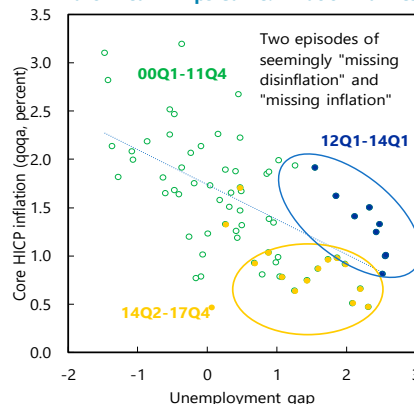
The domestic Phillips curve is found to still hold, with inflation persistence identified as the main factor behind the recent low inflation.

The relationship between slack and inflation holds with different measures of slack (the unemployment gap, the unemployment rate, and both IMF and OECD output gaps) and is robust to the addition of global factors. But euro area inflation is found to be markedly backward looking, in sharp relief to U.S. inflation. The persistence of the euro area inflation process delays the transmission of improving labor market developments to prices, thereby helping to explain the inflation puzzle. The causes for this persistence are beyond the scope of the analysis, but could be related to a greater prevalence in the euro area of contracts with long duration and of small or medium enterprises (SMEs) that tend to be more backward looking in wage and price setting, as well as features of the product market such as sector-specific regulations, long-term customer relationships, and competition.

^{1/} See Abdih, Li, and Paret, 2018, “Understanding Euro Area Inflation Dynamics,” IMF Working Paper (forthcoming).

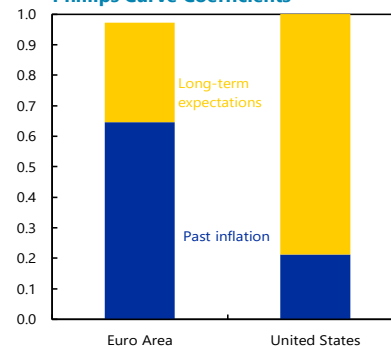
^{2/} Campos, Ericsson, and Hendry, 2005, “General-to-Specific Modeling: An Overview and Selected Bibliography,” Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 838, August 2005.

Euro Area Phillips Curve: Inflation Puzzles



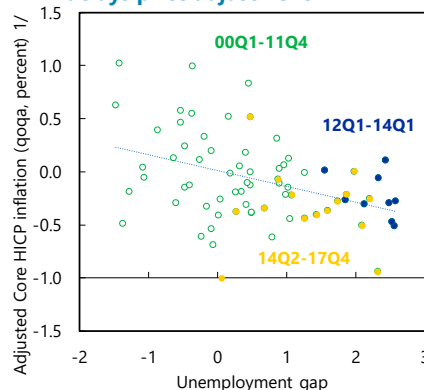
Sources: Eurostat; and IMF staff calculations.

Phillips Curve Coefficients



Sources: IMF staff calculations.

Backward-looking inflation process delays price adjustment



Sources: Eurostat; and IMF staff calculations.

1/ Adjusted for the contributions of inflation expectations and past inflation.

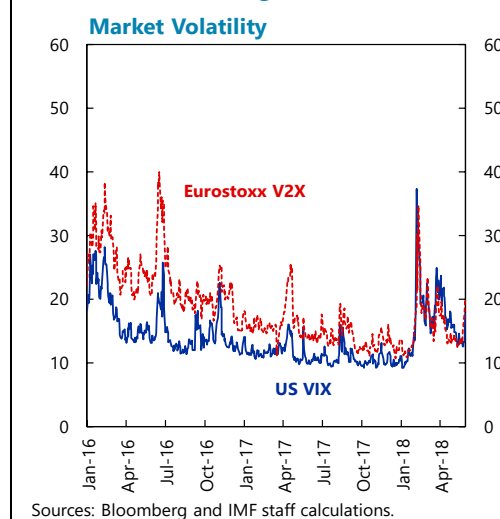
19. The importance of forward guidance will grow even stronger as quantitative easing is wound down.

Clear communication will be essential to anchoring interest rate expectations as net asset purchases are tailed off. The episodes of volatility in 2017 reminded of both the sensitivity of financial markets to perceived changes in the direction of policy and the relatively rapid pass-through of short rates to borrowing costs for corporates and households. Future policy actions will thus need to continue to be both well-telegraphed and gradual, to avoid any destabilizing surprises.

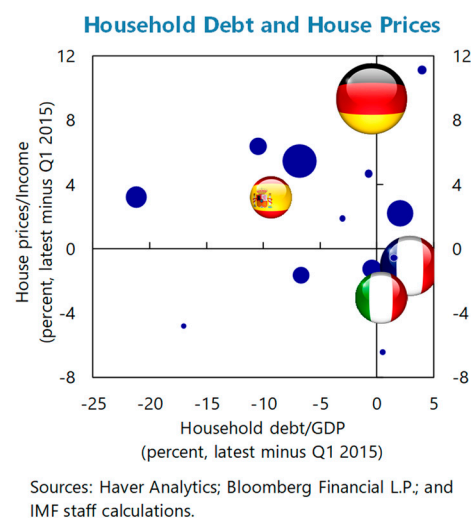
20. The reinvestment strategy should remain anchored to the capital key, but can be calibrated flexibly. In addition to policy interest rates, the path of reinvestments offers another lever of monetary policy. Flexibility should be maintained, not least because the ECB will be venturing into uncharted territory—on the one hand, the supply of U.S. Treasuries will be increasing to fund the U.S. fiscal expansion, tending to push U.S. long rates upward; on the other hand, the supply of German and other highly rated euro area sovereign securities could become relatively constrained, creating downward pressure on euro long rates. Financial conditions could change unpredictably in this environment. The reinvestment strategy provides an additional tool to reduce such uncertainties. As with interest rate policy, clear communication will be essential.

21. Financial vulnerabilities could be emerging in some pockets. There are places—for instance, Luxembourg, some German cities, and some areas in Portugal and the Netherlands—where mismatches between demand and supply are driving strong residential or commercial real estate price appreciation. Separately, corporate debt is outpacing GDP in a few countries, including France, where offsetting steps—limiting banks' exposures to highly indebted corporations—have been taken. Despite this, various financial conditions indices confirm that euro area conditions remain less loose than the global average, and within one standard deviation of historical levels. Policy makers need to remain vigilant to financial stability risks, and move decisively where necessary to defuse pockets

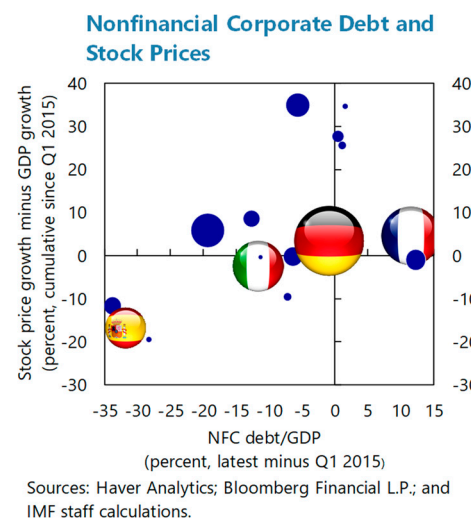
Text Figure 18



Text Figure 19



Text Figure 20



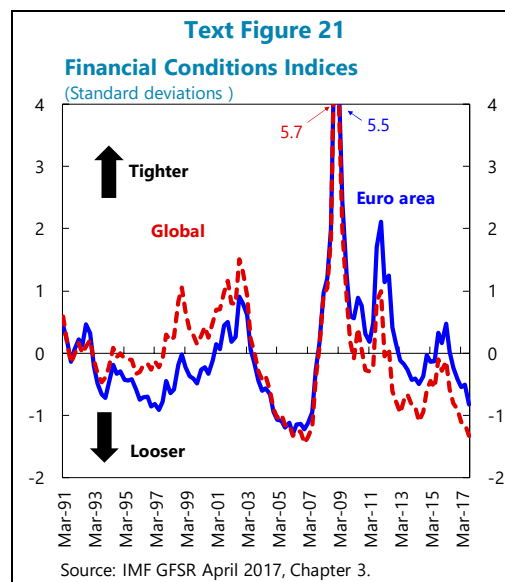
of vulnerability with targeted macroprudential actions. But excesses remain the exception, not the rule, underscoring that the single monetary policy should remain focused on area-wide inflation.

ECB Views

22. The ECB emphasized that the future course of monetary policy will remain data dependent. The Governing Council expects the key ECB interest rates to remain at their present levels at least through the summer of 2019 and in any case for as long as necessary to ensure that the evolution of inflation remains aligned with the current expectation of a sustained convergence of inflation toward the ECB's aim in the period ahead.

ECB staff noted, without necessarily endorsing, market expectations that the first rate hikes would precede the onset of the balance sheet unwind, as in the U.S. experience, with strong transmission through conventional instruments. They agreed with Fund staff that clear communication would be critical to guiding interest rate expectations and thus ensuring a smooth normalization process.

23. The balance sheet was seen remaining large for long. Reinvestment of maturing principal will continue for an extended period after the end of net asset purchases at the end of 2018. Current reinvestment modalities contemplate a relatively neutral approach, embedding neither willful changes to the public-vs.-private sector composition of holdings, nor active duration management. Even after the end of net asset purchases, stock effects would continue to matter.



RISK REDUCTION

This is a time to strengthen the resilience of the euro area and its growth potential. Insufficient policy buffers and deep structural challenges create fragility and stifle opportunity. The resulting threat to euro area cohesion requires determined responses, especially at the national level. Risk reduction needs to include rebuilding fiscal buffers, improving productivity, addressing external imbalances while maintaining trade openness, and enhancing resilience in banking and finance.

A. Fiscal Policies

24. The sum of 19 projected national fiscal stances suggests a modestly expansionary aggregate impulse this year. More consequentially, however, the distribution of national impulses differs diametrically from that advised by staff: the countries with ample fiscal space and excessive external surpluses consistently run tighter-than-advised fiscal policies, while most of the high-debt countries postpone adjustment—or even contemplate fiscal expansion—as growth stays firm.

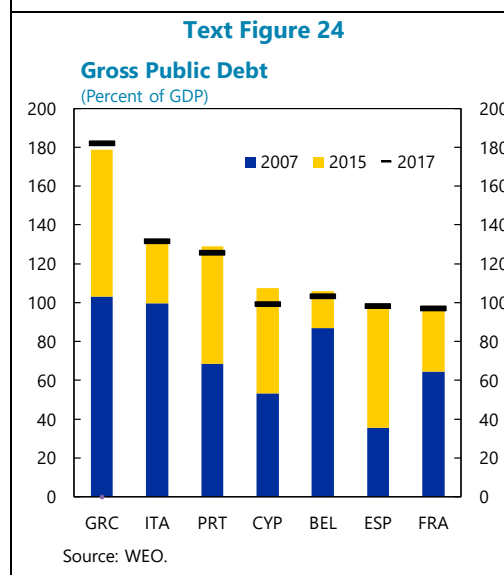
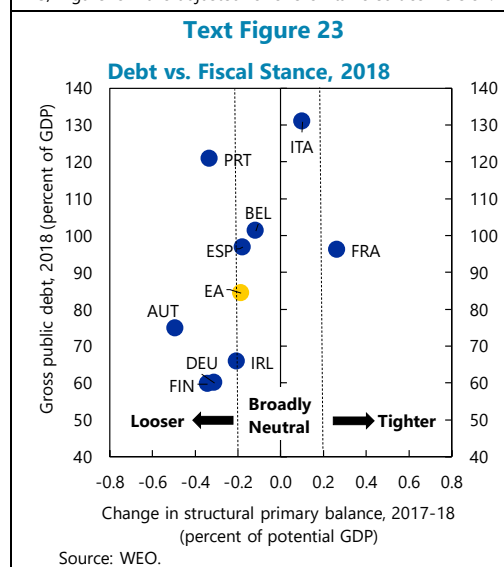
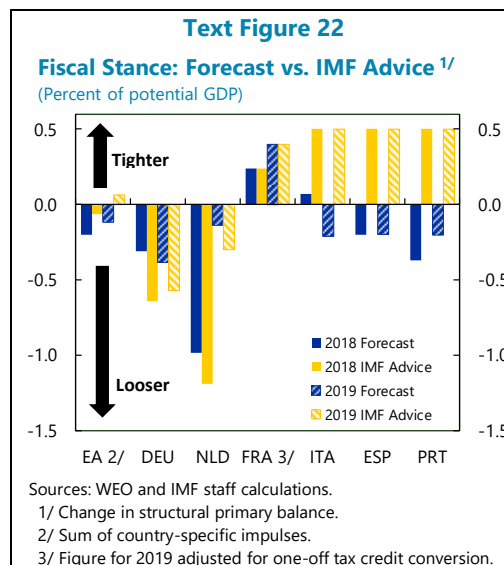
25. With growth remaining vigorous, this is still an excellent time to rebuild buffers where they are lacking. Countries with high debt loads should use the opportunity provided by the still-

strong real economic expansion and still-low borrowing costs to adjust now, obviating a need for sharper adjustments later.

26. Large countries with ample fiscal space should continue to pursue additional spending to lift potential. Such countries, notably Germany and the Netherlands, should invest more in areas such as infrastructure, education, and research and development to lift labor force participation and potential growth, better incentivize private investment at home, and contribute to a necessary external rebalancing.

27. Regrettably, national budgetary plans are doing too little or go in the wrong direction. Expectations of an easing in Germany are tempered by a history of revenue overperformance. And several of the high-debt countries, including Italy, Portugal, and Spain, will continue to adjust only slightly or not at all this year, despite closing or positive output gaps. In Italy, the new government favors tax and spending measures that, if implemented in full, would deliver a significant fiscal expansion at odds with debt sustainability.

28. Better compliance with and enforcement of the fiscal rules are needed. In contrast to previous years, the EU’s country-specific recommendations (CSRs) for 2018 did not specify the required fiscal effort that would be consistent with the Stability and Growth Pact (SGP); moreover, the Commission intends to use a “margin of discretion” in its 2018 compliance assessments, hurting the credibility of the SGP. In its first annual report assessing SGP compliance and enforcement, covering 2016, the European Fiscal Board (EFB) finds that greater flexibility has come at the price of complexity and more discretion. It recommends simplifying the rules to focus on a single operational target and a single fiscal anchor—echoing Fund advice. Incentives could be further strengthened by raising the reputational costs of noncompliance, including by ensuring strong funding, autonomy, and voice for national fiscal councils and the EFB.



29. Brexit is prompting an overhaul of the EU budget, which should be used as an opportunity to seek efficiency gains. Solutions for how to close the hole to be left by the likely loss of the U.K. net contribution (after the transition period) form part of wider discussions around the next multiannual financial framework. The EU budget proposal for 2021–27 envisages a streamlining of existing policies to fund new priority areas, including border control, defense, research and innovation, and the digital economy, and—appropriately—a paring back of outlays on the common agricultural and cohesion policies. Revenue mobilization is to be pursued both by modernizing and diversifying current sources and by eliminating rebates to net contributors.

30. Corporate tax issues are gaining prominence, where steps to limit arbitrage are best taken at an international level. Aided by complex group structures, multinational conglomerates employ techniques ranging from transfer pricing to discretionary relocation of intellectual property to shift taxable income to low-tax jurisdictions. Digitalization adds to the challenge by further blurring concepts of residence. The Commission has made several proposals in this area, including one for an EU-wide corporate tax base and another for a digital sales tax (Box 3). The recent U.S. tax reforms and Brexit remind that EU reforms will need to consider policy developments outside the EU also. Solutions are best embedded in an international framework on income taxation.

Box 3. European Commission Proposals on Corporate Income Taxation

The Commission has made two major proposals in recent years on taxing multinational corporations:

- The [Anti-Tax Avoidance Directive](#), which was adopted by the EU Council in June 2016, lays out five rules against common forms of aggressive tax planning to be applied by member states from January 2019. It complements the [Directive on Hybrid Mismatches](#), adopted in May 2017, which proscribes companies from exploiting differences in national rules to avoid taxation. These initiatives could significantly reduce tax avoidance in the EU.
- The [Common Consolidated Corporate Tax Base proposal](#), in turn, aims to combat undue base erosion and profit shifting within the EU. As a first step, it would harmonize national corporate tax bases while leaving rate setting to member countries. As a second step, it would allocate a firm’s EU-wide profit based on factors such as sales, employment, and assets in each country. While it would not address rate competition and profit shifting out of the EU, it would bring simplicity and transparency to the tax system. On balance, the proposal seems an attractive way forward for the EU.

The Commission has also recommended a [digital sales tax](#) to enhance fair taxation in the digital economy. The proposal is to tax revenue from online activities based on the location of a firm’s users rather than its own domicile. The digital sales tax is envisaged as a precursor to an eventual expansion of the concept of permanent establishment to include “highly digitalized” companies. Staff’s view is that such interim and partial solutions are distortionary and an internationally coordinated comprehensive solution should be found to the taxation challenges posed by an increasingly digitalized global economy.

Authorities’ Views

31. In light of closing output gaps and continued strong growth over the forecast horizon, the Commission is urging more effort by the high-debt countries to rebuild buffers. On an aggregated basis, this would be consistent with a moderate structural tightening in 2018–19 for the

euro area as a whole. Stronger efforts to reduce debt in the high-debt countries could be offset by mobilizing available fiscal space to increase investment in some countries with surpluses.

32. Despite firm growth and low interest rates, however, Commission staff see national fiscal policies drifting askew. Their projections, based on unchanged policies, indicate a slight deterioration in the composite structural balance in both 2018 and 2019, reflecting expected easing in Germany and the Netherlands and little or no adjustment in Belgium, France, Italy, Portugal, and Spain. Several estimated national budgetary outturns for 2018, including in Belgium, France, Latvia, Italy, Portugal, Slovakia, and Slovenia, risk falling short of SGP requirements. Public debt ratios are projected to remain above 90 percent of GDP in more than one-third of euro area countries at end-2019.

33. The Commission argued that the available flexibility under the SGP had allowed it to strike a good balance between macroeconomic stabilization and debt sustainability. In this respect, its matrix-based approach under the preventive arm, which considers the cyclical and debt position of each economy, had served well. Commission staff noted that all countries could come under the preventive arm by 2019, when Spain is expected to exit the excessive deficit procedure. They added that, over the next two years, cyclical considerations would call for sustained fiscal efforts toward the medium-term objectives.

34. Nonetheless, the Commission agreed that SGP compliance and enforcement can be improved, including by simplifying the rules. To this end, the CSRs for 2019 set explicit structural adjustment floors, and do not use the margin of discretion. For countries that have not yet reached their medium-term objective, the CSRs introduce a ceiling on nominal primary expenditure growth consistent with the required minimum structural adjustment—thus shifting the focus to a simple, transparent benchmark.

35. The draft EU budget proposed by the Commission entails more resources for key priorities and relies on an increased share of own resources. Significant savings and efficiency gains are envisaged. Commission staff noted that the budget negotiations will likely take time, with approval requiring unanimity among the EU-27; leaders hope to agree on the main issues before the European Parliament elections in 2019. On corporate taxation, Commission staff saw the consolidated tax base as a potentially path-breaking advance, and defended the digital sales tax as a reasonable interim step ahead of more permanent solutions.

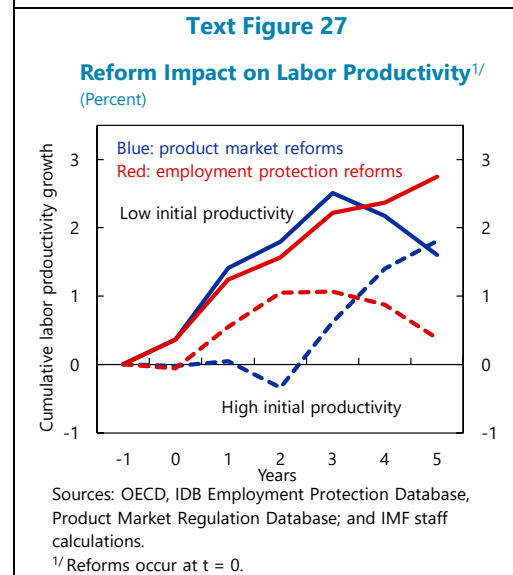
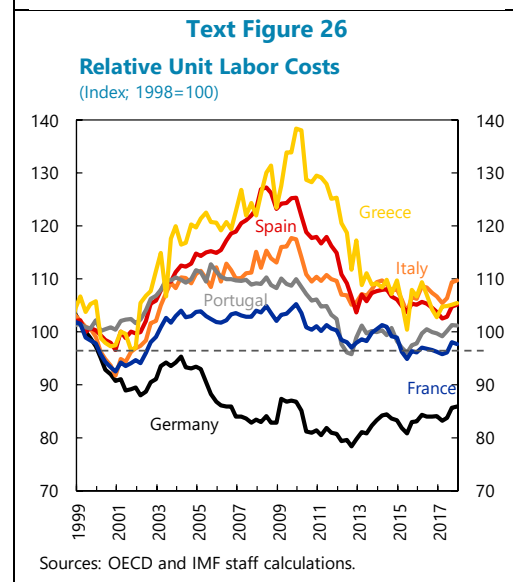
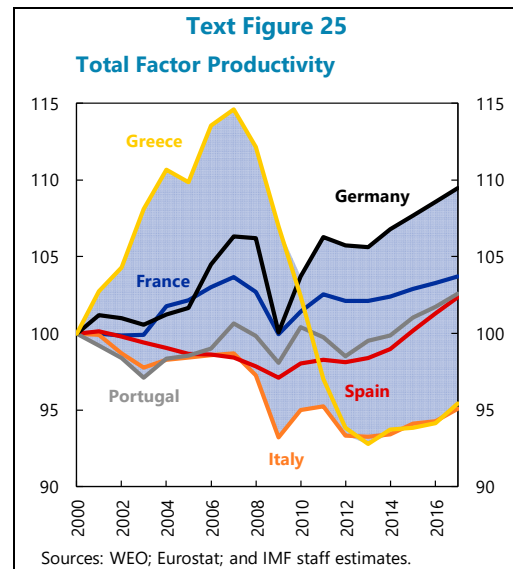
B. Structural Policies

36. Productivity gaps across countries remain a fundamental threat to euro area cohesion. While several countries have increased their productivity, there remain laggards, where catch-up is impeded by deep structural inefficiencies in labor and product markets. Consequences of the resulting productivity gaps include stalled convergence of per capita incomes, high structural unemployment in some countries, and external imbalances.

37. Structural reforms are critical to lifting productivity and closing the gaps. Countries should grasp the opportunity afforded by strong growth to redouble reform efforts. Staff analysis suggests larger reform gains for countries with lower initial productivity levels (see [IMF, 2017](#)). At the same time, strong productivity growth—in excess of nominal wage growth—is needed in lagging economies to reduce unit labor costs and close the competitiveness gap. While several countries made progress in this respect after the crisis, much of the improvement was cyclically driven; these gains now need to be buttressed by structural measures in order to be sustainable.

38. Efforts should concentrate on three areas. Fiscally constrained countries should implement reforms in a budget-neutral manner, including by prioritizing product market reforms with lower up-front fiscal costs:

- Product market reforms.** Countries should focus on reducing the regulatory burden on firms, removing barriers to entry in service markets, and taking steps to encourage innovation and technology diffusion. Further progress in implementing the EU single market strategy in services, energy, the digital market, and transportation will play an important role in raising potential output. At the same time, policies to shield the vulnerable from transition costs and ensure the inclusiveness of reform benefits are vital. Properly done, product market reforms can help generate national fiscal space.
- Labor market reforms.** High youth unemployment remains an issue for most countries (see companion selected issues chapter, “Youth Unemployment during the Euro Area Economic Recovery”). Shifting taxes away from labor, encouraging apprenticeship programs, and implementing well-designed active labor market policies will benefit the young and increase labor force participation, thereby mitigating adverse impacts from population aging. Efforts are also needed to better align wages with productivity, and to ensure that quality education and training are

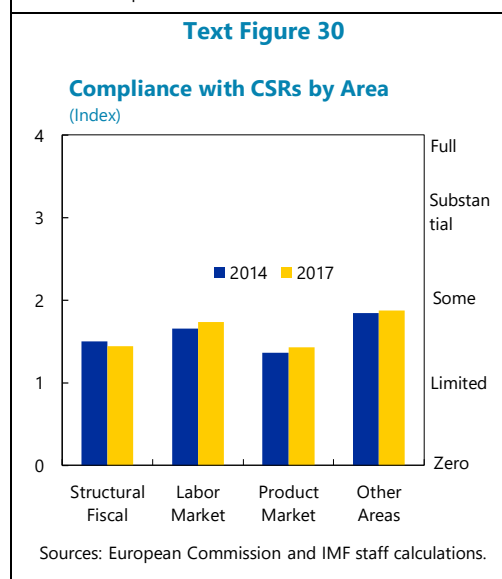
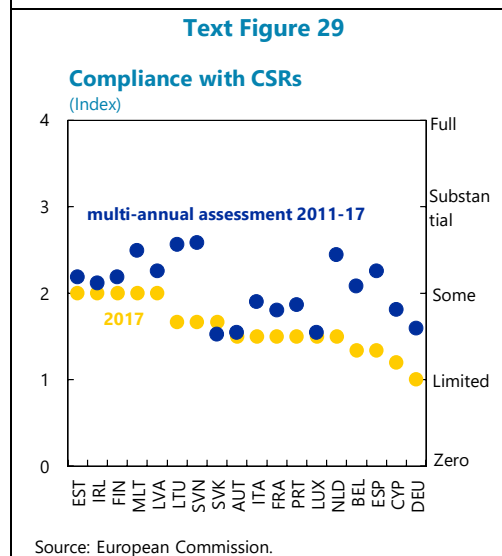
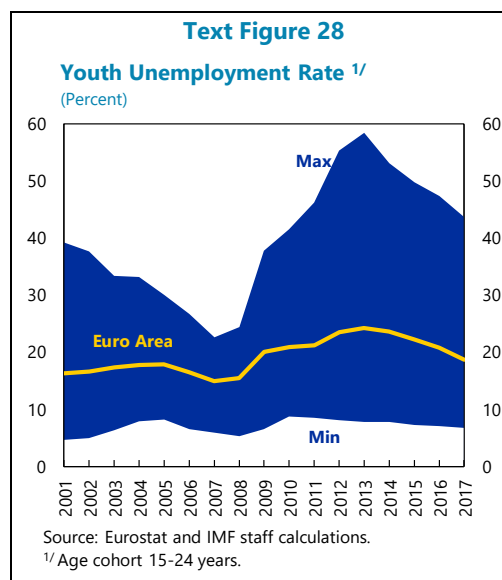


accessible and well-tailored to labor market needs. Social safety nets should be modernized to reduce disincentives to work and to help populations adapt to globalization, technology, and a shift in investment from tangibles to intangibles (Box 4).

- **Governance and institutions.** The benefits of structural reforms can be increased by steps to enhance public administrative capacity, procurement frameworks, and the effectiveness of justice systems.

39. Regrettably, structural reform delivery has been uneven. In France, last year's labor market and tax reforms are expected to boost employment, investment and growth, and the policy agenda remains ambitious going forward. However, in several other countries, reform implementation has slowed. As a result, progress on implementing CSRs has slipped, with product market reforms being an area of especially poor delivery. National implementation of the 2015 EU single market strategy remains halting. Some progress has been achieved in the energy union project, including in the areas of regional market integration and infrastructure development, despite delays in agreeing a legislative framework. There has been some movement on the EU's digital single market initiative, including the elimination of roaming charges for mobile telephone service and of geographic discrimination in electronic commerce ("geo-blocking"). But progress on other fronts—such as implementing EU standardization policy in the information technology sector—remains limited.

40. Linking EU financial support to reform implementation could help improve incentives. In this vein, the Commission has proposed a new reform delivery tool to bring direct financial support to national reform efforts, while also mooting more funding for its standing technical assistance under the Structural Reform Support Program.



Box 4. Capitalizing on Knowledge-Based Capital

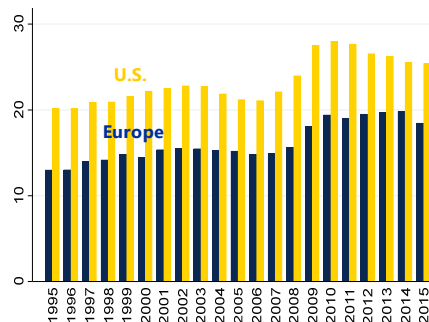
There has been a remarkable shift in investment towards intangibles in advanced economies. The share of investment in intangibles (which includes items such as research and development, software, databases, and intellectual property) has increased from about 10 percent of gross fixed capital formation in Europe in the early 1990s to close to 20 percent in more recent years. The bulk of this increase took place in the manufacturing and service trade sectors. Nevertheless, the gap with the U.S. remains substantial.

Such a shift brings both opportunities and challenges. On the one hand, knowledge-based capital, which reflects the adoption of more efficient business practices as well as the growing value of brands, can on its own improve business performance and productivity without the installation of new physical capital. On the other hand, knowledge-based capital can be disruptive when it primarily rewards high skills and leads to worker displacement. Staff has empirically tested these hypotheses using granular data for Europe.

There is some evidence that efficiency gains from intangibles drive employment losses. The panel estimations using cross country sectoral data find that intangible capital is (i) strongly and positively correlated with sectoral productivity, but (ii) negatively correlated with employment, suggesting the presence of substitution effects.

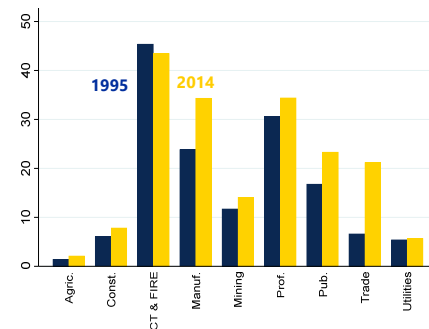
Policies should aim at addressing the efficiency–equity tradeoff. Removing structural impediments in labor and product markets and broadening access to finance (for instance, via the capital markets union initiative) would help sustain productivity while benefiting job creation. However, even with the best policy design, the rising importance of intangible and soft skills could still cause economic and social disruptions in the short run as patterns of labor demand change. A focus on education and adult learning policies as well as the strengthening of social safety nets to alleviate the burden of adjustment on the most vulnerable groups would help capitalize on knowledge-based capital without fueling social discontent and populism.

Investment in Intangibles
(Total industries; in percent of total GFCF)



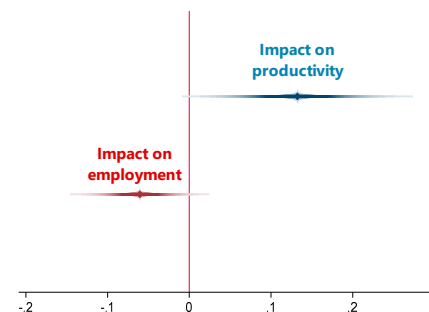
Sources: EUKLEMS; and IMF staff estimates.

Investment in Intangibles
(In percent of GFCF)



Sources: EUKLEMS; and IMF staff estimates.

Impact of Investment in Intangibles^{1/}
(In percent, point estimates derived from regressions)



Sources: EUKLEMS; and IMF staff estimates.

^{1/} Controls are sectoral growth, market rigidities, trade openness, bank and market financing, and fixed effects.

Authorities' Views

41. The authorities agreed on the pressing need to step up structural reforms. Commission staff noted that, despite some streamlining of the CSRs starting in 2011, implementation continues to fall short of expectations, with some or substantial progress made on only about half of the 2017 CSRs. Nonetheless, a multi-annual assessment covering 2011–17 found that more than two-thirds of the CSRs have seen at least some progress. For 2018–19, the Commission has strived to further streamline the CSRs, focus on medium-term challenges, and to step up its dialogue with stakeholders. Its newly proposed reform delivery tool aims to help cushion short-term costs and build

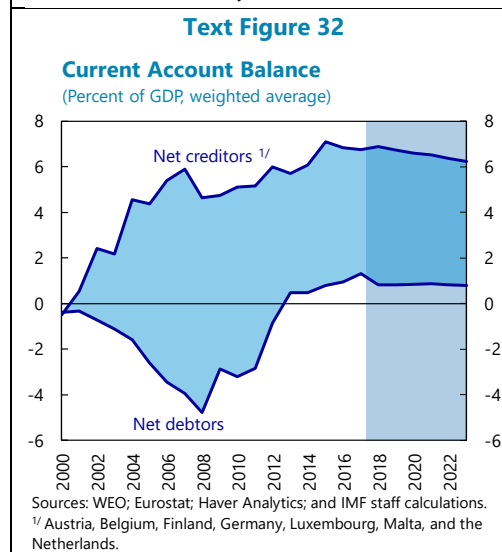
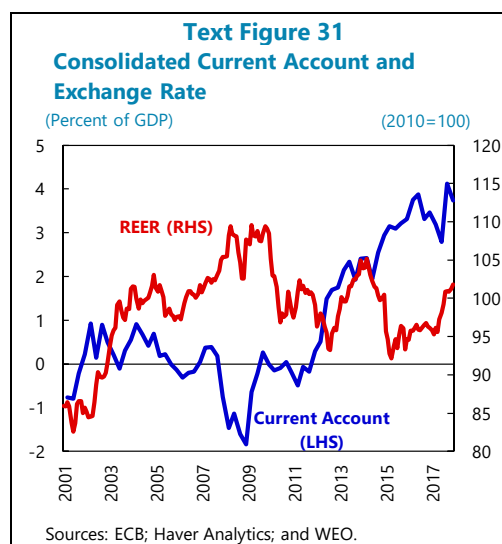
country ownership; financial support will be closely linked to milestones and targets already laid out in countries' reform proposals. The Commission is also working closely with national productivity boards to build consensus for reforms.

C. External Sector Policies

42. The euro area's external position in 2017 was moderately stronger than implied by medium-term fundamentals and desired policy settings. The consolidated current account surplus edged up to 3½ percent of euro area GDP, while the real effective exchange rate (REER) appreciated modestly, by about 1.6 percent, consistent with the momentum of the recovery. The cyclically adjusted current account balance for 2017 is estimated at 3.4 percent of GDP, yielding a gap of 1.3 percent of GDP relative to staff's estimated "norm" (Table 2). This suggests the current account position was moderately stronger than implied by fundamentals—including demographic trends—and desired policy settings. The REER was assessed to be broadly in line with fundamentals in 2017, exhibiting a small undervaluation of about 4 percent.

43. The policy response should center on the large net creditor countries taking steps to limit their excessive current account surpluses. Germany's reached 8 percent of GDP last year, and the Netherlands' almost 10 percent, on the back of material REER undervaluation; in both cases, the main causes are excess savings relative to investment in the nonfinancial corporate and household sectors, with government balances playing a relatively smaller role. Staff projections indicate only limited reductions of these surpluses going forward. If left unchecked, they could stoke protectionism among major trading partners, with costly economic and political ramifications. It is thus increasingly important that net creditor countries such as Germany use some of their ample fiscal space to finance well-targeted reforms and investments, while also gearing public communications toward encouraging more rapid wage growth. Such actions would enhance potential growth, raise the returns to private investment at home, and lift current wages, thereby facilitating a relative price adjustment with respect to trading partners.

44. The EU should stay committed to free trade and the rules-based global trading system. Trade is a powerful engine of growth and prosperity—raising productivity, lowering prices, and improving living standards in all countries. The EU maintains an open trade regime and should aim for further liberalization.

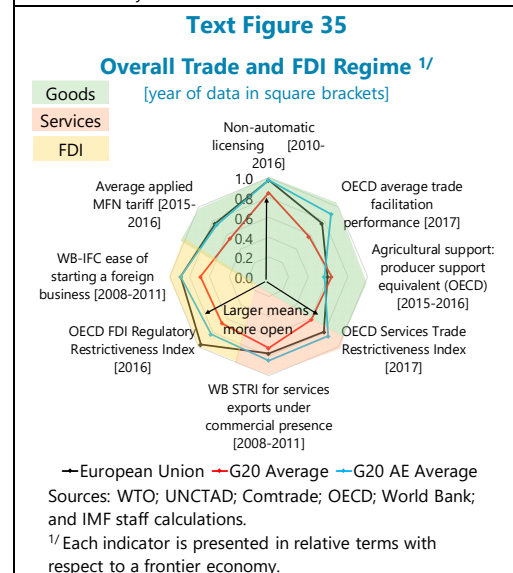
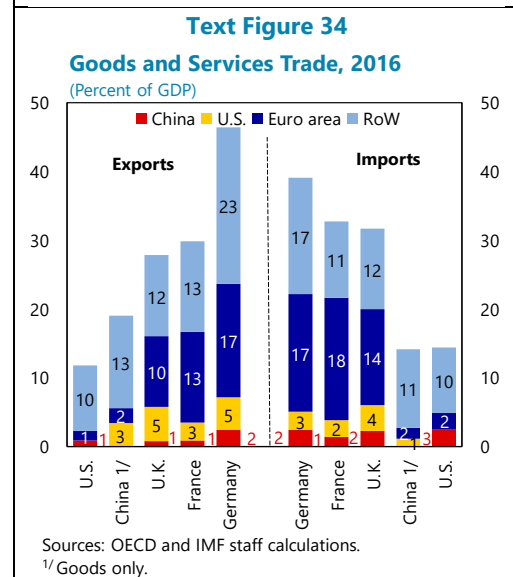
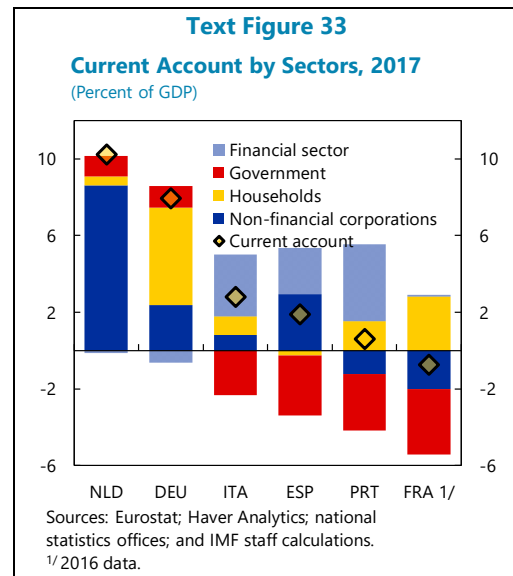


Its free trade agreement with Canada provisionally entered into force in 2017. Trade negotiations have been finalized with Japan, Mexico, Singapore, and Vietnam, and are at an advanced stage with Indonesia and Mercosur. The United States imposed tariffs on imports of steel and aluminum from the EU on June 1, 2018, and has also launched an investigation into whether automotive imports threaten to impair its national security. In response, the EU requested a dispute settlement consultation at the WTO on June 1, and on June 20 adopted rebalancing measures targeting a list of U.S. products with additional duties. Staff cautions against further escalation and any deviations from the rules-based global trading system. The EU and its partners should work together constructively to reduce trade barriers and, whenever possible, resolve disagreements through the WTO.

45. Good domestic policies can help ensure open and free trade. Trade can have adverse side effects. While increasing the wage premium for skilled workers, it can result in job losses in some industries, widening income inequality across sectors and regions (see [IME, World Bank, and WTO, 2017](#)). EU countries should ensure that the gains from trade are more widely shared, and thereby reinvigorate trade integration. Policies to upgrade education systems, provide vocational training, and assist with job search can help prepare workers for the changing demands of the modern labor market. Measures aimed at helping hard-hit regions and communities and strengthening safety nets, including unemployment insurance, health benefits, and portable pensions, can also smooth the adjustment process.

Authorities' Views

46. The authorities stressed the centrality of national actions to tackle external imbalances. The ECB assesses the consolidated external position of the euro area and the REER as broadly in line with fundamentals in 2017, while the Commission considers the current account surplus as being stronger than implied by fundamentals. The authorities, noting that



significant current account adjustment had already occurred in the erstwhile deficit countries, underscored the importance of corrective policies by the large net external creditor countries to address their outsized current account surpluses, emphasizing the role of private investment. Further efforts to improve competitiveness by the net debtor countries were also a necessary ingredient of the rebalancing.

47. The authorities reiterated their commitment to free trade and the rules-based system.

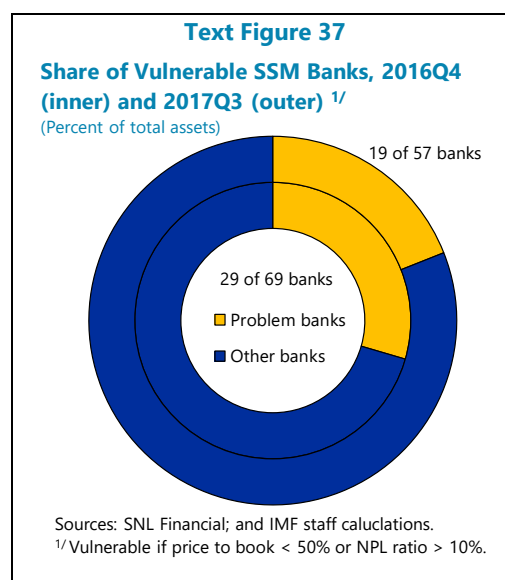
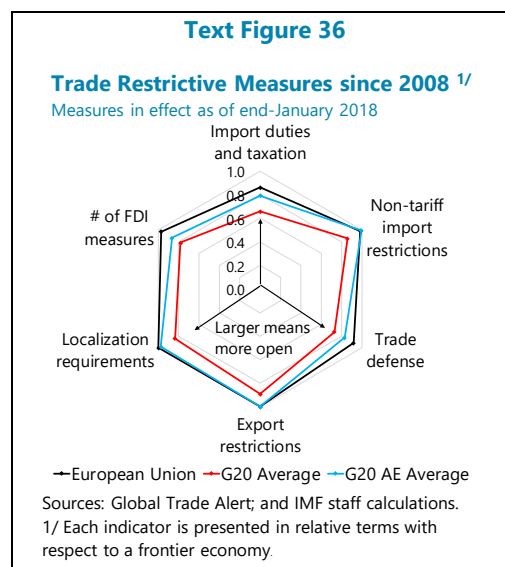
They view the current tensions partly as a result of gaps in WTO rules that leave important non-market distortions unaddressed. As such, they see an urgent need to work with trading partners to modernize the multilateral trading system. But they protest recourse to unilateral measures by some countries, which jeopardizes the rules-based system. Commission staff assess the EU response to the U.S. steel and aluminum tariffs to be WTO compliant, and assure that any further measures by the EU would likewise remain within the rules. The EU will continue to pursue ambitious free trade agreements. It also plans to use initiatives such as the European Pillar of Social Rights, the European Globalization Adjustment Fund, and the Structural and Cohesion Fund—supported by pro-growth and pro-jobs policies at the national level—to ensure that the benefits from trade are spread more equally.

D. Financial Sector Policies

48. **The health of banks directly supervised by the SSM continues to improve.** The subset of SSM-supervised “significant institutions” still beset by double-digit NPL ratios, price-to-book ratios below 0.5, or both accounts for a fifth of significant institutions’ aggregate assets, down from over a quarter in 2016. However, findings from a stress test of 29 large SSM-supervised banks conducted as part of the first Financial Sector Assessment Program (FSAP) exercise for the euro area—the overall conclusions of which are presented in the accompanying financial system stability assessment report—suggest both credit and market risk factors remain significant, with some banks more vulnerable than others. The FSAP calls for closer inter-agency coordination and data sharing, including to facilitate earlier intervention in problem banks.

49. Supervisory actions can and should push banks to improve their internal capital generation.

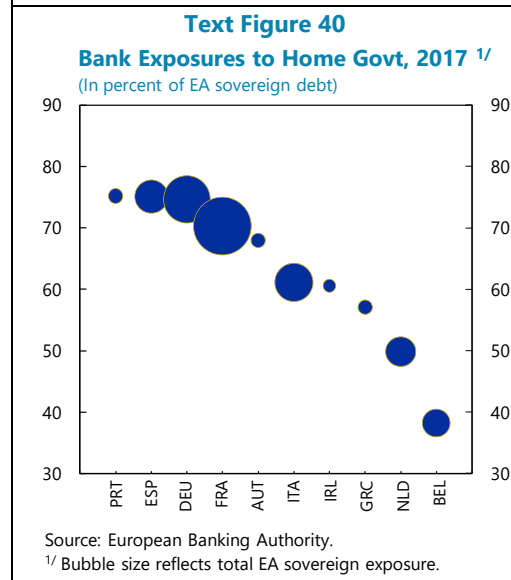
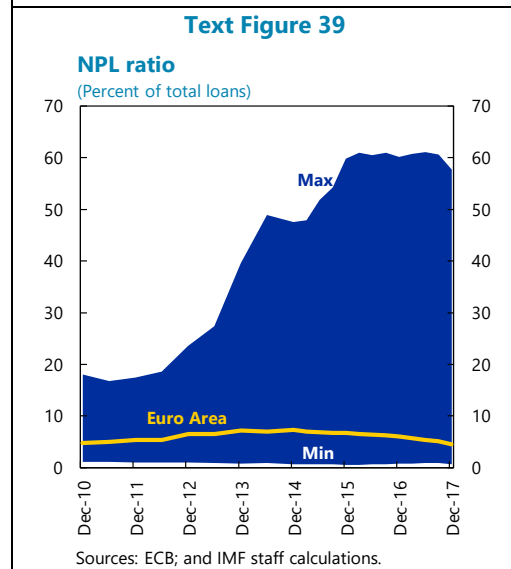
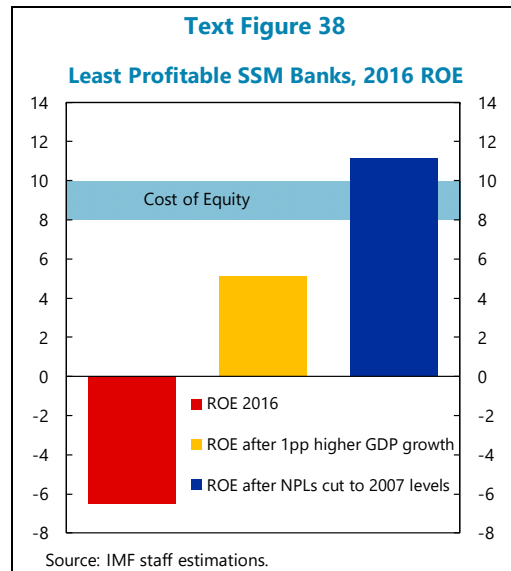
Although better results in 2017 spurred bank stock overperformance relative to the overall market indices,



banks' returns on equity remain far below pre-crisis levels. This reflects deep structural issues, including overbanking, both in terms of staff numbers and branch networks, and unviable business models in some cases. In some countries it also reflects still-high NPL burdens. An FSAP empirical analysis of 109 SSM-supervised banks concludes that even if real GDP growth in 2016 had been 1 percentage point higher than the actual outcome, it would not have restored the least profitable banks (a group with €5½ trillion in assets) to healthy profitability without aggressive reductions in NPLs. The findings underline the role of NPL reduction, and thus the need for strong supervision.

50. Continued progress is needed on legacy asset clean-up. NPLs fell by €145 billion in 2017, to near €842 billion, with a €70 billion reduction in Italy alone—the latter almost entirely reflecting proactive NPL sales by two large banks. Too many banks, however, still have double-digit NPL ratios and low provisioning coverage by international standards, calling for intense supervisory pressure. The FSAP encourages supervisors and policy makers to energize banks' NPL restructuring and disposal efforts with demanding timelines for provisioning and charge-off and stricter valuation rules for immovable collateral, supported by more consistent reporting and parallel efforts to set minimum standards for national insolvency laws and creditor rights regimes. Although less stringent than earlier proposals, the ECB's supervisory addendum on provisioning expectations and the Commission's recent policy package on NPLs—which includes measures to develop a pan-European secondary market—are steps in the right direction (Box 5).

51. Careful steps should be taken to encourage a gradual reduction of home bias in financial intermediaries' sovereign exposures. This would help ameliorate the nexus between national governments and domestic financial institutions. Almost 60 percent of French, German, Italian, and Spanish banking groups' exposure to euro area sovereigns, for instance, is concentrated in securities issued by the home sovereign. Similarly, 60–80 percent of French, Italian, and Spanish



insurance companies' investments in sovereign debt are in home-country bonds. Proposals to reduce the bias, ranging from concentration charges to sovereign risk weights to risk-based premia for common deposit insurance, warrant careful consideration, with due attention to transition risks.

Box 5. Recent Policy Proposals on NPLs

In March 2018, the Commission and the ECB proposed new risk-reduction measures. Both initiatives follow on from the EU Council's far-reaching [Action Plan for Non-Performing Loans](#) of July 2017, the formulation of which benefited from extensive Fund staff input.

The Commission's package proposes to:

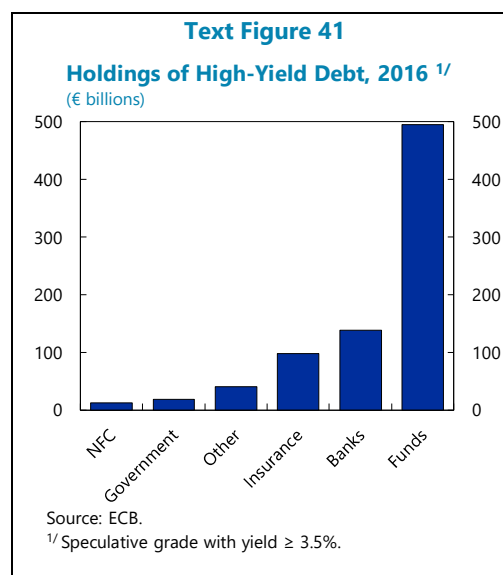
- **Amend the Capital Requirements Regulation.** Changes would require that new unsecured loans be fully provisioned no later than two years, and new secured loans no later than eight years, after they become nonperforming, with concomitant pillar 1 deductions from banks' own funds.
- **Put forward a directive on credit servicers, credit purchasers, and collateral recovery.** This would seek to provide banks with efficient out-of-court mechanisms for value recovery on secured loans while pushing the development of distressed debt markets supported by specialized credit servicers.
- **Guide EU member states that choose to set up national asset management companies.** A blueprint clarifies that, under exceptional circumstances, state aid may be permissible.

The ECB's guideline sets provisioning expectations for all loans, new or existing, that become nonperforming going forward. As part of the supervisory dialogue, banks will be expected to cover the full value of unsecured loans no later than two years, and secured loans no later than seven years, after default, with more ambitious interim expectations than the binding requirements proposed by the Commission. Provisioning shortfalls could incur pillar 2 add-ons from 2021 onward.

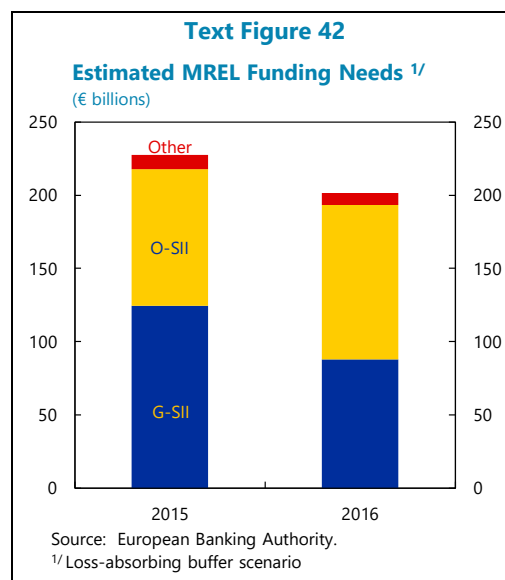
The euro area FSAP urges that the ECB be given broad powers to adjust loan classification rules and regulatory provisioning requirements.

52. A euro area safe asset could in principle help financial intermediaries to diversify their balance sheets. One prominent proposal, put forward by a high-level task force of the European Systemic Risk Board (ESRB), is for sovereign bond-backed securities: collateralized debt obligations backed by a portfolio of sovereign bonds of all euro area member states, issued in three tranches. The proposal hinges on harmonization of the regulatory capital treatment of banks' exposures to these asset-backed securities *vis-à-vis* sovereign debt, which the Commission is proposing. It would remain to be seen whether this change alone would allow the three tranches to find uptake in the credit markets.

53. On the liability side, the authorities should seek to expedite the buildup of "bail in-able" debt in the largest banks. The new EU bank resolution framework requires minimum burden sharing of 8 percent of total liabilities and equity before a bank in resolution may receive any resolution funds. This system



works best when banks go into resolution with sufficient remaining capital and junior debt to shield their senior debt and deposits from losses. Recognizing this, the Single Resolution Board is setting binding minimum requirements for own funds and eligible liabilities (MREL) for banks under its purview. These initially comprise so-called “external MREL” at the level of ultimate parents of banking groups, but will later also include “internal MREL” at the level of subsidiary banks within groups. The process of setting these requirements, based on detailed resolution planning, is slow. Rather than waiting, supervisors and resolution authorities should push the largest banks to issue more capital and junior debt now given still-supportive financial conditions, yet should remain alert to cross holdings of MREL among banks as well as potentially uneven profitability impacts.



54. Localized financial stability risks should be addressed with well-targeted macroprudential policies.

The ESRB has warned several countries—Austria, Belgium, Finland, Luxembourg, and the Netherlands—about potential housing market overvaluation coupled with a recent pick-up in household indebtedness. Most of these countries, and some others, have subsequently tightened bank- or borrower-based tools. Risks in nonbank financial intermediaries also warrant careful monitoring, especially where there is leveraged maturity transformation; significant data gaps remain, however, in this area. The FSAP provides a range of recommendations on the framework for macroprudential policy, including on how to increase national authorities’ flexibility, improve the transparency of ESRB warnings and ECB decisions on top-ups, legislate borrower-based tools, strengthen reciprocity arrangements, and close data gaps in commercial real estate and shadow banking.

Authorities’ Views

55. The ECB is pushing banks to improve profitability, with supervisory pressure working as a complement to market discipline. Supervisors have the tools to do this without unduly interfering in banks’ management decisions. Onsite inspections assess banks’ main profit sources as well as their product pricing decisions. Supervisory dialogue is backed by public communications that shed light on the SSM’s general stance. Offsite monitoring by joint supervisory teams scores banks on their profitability prospects, with low scores triggering intensified supervisory actions. Pillar 2 requirements thus fully reflect banks’ business model challenges and profitability prospects.

56. The ECB agreed that many banks’ NPL reduction strategies are not ambitious enough. The aggregate NPL ratio for the euro area is declining, but too slowly, with projections suggesting it will not reach 3½ percent until 2026. Many banks may have to confront NPL sales receipts below net book value, suggesting a continuing element of under-provisioning. Although greater reliance on

loan restructurings would be good, the authorities noted that many banks with high NPL loads lack adequate workout capacity, leaving disposals as the main plank of their clean-up strategies.

57. The authorities were careful not to raise expectations around the safe asset proposals, including because political consensus remains elusive. The Commission has put forward a legislative proposal to remove regulatory impediments to the origination of sovereign bond-backed securities and address the regulatory capital treatment of banks' holdings of the same. It noted that, while such an instrument can be useful to support risk diversification, it remains a private sector instrument and its viability remains to be ascertained through a market test. Both the Commission and the ECB agreed that a true euro area safe asset is desirable, not least as a price benchmark for the capital markets union, but that this will require additional work to develop potential proposals.

58. There was broad support for accelerating MREL issuance by the largest banks. A new legislative proposal from the Commission seeks to harmonize MREL norms with the international standard for total loss absorbing capacity and, for the EU's globally systemically important banks, to embed them in a pillar 1 requirement. The draft rules are being negotiated with the EU Council and European Parliament, where a general approach agreed in June 2018 proposes that a similar treatment to that for the globally systemically important banks be applied, with a lower calibration, to other top-tier banks above a certain size. All authorities agreed that MREL issuance should be expedited at the largest and most complex banks, with challenges due to limited market access or market capacity duly taken into account when setting the transition periods.

59. The ESRB flagged overheating risks in several EU countries, with many yet to step in with an adequate policy response. Rapid growth of corporate debt, real estate prices, or both is seen in 15 EU countries. Thus far, only France has deployed macroprudential tools to curb corporate credit, purposefully targeting large and highly indebted firms. In some countries, borrower-based tools have been legislated but not yet used. More broadly, the paucity of data on commercial real estate is a challenge, with the closing of such data gaps likely to require years of effort.

ARCHITECTURE

Architectural reforms are a necessary complement to national action. The priorities are completing the banking union to build a borderless banking system; advancing the capital markets union to diversify financing choices; and creating a central fiscal capacity to improve macro stabilization, with mechanisms to improve compliance with the fiscal rules. All these efforts need to bring together risk sharing and risk reduction: for either to progress, so must the other.

A. Banking Union

60. Considerable risk reduction has been achieved in euro area banking to date, yet more needs to be done. Although zones of weakness persist, most banks report major improvements in capital levels and quality, significant reductions in legacy assets, and some efficiency gains. This record of achievement—matched by advances in building the banking union and enshrining the

principle that uninsured claimants and the banking industry must bear the costs of bank failure—has reduced credit risk correlations between banking systems and governments, much as intended. But the project is incomplete, leaving an important and challenging agenda ahead.

61. The euro area FSAP is generally complimentary of initial progress in setting up a banking union to support the monetary union. It confirms that the quality of banking supervision has undergone a step improvement with the creation of the SSM. Yet, it notes that important challenges remain, including on supervisory resources, oversight of liquidity risk and credit risk and, crucially, fragmentation of national laws. And, after reflecting on the bank restructuring, resolution, and liquidation experiences in Italy, Spain, and Latvia, it recommends a set of legislative and operational steps to improve the fledgling SRM.

62. Yet the banking union remains incomplete and fragmented. Many national authorities—especially but not only in the smaller, so-called host jurisdictions—continue to favor ring fencing of capital and liquidity, which runs contrary to the “banking without borders” vision behind the banking union. This preference for decentralized buffers reflects an awareness that most of the costs of imprudent bank risk taking and banking failure remain national. Moreover, centralized supervision is fragmented by an array of national legal provisions in areas where the relevant SSM or SRM directives and regulations are insufficiently strong or, in some important areas, silent—examples include powers to limit related party lending, require tighter loan classification and provisioning, oversee corporate governance, or impose sanctions.

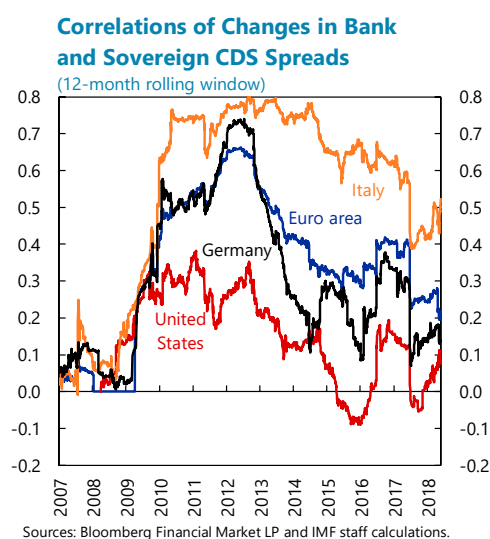
63. Alongside needed steps to reduce legal fragmentation, a truly borderless single banking market will require a shared financial safety net. Specifically, this means a common backstop to bank resolution and a common deposit insurance scheme. Staff urges swift progress on creating an ESM credit line

Text Figure 43

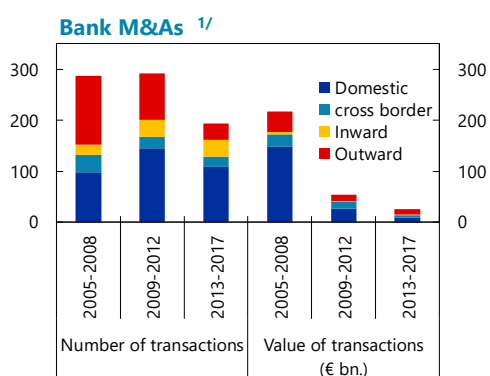
Risk Reduction		
	2012	2017Q3
Tier 1 capital ratio (%)	13.0	15.6
Equity to assets (%)	5.3	6.7
ROA (%)	-0.2	0.3
ROE (%)	-3.0	4.7
NPL ratio (%)	6.5	5.1
Home bias in sovereign debt (%)	72	67
Sovereign-bank CDS correlations	0.54	0.24

Sources: ECB; Bloomberg; and IMF staff estimates.

Text Figure 44



Text Figure 45



Sources: S&P Global Market Intelligence; and IMF staff calculations.

^{1/} The value of some transactions is not reported. "Cross border" refer to intra-euro area transactions involving a non-domestic acquirer. "Inward" refers to M&As by non-euro area bank and "outward" indicates M&As carried out by euro area banks outside the euro area.

to backstop the Single Resolution Fund (SRF), which even after it reaches its steady state in 2024 will not be of sufficient size to cope with serious systemic disturbances. Staff also urges constructive discussions to agree a risk-reduction roadmap to common deposit insurance, which could include targets for banks' capital, junior debt, and NPLs, regulations on banks' sovereign bond holdings, and more. Agreement on a plan would represent important progress toward completing the banking union, even if some milestones could take years to reach. Leaving the banking union incomplete risks dysfunction in the face of a future shock.

64. Adjustments to the resolution and crisis management framework are also needed to strengthen the banking union. This year's review of the SRM provides a timely opportunity to make improvements to secure a well-functioning bank resolution framework that protects financial stability while minimizing costs to surviving banks, taxpayers, and the economy. The recent experience has raised a raft of questions, including on whether national bank insolvency rules are too fragmented, decision-making processes too slow, burden-sharing rules too inconsistent, or resolution-funding arrangements too dependent on SRF resources.

65. Staff has made specific suggestions aimed at securing a unified, transparent, and predictable resolution regime. Staff supports establishing an indemnity to protect the Eurosystem from credit losses on liquidity provision to new banks post-resolution, while also harmonizing and centralizing arrangements for emergency liquidity assistance. The FSAP recommends adopting a common creditor hierarchy for bank liquidation; aligning loss-sharing requirements to ensure that no creditor can be better off in liquidation than in resolution; and adding an administrative liquidation tool to the resolution toolkit. With these recommendations seeking to limit options to avoid bailing-in bank creditors, the FSAP also advises creating a financial stability exemption from minimum bail-in to ensure flexibility in extreme circumstances—noting that this will need stringent governance arrangements to prevent misuse.

66. Some central anti-money laundering (AML) supervision is also desirable. The recent experience in Latvia demonstrates that inadequate or uneven AML oversight can result in bank failures. Yet AML supervision lies beyond the SSM's remit, as a national function. To enhance supervisory convergence, the FSAP recommends that the authorities consider ultimately establishing an EU-level institution responsible for aspects of AML supervision.

B. Capital Markets Union

67. A more developed capital markets union would add a layer of private cross border risk sharing. The Capital Markets Union Action Plan aims to give firms access to a wider range of domestic and cross border financing options (Box 6). Notable progress has already been made, including by securing agreement on a standard for simple, transparent, and standardized securitization aimed at diversifying funding options for SMEs—although, here too, the litmus test is whether there will be sufficient market uptake. A new Prospectus Regulation has also been issued to

streamline issuance norms and make it easier and cheaper for SMEs to raise funds. Some pending elements of the Plan—such as insolvency law standards—would also support the banking union.

Box 6. Specific Steps Toward Capital Markets Union

The Capital Markets Union Action Plan spans a range of legislative and regulatory initiatives.

Its core objective is to help mobilize capital for financial integration in the EU as a complement to the banking union. Adopted in 2015, the Plan's goal is to reach completion by 2019. It aims to (i) provide more market-based financing options for firms, including SMEs, to gradually reduce dependence on loans from banks and nonbank financial intermediaries; (ii) ensure an appropriate regulatory environment for long-term infrastructure investment; (iii) increase investment choices for retail and institutional investors; (iv) support securitization markets; and (v) reduce cross border barriers to a unified EU capital market.

Last year's mid-point review found that more than half of the Action Plan's individual items had been implemented.

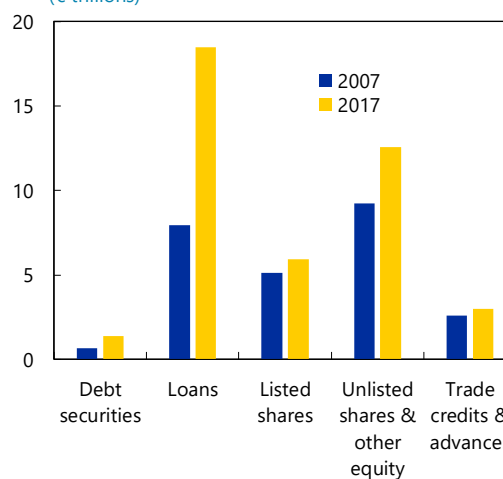
A new EU Prospectus Regulation, to take effect in 2019, enhances cross border comparability of

firms' financial statements, with the European Securities and Markets Authority (ESMA) planning to set up an EU-wide online prospectus database. The European Venture Capital Funds Regulation supports financing for start-ups. Agreement in principle by the European Parliament and the EU Council on a standard for simple, transparent, and standardized securitization could help SMEs tap market financing.

New action items are being added. New Commission proposals floated in early 2018 include an enabling framework for covered bonds; measures to reduce regulatory barriers to the cross border distribution of investment funds in the EU; and action plans on fintech and green finance. Other items to help support cross border investment activities intersect with the EU Council's Action Plan on NPLs, including steps to develop distressed debt markets and strengthen secured lenders' ability to attach collateral.

Nonfinancial Corporates' Liabilities

(€ trillions)



Sources: ECB; Haver Analytics; IMF staff calculations.

68. Brexit adds urgency, and a slew of new priorities, to the capital markets project. To the extent nonbank finance migrates to the continent, an upgrade of regulatory and supervisory resources and capacities will be essential for the EU-27 (Boxes 7 and 8). The FSAP recommends the EU-27 anchors its strategy on investor needs, including by addressing national variations in financial reports that impede comparability, barriers to accessing collateral that hurt secured funding, and procedures for withholding tax refunds that deter cross border investment. Specific measures could include central warehousing of firms' financial data with some smoothing of accounting differences, common collateral conventions, and steps to minimize double counting on withholding taxes. On the latter, the European Commission has recently released [new guidelines](#) on withholding taxes that aim to reduce costs and simplify procedures for cross border investors in the EU.

Box 7. Preparing the Financial Sector for Brexit

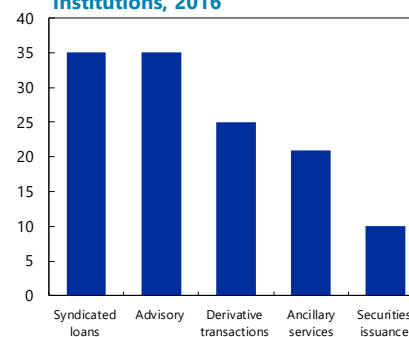
The EU (and U.K.) authorities need to take various urgent steps to avoid financial disruptions from Brexit. Almost one-third of EU-27 syndicated lending and advisory services and a significant share of EU insurance and derivative business are currently centered in London. With many financial services moving or preparing to move, shortfalls in service provision seem unlikely. Nonetheless, the FSAP urges that EU and U.K. authorities take steps, together, to ensure legal continuity in insurance and derivative contracts and proper data sharing to avoid any cliff effects.

Enhanced oversight arrangements and close EU–U.K. cooperation are especially needed in the area of euro clearing.

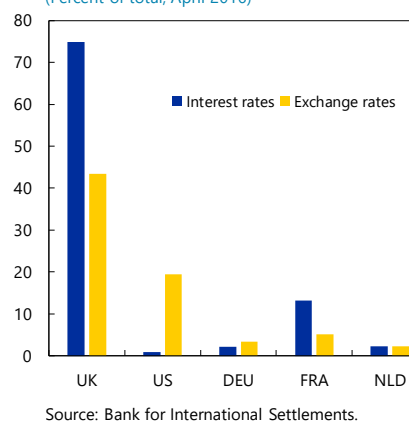
Central clearing counterparties (CCPs) process a large share of repo and over-the-counter derivative transactions both in London and in the euro area. Currently, large volume multilateral netting and collateral pooling across currencies and instruments by CCPs based in London provide material savings, supporting market liquidity and price discovery. The systemic nature of these operations points to a need for enhanced cross border oversight arrangements post-Brexit. The FSAP recommends that ESMA be given direct supervisory powers over non-EU CCPs of systemic importance to the EU; it also favors a stronger role for the Eurosystem in CCP oversight. The FSAP cautioned against mandatory relocation of euro clearing to the EU-27.

Oversight arrangements for foreign bank branches and investment firms also need to be upgraded, urgently. It is vital that ESMA, national securities regulators, macroprudential authorities, and the Eurosystem build oversight capacities and corrective tools. The late 2017 Commission proposals to strengthen the coordination of the European Supervisory Authorities (the European Banking Authority, ESMA, and the European Insurance and Occupational Pensions Authority) seek to help limit systemic risks. The FSAP, in turn, recommends systemic investment firms and EU branches of non-EU banks—especially the large ones forming or growing in advance of Brexit—be brought under the SSM, while supervision of smaller investment firms by national authorities become more harmonized, under the aegis of ESMA.

Share of EU-27 Financing Provided by UK-based non-EU Financial Institutions, 2016



Share of Euro OTC Derivative Turnover (Percent of total, April 2016)



C. Fiscal Institutional Reforms

69. A central fiscal capacity (CFC) would strengthen countries' ability to use fiscal policy for macroeconomic stabilization in a downturn. At the aggregate level, the euro area relies excessively on monetary policy to stabilize the economy when hit by a shock. And at the national level, euro area countries facing shocks have only their own fiscal policies to stabilize their economies, since the single monetary policy cannot be tailored to individual country needs. A CFC would provide countries with additional fiscal space for the bad times, dampening any repeat of the recent crisis where countries were forced to raise taxes and cut spending, deepening the slump.

70. Staff's proposal for a CFC, as laid out in a recent [staff discussion note](#), explicitly links stabilization to risk reduction. The proposal—to establish a moderately sized, yet potent, CFC—

Box 8. Some Background on Euro Clearing and Brexit

The debate around euro clearing follows years of CCP expansion worldwide. Historically, CCPs were used mostly in exchange-traded derivative markets. In response to the global financial crisis, however, the G20 supported mandatory clearing of most standardized over-the-counter derivatives through CCPs. In the EU, this requirement is introduced through the European Markets Infrastructure Regulation ([EMIR](#)). The EU currently hosts 16 CCPs, three of which are in the United Kingdom.

The three U.K.-based CCPs are important for the euro area. These—LCH Ltd., LME Clear Ltd., and ICE Clear Europe Ltd.—collectively provide vast, multi-currency and multi-product services. London accounts for almost 75 percent of the global turnover of euro-denominated interest rate derivatives, compared with about 14 percent of global turnover for dollar-denominated contracts; and more than 40 percent of euro-denominated foreign exchange derivatives, compared with about 37 percent for dollar contracts. London also accounts for a significant volume of euro-denominated repo agreements.

Efficiency enhancement by CCPs is a function of size and scope. Clearing, as a process that occurs between the execution of a trade and its settlement, involves calculating the net obligation, and ensuring that securities, cash, or both are available to secure it. CCPs centralize this process, as principal parties rather than just arrangers: in a bilateral trade, the CCP becomes counterparty to both ultimate trading parties, committed to honoring the contract even if one trading party defaults. Pooling transactions allows important—if not easily quantified—efficiency gains in netting and collateral management. Margins can safely be, and are, lower when a large volume and diversity of trades flows through a single CCP.

But the largest CCPs are also the epitome of financial institutions that are too big to fail. CCPs require their members to provide initial and variation margins to cover potential losses from net open positions as well as contributions to default funds. In the event of a member's default, its margin and default fund contributions provide the first layer of loss absorption, followed by a portion of the CCP's capital. Thereafter, the CCP may mutualize the remaining loss across its members by tapping into its default fund. The largest CCPs, however, have become critical nodes in the financial system, reducing yet concentrating counterparty and operational risks. The argument that CCPs reduce systemic risk requires that they themselves be of unquestionable soundness.

The current EU oversight framework already differentiates between EU and "third country" CCPs. For EU-based CCPs, EMIR lays out detailed organizational, conduct, and prudential requirements. Authorization and oversight are entrusted to national competent authorities, which chair colleges of supervisors that include ESMA and relevant central banks (with relevance as a currency-based concept). In the U.K. case, the Bank of England is the competent authority, and it has a memorandum of understanding with the ECB on CCP oversight and information sharing and reciprocal currency swaps. For "third country" CCPs, the home jurisdiction must be determined by the European Commission to have legal and supervisory arrangements for CCPs equivalent to those contained in EMIR. CCPs in that jurisdiction may then be recognized by ESMA, which generally defers oversight to the home supervisor. In the U.S. case, this deference is enshrined in an equivalence agreement with the Commodity Futures Trading Commission.

With Brexit, however, EU concerns center on losing jurisdiction over the London-based CCPs so deeply engaged in euro clearing. Proposed changes to EMIR would establish a new system for classifying third country CCPs based on size, structure, and volume of business in EU currencies. Non-systemic CCPs would continue to operate under the existing EMIR recognition framework. Systemically important "tier 2" CCPs would be subject to stricter requirements, including agreements to permit onsite inspections, with confirmation that such agreements are legally binding. In special cases where CCPs are deemed of such systemic importance that the tier 2 safeguards do not suffice, the Commission, upon request by ESMA and in agreement with the relevant central bank, may deny recognition. In such cases, continued service provision to EU clients would require relocation to the EU.

recognizes that the fundamental rift is between those calling for greater risk sharing and those concerned about moral hazard and permanent transfers (Box 9). Staff's CFC would require countries to save in good times, paying into a central fund. In bad times, they would receive transfers, supporting their ability to cushion downturns with fiscal policy. Countries would still need to build their own buffers—the proposal is careful to note that the fund would be a support, not a substitute, to national fiscal responsibility. To further address moral hazard, payouts would be conditional on compliance with the fiscal rules—and, ideally, the rules should be reformed to make it easier to monitor compliance. The CFC would also have mechanisms to prevent permanent transfers.

Box 9. A Central Fiscal Capacity for Macroeconomic Stabilization

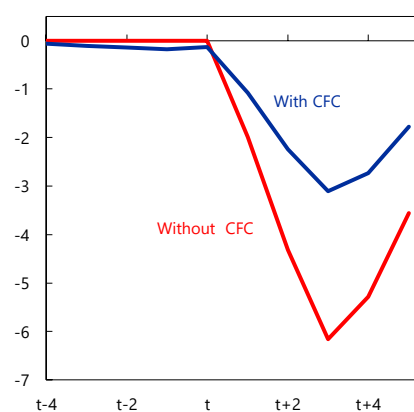
Staff's proposed CFC would be a macroeconomic stabilization fund. It would be financed by annual contributions from national budgets—used to build assets in good times—and would make transfers to countries in bad times. It would have a borrowing capacity in the event of an exceptionally large shock that necessitates transfers so large as to exhaust the fund's assets. Transfers would be triggered automatically by a cyclical indicator: the deviation in the unemployment rate above its moving average, which avoids triggering transfers in response to structural increases in the unemployment rate.

To address moral hazard risk, transfers from the CFC beyond a country's own contributions would be conditional on past compliance with the fiscal rules. For example, in a downturn, if over the past five years a country was only compliant in three years, the transfer rate would be reduced proportionally. The complexity and opacity of the current EU fiscal rules, however, open up the assessment of compliance to significant discretion, making them less than ideal for linking with a CFC. Ideally therefore, the rules would be reformed in conjunction with the creation of a CFC, to make them more transparent and enforceable.

Several mechanisms, which could be combined, are proposed to help prevent permanent transfers. These include a “usage premium,” a cap on cumulative net transfers to a country, and a cap on cumulative net contributions from a country. The usage premium would be paid based on a country's past receipts of net transfers from the CFC, but only once its economy has recovered. The cap on cumulative net transfers would help limit the risk of permanent transfers, but would also limit the support for economic stabilization. The cap on net contributions would limit the size of the asset build-up in good times, increasing the likelihood of needing to invoke the CFC's borrowing capacity.

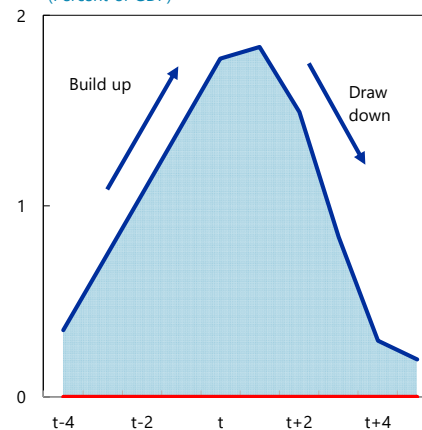
Staff's analysis shows that the CFC could provide meaningful stabilization at moderate cost. With an annual contribution of 0.35 percent of GDP and a transfer rate of $\frac{1}{2}$ percent of GDP for each percentage point of unemployment gap, simulations suggest the CFC could help smooth 30–60 percent of a common shock, depending on whether monetary policy is constrained or not. It could also help smooth up to 50 percent of country-specific shocks. Simulations also confirm that the assets built up during a typical expansion should be sufficient to cover the prescribed transfers in all but the most severe downturn.

Impact of Large Shock on Output Gap
(Percent of GDP)



Source: IMF staff calculations.

Size of Fund
(Percent of GDP)



Source: IMF staff calculations.

71. More time will be needed to build support for a full-fledged CFC, with several countries seeking a longer track record of discipline before considering greater risk sharing.

The Commission has proposed a small investment stabilization function for the euro area linked to the EU budget. At the same time, France and Germany support a euro area budget within the EU budget to ensure convergence and stabilization, but envisage further discussions, including with other euro area countries, to determine the specific features of the stabilization mechanism. While both proposals envisage less macroeconomic stabilization than the CFC advocated by Fund staff, progress on either would still be an important step forward.

72. Efforts are also underway to strengthen the euro area’s crisis management framework.

Staff supports such efforts, while not taking a view on the relative roles of the various institutions. There are ongoing discussions on strengthening the ESM’s role in crisis management, and possibly involving the institution in economic surveillance also. Governance arrangements will be key, given the need for independent decision making, insulated from political pressures. Steps such as removing the unanimity requirement at the ESM’s Board and moving to a system of majority voting will likely be required.

Authorities’ Views

73. The authorities agreed that risk reduction and risk sharing should proceed together, as they are mutually complementary.

A concern was voiced, however, that some member states are “moving the goal posts” over time, which may delay the completion of the banking union. The Commission noted that substantial risk reduction has been achieved, in line with—and in some respects surpassing—the goals set out in the 2016 EU Economic and Financial Council roadmap for the banking union. It also noted that it has delivered all elements falling under its remit with regard to the 2017 EU Council Action Plan for NPLs. Moreover, several policy packages are being proposed or implemented that will further reinforce banks’ risk management, strengthen market discipline, improve insolvency regimes, and thereby accelerate the ongoing reduction of NPLs. It is now up to member states and the European Parliament to agree on the legislative packages.

74. The authorities stressed that, in the absence of an SRF backstop and common deposit insurance, the banking union remains incomplete.

They emphasized that the backstop needs to be promptly accessible, with an efficient decision-making process. The authorities agreed with Fund staff on the need for refinements to the crisis management and resolution framework. At this stage, however, it is essential to ensure timely finalization of the legislative texts as currently proposed, which focus on critical issues such as MREL and a moratorium to allow more time for resolution. Any assessment of the need for further amendments should be taken on only after the adoption of the current package—realistically, under the European Commission’s new mandate starting in 2020.

75. The Commission underscored that state aid control remains a central element in the banking union, alongside the bank resolution framework.

It stressed that this function derives from the Treaty on the Functioning of the EU. Commission staff argued that state aid control acts as a gatekeeper, preventing member states from circumventing the bank resolution framework, with that framework explicitly foreseeing that banks requiring public support shall normally be

considered failing or likely to fail. They also noted that state aid rules for the financial sector are periodically reviewed in light of changes in market conditions.

76. The authorities noted a need to revisit the aims of the capital markets union in light of Brexit. Member states remain supportive of the Capital Markets Union Action Plan, and some of the hurdles to its completion are technical rather than political. However, there remains opposition to further centralization in some areas of capital markets oversight. Separately, the authorities noted that the absence of a genuine euro area yield curve renders cross border risk sharing more difficult. The creation of a genuine euro area safe asset would be instrumental in building such a yield curve, thereby supporting the broader capital markets endeavor.

77. A stocktaking is underway on issues surrounding the loss of passporting and any implications on existing insurance and derivative contracts through Brexit. The authorities emphasized that the primary responsibility to prepare for Brexit is with market participants. They cautioned that a general grandfathering of contracts is unworkable because it could provide unintended incentives regarding potentially affected contracts, and might imply a continuation of current authorizations to provide financial services in the EU. A technical working group chaired by the ECB President and the Governor of the Bank of England has been set up to look into risk management in the area of financial services through Brexit. The EU considers that any Brexit-related financial sector impact is more likely to be reflected in the cost of financial services, at least in the transition to a new steady state. The authorities clarified that they are seeking greater supervisory cooperation to manage risks in non-EU CCPs, including those in the United Kingdom. They noted that “mandatory relocation” was intended only as a last resort if arrangements would prove insufficient to manage risks to the EU from any given non-EU CCP.

78. The authorities agreed that a CFC would complement national fiscal policies in enhancing macroeconomic and financial stability. As part of the EU budget proposal for 2021–27, the Commission is proposing a €30 billion (about 0.2 percent of euro area GDP in 2021) central scheme to help countries protect public investment in the face of large asymmetric shocks. Support would come through back-to-back loans under the EU budget, coupled with a subsidy to cover interest, the latter financed by contributions from member states proportionate to their national central banks’ monetary income. Access to the scheme would be conditional on a number of eligibility criteria. The arrangement could be complemented over time by additional means outside the EU budget—such as a possible role for the ESM loans, and a possible insurance mechanism to be set up by member states. The authorities contend that their borrowing–lending scheme would prevent permanent transfers more easily than Fund staff’s proposed contribution–transfer scheme, while providing less stabilization given its smaller size.

79. ESM reform is a topic of active discussion. The Commission has put forward a proposal on how to create a European Monetary Fund. Commission staff observed that there does not appear to be a consensus yet among member states to integrate the ESM into the EU framework. Discussions are underway on a targeted reform of the ESM’s role, which would require changes to the ESM Treaty and, in turn, ratification by national parliaments. The Commission recalled that the Treaties’ attribution of competences and tasks to EU institutions—the EU Council and the Commission—including for economic surveillance, needs to be respected. As regards debt sustainability, the

Commission rejected any automatic or mechanical approach to its assessments and the consequent decisions, given the repercussions that this could have on financial stability.

STAFF APPRAISAL

80. The continuing expansion offers a good opportunity to build resilience, lift growth potential, and deepen the currency union. Despite signs that growth has peaked, the recovery remains strong. Countries should grasp it to tackle structural challenges, build buffers, and rebalance externally. Respecting the shared fiscal rules—and pursuing needed structural reforms—is central to cohesion and trust, and to allowing architectural advances that would further support resilience.

81. Risks, however, are particularly serious at this time. The ascendance of trade protectionism is deeply worrisome. At home, policy complacency is amply evident, as is the risk of political shocks, with some countries raising the specter of policy reversals that would hurt debt sustainability and could push up borrowing costs across the union. In addition, the lack of progress in Brexit negotiations raises the risk of a disruptive exit.

82. Monetary policy needs to stay accommodative until inflation is convincingly converging to objective. Positive output gaps and tightening labor markets will eventually lift inflation, but this will take time given a strong backward-looking element in the euro area inflation process. The ECB's commitment to keep policy rates low through mid-2019, and beyond, if necessary, is vital. Clear communication is becoming ever more important.

83. National fiscal policies must be tailored to rebuilding buffers or boosting investment, as country-specific conditions require. High-debt countries must ramp up their fiscal efforts while conditions remain supportive. Equally, the large net external creditor countries with ample fiscal space and excessive current account surpluses should increase public investment in infrastructure, education, and innovation, seeking to incentivize more private investment at home as they do so.

84. Better compliance with and enforcement of the fiscal rules is needed. Enforcement by the responsible EU institutions has been too lenient. As output gaps close, the case for a flexible interpretation of the fiscal rules is becoming ever weaker. Strict compliance with the SGP will help rebuild buffers and ensure debt sustainability. Simplifying the rules would support discipline in both compliance and enforcement.

85. Structural reforms are critical to lifting productivity—and creating job opportunities—in many countries. Product and labor market reforms should be energized to improve resilience, boost potential growth, and close competitiveness gaps. Linking EU financial and technical support to structural reform implementation can improve incentives.

86. Policy efforts should pursue external rebalancing and defend trade openness. The euro area current account in 2017 was moderately stronger than justified by medium-term fundamentals and desired policy settings. The policy response should center on fiscal policy actions—especially measures that would raise the returns to private investment at home—in the large net creditor

countries where current account surpluses are persistently excessive. Architectural advances that can support credit flows and investment are also part of the remedy. Trade openness must be preserved, with unwavering commitment to the rules-based global trading system.

87. In banking and finance, the risk reduction momentum should be maintained. The FSAP finds that, overall, the resilience of large euro area banks has improved, albeit with some banks remaining vulnerable to credit, market, or liquidity risks. Low profitability remains a serious challenge, calling for sustained supervisory pressure. Legacy asset clean-up should be taken to the finish line, again spurred on by energetic supervision. MREL issuance needs to be stepped up at the largest banks. Steps should be considered to encourage the reduction of widespread home bias in banks' sovereign exposures, but with due attention to transition risks.

88. Architectural reforms would help build collective resilience to future shocks. The challenge is to combine risk sharing with incentives for further risk reduction. Efforts should focus on completing the banking union, advancing the capital markets union, and building consensus for meaningful public risk sharing. Creating a borderless banking market requires less legal fragmentation across national lines, an improved resolution framework, and a shared financial safety net complete with common deposit insurance and a backstop to the SRF—steps that in themselves would further reduce risks. Brexit increases the urgency of capital markets union, and the importance of cross border regulatory cooperation. Finally, better macro stabilization calls for a well-designed CFC, with strong safeguards against permanent transfers and moral hazard.

89. It is proposed that the next consultation on euro area policies in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

Table 1. Euro Area: Main Economic Indicators, 2015–23

	2015	2016	2017	Projections 1/					
				2018	2019	2020	2021	2022	2023
Demand and Supply									
Real GDP	2.1	1.8	2.4	2.2	1.9	1.7	1.5	1.5	1.4
Private consumption	1.8	2.0	1.6	1.5	1.7	1.5	1.5	1.4	1.3
Public consumption	1.3	1.8	1.2	1.4	1.2	1.0	1.0	1.0	1.0
Gross fixed investment	3.3	4.6	3.2	3.9	3.6	2.9	2.5	2.3	2.2
Final domestic demand	2.0	2.5	1.8	2.0	2.0	1.7	1.6	1.5	1.5
Stockbuilding 2/	0.0	-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand	2.0	2.3	1.9	2.1	2.0	1.7	1.6	1.5	1.5
Foreign balance 2/	0.1	-0.4	0.6	0.2	0.0	0.0	0.0	0.0	0.0
Exports 3/	6.4	3.3	5.3	4.7	4.4	3.8	3.6	3.4	3.3
Imports 3/	6.7	4.6	4.3	4.6	4.7	4.2	3.9	3.6	3.6
Resource Utilization									
Potential GDP	1.5	1.3	1.4	1.6	1.6	1.6	1.6	1.5	1.5
Output gap	-1.6	-1.2	-0.2	0.4	0.8	0.8	0.8	0.7	0.6
Employment	1.0	1.4	1.6	1.0	0.7	0.6	0.4	0.3	0.2
Unemployment rate 4/	10.9	10.0	9.1	8.4	8.0	7.8	7.6	7.5	7.4
Prices									
GDP deflator	1.4	0.8	1.1	1.5	1.6	1.8	1.9	2.0	2.0
Consumer prices	0.0	0.2	1.5	1.7	1.7	1.8	2.0	2.1	2.1
Public Finance 5/									
General government balance	-2.0	-1.5	-0.9	-0.6	-0.6	-0.5	-0.7	-0.7	-0.8
General government structural balance	-1.0	-0.8	-0.7	-0.8	-1.0	-0.9	-1.1	-1.1	-1.2
General government gross debt	89.9	89.0	86.7	84.3	81.8	79.8	77.9	76.1	74.5
External Sector 5/, 6/									
Current account balance	3.2	3.6	3.5	3.2	3.1	3.1	3.0	3.0	2.9
Interest Rates (end of period) 4/, 7/									
EURIBOR 3-month offered rate	-0.1	-0.3	-0.3	-0.3	...	...	...	...	...
10-year government benchmark bond yield	1.2	1.3	0.9	1.2	...	...	...	...	...
Exchange Rates (end of period) 7/									
U.S. dollar per euro	1.09	1.05	1.18	1.18	...	...	...	...	...
Nominal effective rate (2005=100)	101.2	102.6	110.0	110.2	...	...	...	...	...
Real effective rate (2005=100, ULC based)	90.7	90.6	96.3	96.7	...	...	...	...	...

Sources: IMF, *World Economic Outlook*, Global Data Source; Reuters Group; and Eurostat.

1/ Projections are based on aggregation of *WEO* April 2018 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/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

7/ Latest monthly available data for 2018.

Table 2. Euro Area: External Sector Assessment

	Euro Area											Overall Assessment	
Foreign asset and liability position and trajectory	<p>Background. The net international investment position (NIIP) of the euro area fell to about -18 percent of GDP by the end of 2008, but has since recovered, reaching around -1 percent by end 2017. The rise has been driven by stronger current account balances and modest nominal GDP growth. Growth in both gross foreign asset and liability positions remains low, but relatively steady after sharply slowing in 2008, coincident with the broader global slowdown in international financial flows. Gross foreign positions are now about 221 percent of GDP for assets and 222 percent of GDP for liabilities in 2017. However, net external liabilities remain high in some countries, including Spain and Portugal.</p> <p>Assessment. Projections of continued current account surpluses suggest that the NIIP-to-GDP ratio will improve further, at a moderate pace, with the euro area expected to soon become a net external creditor, absent large differences in valuation changes on gross external assets versus liabilities. The region's overall NIIP financing vulnerabilities appear low. Despite improved current accounts, large net external debtor countries still bear a greater risk of a sudden stop of gross inflows.</p>											<p>Overall Assessment: <i>The external position of the euro area in 2017 was moderately stronger than the level implied by medium-term fundamentals and desirable policies. In 2018, the current account surplus is projected to shrink modestly as the region's economic recovery continues.</i></p> <p>Imbalances at the national level remain sizeable and progress in reducing them slow (see individual euro area member country pages). Countries with excess CA surpluses should continue to strengthen domestic demand while those with weak external positions should work to further raise productivity and competitiveness. The euro area's external position may be affected by the U.K.'s eventual exit from the EU and rising trade tensions. These will be assessed in the context of future ESR reports.</p> <p>Potential policy responses: Monetary policy should remain accommodative until inflation has durably converged to the ECB's medium-term price stability objective, facilitating relative price adjustments at the national level by enabling greater inflation differentials across monetary union members. Area-wide initiatives to make the currency union more resilient (e.g., banking and capital markets union, fiscal capacity for macro stabilization) could also reinvigorate investment and reduce savings-investment imbalances. At the country level, efforts are needed to address imbalances, including policies to strengthen private sector balance sheets, structural reforms to enhance productivity and competitiveness, and a more growth-friendly composition of national fiscal policies. Countries with stronger-than-warranted external positions should use available fiscal space to expand investment and promote structural reforms to raise their potential and reduce their current accounts, while those with weaker external positions should continue consolidating to reduce their debt and increase their buffers, while undertaking competitiveness-enhancing reforms. In general, a more balanced policy mix with the implementation of priority institutional and structural reforms at the country level would help to reduce external imbalances, including within the euro area.</p>	
Current account	<p>Background. The current account (CA) balance for the euro area in 2017 was at 3.5 percent of GDP (cyclically adjusted 3.4 percent), having increased steadily since 2011, when it was close to zero. Most euro area countries are now running current account surpluses (apart from Cyprus, France, Greece, Latvia, and Slovakia). Import compression in the aftermath of the crisis and external competitiveness gains from price and wage adjustments have strengthened the current accounts of net external debtors, like Spain and Portugal. Some large creditor countries, such as Germany and the Netherlands, continued to accumulate sizable surpluses, reflecting strong corporate and household saving and weak investment.</p> <p>Assessment. The EBA model estimates a CA norm of 1.5 percent of GDP, against a cyclically adjusted CA of 3.4 percent of GDP. This implies a gap of 1.9 percent of GDP. Staff's analysis indicates a higher CA norm than estimated by the EBA model, consistent with the assessed external positions of euro area member countries. The higher norm considers the large net external liabilities positions in some countries (e.g., Spain) and reflects uncertainty over the demographic outlook and the impact of the recent large-scale immigration on national savings (e.g., Germany). Considering the uncertainties in the estimates, staff assess the CA gap to be 1.3 percent, with a range of 0.6 to 2.0 percent of GDP for 2017. This leaves the underlying CA moderately stronger than the level implied by medium-term fundamentals and desirable policies. 1/ 2/</p>												
CA Assessment 2017	Actual	3.5	Cycl. Adj. CA	3.4	EBA CA Norm	1.5	EBA CA Gap	1.9	Staff Adj.	0.6	Staff CA Gap		1.3
Real exchange rate	<p>Background. The CPI-based real effective exchange rate appreciated by about 1.6 percent from 2016 to 2017, mostly reflecting the gradual strengthening of the euro area's recovery. Weaker inflation in the euro area relative to its trading partners accounts for a real appreciation lower than the nominal appreciation of about 2.1 percent. Estimates through May 2018 show that the REER has appreciated by 2.2 percent relative to the 2017 average.</p> <p>Assessment. The EBA index REER model points to an overvaluation of about 2.2 percent in 2017, while the level REER model suggests an undervaluation of about 2.9 percent. On balance, staff assesses the euro area 2017 average real exchange rate gap of -8 to 0 percent, consistent with assessed exchange rates of euro area member countries. As with the CA, the aggregate masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 10–20 percent in Germany to overvaluations of 0–10 percent in several small to mid-sized euro area member states. The large differences in REER gaps within the euro area highlight the continuing need for net debtor countries to improve their external competitiveness and for net creditor countries to boost domestic demand.</p>												
Capital and financial accounts: flows and policy measures	<p>Background. Mirroring the 2017 CA surplus, the euro area experienced net capital outflows, largely driven by portfolio debt and FDI outflows. These were somewhat tempered by inflows into portfolio equity and loans and other bank-related instruments. The geography of gross capital inflows shifted with the global financial and sovereign debt crises, with inflows from the core euro area economies into the rest of the euro area diminishing.</p> <p>Assessment. Capital outflows in portfolio debt and inflows into portfolio equity over the past couple years likely arose in large part from the ECB's monetary accommodation through its asset purchase program, which has lowered yields on debt and spurred interest in equity.</p>												
FX intervention and reserves level	<p>Background. The euro has the status of a global reserve currency.</p> <p>Assessment. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.</p>												
Technical Background Notes	<p>1/ The IMF EBA analysis for the euro area covers 11 euro area members, which are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain. The assessments of CA and REER gaps for the euro area are derived from GDP-weighted averages of the assessments of the individual countries listed above.</p> <p>2/ When applying GDP-weighted aggregation for the euro area, the CA is corrected for reporting discrepancies in intra-area transactions, as the CA of the entire euro area is about ½ percent of GDP less than the sum of the individual 11 countries' CA balances.</p>												

Table 3. Euro Area: Risk Assessment Matrix ^{1/}

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Response
Retreat from cross border integration	Medium Protectionism and economic isolationism could reduce global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment and growth.	High <ul style="list-style-type: none"> A retaliatory cycle of trade restrictions. Undermining of the rules-based international trading system. Lower growth due to trade barriers. Increased investor uncertainty, exacerbating low investment, weak productivity and undermining cyclical recovery. 	<ul style="list-style-type: none"> Continued support for the multilateral rules-based trading system, trade liberalization and free trade agreements. Re-double efforts to secure the benefits of economic integration and cooperation across the EU. Strong collaboration to ensure smooth and predictable transition to a new economic relationship between the U.K. and the EU.
Policy and geopolitical uncertainties.	Medium Global spillovers from two-sided risks to U.S. growth with uncertainties about the impact of the tax bill, uncertainty associated with negotiating post-Brexit arrangements and evolving political processes in some European countries.	<ul style="list-style-type: none"> Rise in euro skepticism, leading to less cooperation and a reversal of integration. 	
Intensification of security dislocation could lead to sharp rise in migrant flows into Europe.	High New geopolitical flashpoints could lead to socio-economic disruptions.	High <ul style="list-style-type: none"> Continued slow implementation of the modest EU-level agreements on relocating refugees could deepen political division. Lack of integration of migrants could raise unemployment, put pressure on national budgets and put social cohesion at risk. Border controls could restrict movement of goods, services, and labor in the single market. 	<ul style="list-style-type: none"> Refugees should be rapidly integrated into host country labor markets. Temporary costs related to refugee expenditures should be accommodated within current fiscal targets on a case-by-case basis. A new system to relocate refugees is needed to reduce the burden on frontline countries.
Tighter global financial conditions.	High An abrupt change in global risk appetite (e.g., due to higher-than-expected inflation in the U.S) could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions.	High <ul style="list-style-type: none"> Highly indebted countries could face higher borrowing costs. Less favorable financial conditions in vulnerable countries when global financial conditions tighten. Loss of market confidence. Negative shocks to growth, worsening an already weak growth outlook. 	<ul style="list-style-type: none"> To build buffers against adverse shocks, structural reforms, balance sheet repair and fiscal consolidation are needed in high-debt countries. The ECB's monetary policy stance should remain accommodative and remain focused on its euro area-wide medium-term price stability objective.
Further pressure on traditional bank business models.	Medium Legacy problems and potential competition from nonbanks curtail banks' profitability, which could lead to financial distress in one or more major banks.	Medium Given insufficient progress in balance sheet repair in some countries and broader profitability concerns, such an event could reverberate through the entire financial sector and widen sovereign yield spreads within the banking union.	<ul style="list-style-type: none"> The ECB's new guidance on NPL management should be followed with strict supervisory monitoring of all banks. Insolvency reform, further development of distressed debt markets, cost cutting, and banking system consolidation would facilitate the sector's adjustment.
Euro area insurance sector stress from low interest rates.	Low Stress on life insurer balance sheets due to investment returns falling below minimum return guarantees.	Low Absent a unified supervisory or resolution regime, the failure of a number of mid-size insurers could be a funding risk for domestic sovereigns in some countries.	<ul style="list-style-type: none"> Restrict use of new guarantee-based products, review rates on existing products, and transition to unit-linked instruments, review business models or consolidate through M&As. Some insurers may need additional capital based on EONIA stress tests. Transition to Solvency II framework requires periodic review and regular system-wide stress testing.
Structurally weak growth in key advanced economies relative to baseline.	High Low productivity growth, a failure to fully address crisis legacies and undertake structural reforms, as well as persistently low inflation undermine medium-term growth.	High <ul style="list-style-type: none"> Lower growth potential and higher output gaps compared to baseline due to weaker investment and persistent long-term unemployment. Further deterioration in public debt sustainability, private balance sheets, intra-euro area rebalancing. 	<ul style="list-style-type: none"> Accelerate structural reforms to spur investment, productivity and competitiveness, advance rebalancing of bank, corporate, and household balance sheets to enhance monetary transmission. Continue accommodative monetary policy to raise inflation and support demand.
Significant slowdown in China and its spillovers.	Low-Medium Too fast an adjustment and improper sequencing of actions in China to "de-risk" the financial system may weigh on near-term growth (Low). Over the medium term, overly ambitious growth targets lead to unsustainable policies and a sharp adjustment would weaken demand with adverse international spillovers (Medium).	Medium <ul style="list-style-type: none"> Slower export growth, higher output gap. Lower growth and inflation weakens public debt sustainability and private balance sheets. 	

^{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.)

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

	Reform Priorities	Recent Progress	Staff Recommendations
France	<p>Improve the functioning of the labor market to lower structural unemployment and improve opportunities for disadvantaged groups.</p> <p>Improve the business environment and strengthen competition in service sectors.</p> <p>Reform government spending to put debt on a firm downward path and attain MTO.</p>	<ul style="list-style-type: none"> The government enacted key reforms of the labor code in 2017, including: (i) limiting the automatic extension of branch-level agreements and allowing firms more freedom to opt out from such agreements; (ii) further reducing judicial uncertainty surrounding dismissals (notably through capping damages and limits on the time for recourse to labor tribunals); and (iii) simplifying social dialogue. In the context of the 2018 budget, the authorities legislated tax reforms supporting investment and job creation, including lowering the tax wedge in a budget-neutral way, reducing the CIT gradually, and simplifying capital taxation. Previous structural reforms (2015–16) include reducing judicial uncertainty around unfair dismissals; liberalization of some legal professions, coach transport, retail trade opening hours; and expansion of competencies of the Competition Authority. 	<ul style="list-style-type: none"> Finalize and implement planned reforms of the apprenticeship and professional training systems, monitor the effects of reforms carefully and stand ready to them with additional measures if needed, including by: (i) expanding firm-level flexibility in setting base wages, (ii) reforming the mechanism governing minimum wages, (iii) improving professional high-schools and pre-apprenticeship programs, and (iv) further strengthening the unemployment insurance system's incentives to work. Continue to pursue complementary product and service market reforms to open the railway sector to competition and reduce the administrative burden for firms, while taking steps to further liberalize regulated professions. Provide specific plans on how to reduce public spending while making it more efficient, including by: (i) better targeting social transfers, (ii) improving the efficiency of health spending, (iii) rationalizing tax expenditures, (iv) simplifying the pension system and progressively raising the effective retirement age, (v) reforming the public administration and achieve reductions in the number of civil servants through attrition; and (vi) limit local government spending, merge municipalities, and eliminate overlaps with state functions.
Germany	<p>Increase labor force participation of women, older workers, and refugees, and facilitate immigration of qualified workers.</p> <p>Increase productivity and competition, especially in the services sector.</p> <p>Advance digitalization.</p> <p>Support innovation and venture capital and reduce administrative burden.</p>	<ul style="list-style-type: none"> Progress in extending child care provision (stepped up federal financial support for municipalities to this end). A 2016 law reduces financial disincentives to work after pensionable age. Several measures taken in 2015–16 to broaden access to training and active employment services to refugees and asylum seekers. Action plan on professional regulations submitted to the EC in January 2016. Modifications to regulations regarding the practice (not access) of a few professions announced or being considered. Federal measures to improve the environment for venture capital and startups were adopted in 2015. A December 2016 law allows more corporations to deduct past tax losses following a change in shareholders from taxable income. The Federal Government aims to roll out comprehensive gigabit networks through Germany by 2025. The coalition agreement contains plan to expand digital infrastructure (10–12 billion euro), with the Gigabit Investment Fund available for deployment of gigabit networks in rural areas. The new government has political commitment to introducing R&D tax credit and further reducing administrative burden, 	<ul style="list-style-type: none"> Lower the tax wedge, in particular for the low skilled and women. Improve the provision of child care. Increase retirement ages. Facilitate labor market integration of low-skilled migrants. Further deregulate professional services. Strengthen the regulator's powers to stop discrimination against the incumbent operators' competitors in railways and postal services. Continue policy focus on innovation and the digital economy, and reduce administrative uncertainties surrounding venture capital.

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

	Reform Priorities	Recent Progress	Staff Recommendations
		<p>including through expanding e-government service provisions.</p> <ul style="list-style-type: none"> The Act to Strengthen Competition in the Railway Sector was passed in August 2016. 	
Greece	<p>Preserve and further expand labor market flexibility.</p> <p>Foster competition in service and product markets.</p> <p>Improve the business environment.</p>	<ul style="list-style-type: none"> The 2011 collective bargaining reform was effectively reversed (beginning on September 2018), raising risks to competitiveness. Reform of the collective dismissal framework, eliminating ex-ante approval of dismissals, was legislated, and the threshold for quorum to vote on a strike was raised. Restrictions on dockworkers (stevedores) were removed, and the medical code was streamlined. Reversals of pharma ownership and one-day clinics have been addressed. Steps to remove geographical and other restrictions on the engineering profession and public work registries are close to be completed. Regulations for private clinics are being streamlined. Some reforms completed, such as OTC trade of pharmaceuticals and liberalization of Sunday trade. But the Sunday trade reform falls short of OECD recommendations due to Constitutional constraints. OECD toolkit III recommendations (in several sectors including construction and media) were implemented). The investment licensing reform has been largely completed, with only a few sectors yet to be addressed. The reform moves most sectors from a system requiring authorization to one relying on notification and risk-based ex-post inspections. 	<ul style="list-style-type: none"> Preserve recent labor market reforms, including collective bargaining reforms. Adopt legislative changes to align framework on collective dismissals and industrial actions with EU best practices. Significantly accelerate the opening up of regulated professions, prioritizing macro-critical professions (e.g., engineers, lawyers, notaries). Implement pending OECD recommendations to reduce barriers to competition (including Sunday trading, and building materials). Fully implement the recently approved reform, and finalize the overhaul of the investment licensing system addressing the 24 sectors that remain pending, finalize the pending secondary legislation on environmental activities, and—in the coming years—harmonize the categorization of nuisance with an updated environmental classification.
Italy	<p>Increase competition in product and services markets.</p> <p>Raise public sector efficiency.</p> <p>Labor market reform.</p> <p>Civil justice and insolvency reform.</p>	<ul style="list-style-type: none"> In August 2017, parliament approved the Annual Competition Law—the first such approval since 2009 when the requirement to annually pass such a law was legislated. However, some of the original provisions of the law were weakened over two years of discussion in parliament. The 2014 Jobs Act overhauled the labor market, reduced duality by introducing a new standard employment contract with protection increasing with tenure, expanded the social safety net and plans to strengthen active labor market policies (ALMPs). Progress is uneven (e.g., delays in ALMPs) and some elements of the reform (e.g., voucher scheme for irregular work) have recently been revised (April 2017). In October 2017, parliament approved a framework law that establishes high-level principles to modernize the insolvency regime by facilitating out-of-court agreements and simplifying bankruptcy 	<ul style="list-style-type: none"> Ensure annual process of adopting pro-competition laws. Enhance competition including in local public service provision, transport, legal and professional services, and fully implement existing legislation (e.g., retail sector). Enhance the independent role of the competition authority to expedite deregulation. Align wages with productivity at the firm level, thereby also reducing regional disparities in labor outcomes by giving clear primacy to firm-level contracts and introducing a (possibly differentiated) minimum wage across regions. Strengthen the role of ALMPs and extend the new Jobs Act contracts to all open-ended contracts in the private sector. Swift passage of the implementing decrees of the new insolvency reform would ensure its adoption. Further improve the efficiency of civil justice to reduce trial lengths and the backlog of pending cases.

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

	Reform Priorities	Recent Progress	Staff Recommendations
		<p>procedures. The government has up to one year to issue all implementing decrees for the reform to take effect.</p> <ul style="list-style-type: none"> The implementing decrees on public administration reform were issued, including to reform public employment. However, some critical reforms (e.g., rationalizing local public enterprises, liberalizing local public service provisions, and accountability of senior managers) remain to be addressed. 	<ul style="list-style-type: none"> Operationalize the reform to public employment and SOEs. Improve the public sector skill mix, match positions with skills, align wages with productivity, and reduce high public-private wage premiums. Fully rationalize procurement, and tackle privileges and employment in public enterprises, including through privatization.
Portugal	<p>Alleviate impediments to external competitiveness and potential growth.</p> <p>Continue to improve the functioning of labor and product markets.</p> <p>Improve the efficiency of the judicial sector.</p>	<ul style="list-style-type: none"> Public transport concessions have been halted and the privatization of the national airline TAP to retain a 50 percent stake has been renegotiated. A one-time levy on GALP, the largest natural gas provider, was imposed and paid in May 2015, lowering gas prices for end users by an estimated 7–12 percent in the next three years. A new Budgetary Framework Law was adopted in 2015, including measures to reduce budget fragmentation and improve transparency through better fiscal reporting, but implementation is delayed. The authorities' National Reform Program for 2017–21 focuses on the modernization of the public sector, including simplification of administrative and licensing procedures for enterprises. It also seeks to expand programs providing mid-career and managerial training in an effort to improve the comparatively low skill level of the labor force. There is a discrepancy between official data showing much more efficient resolution of debt enforcement and insolvency cases in recent years, and anecdotal evidence suggesting that frequent delays and low pay-outs remain a persistent problem. 	<ul style="list-style-type: none"> Revisit reforms that have not yielded expected results, fully implement already initiated reforms, and address remaining bottlenecks through fresh reforms. Preserve recent labor market reforms. Promote managerial skills; more inclusive labor support systems; link minimum wage increases to productivity growth and use alternative policies to fight poverty; reduce duality by making permanent contracts more flexible. Upgrade the quality of public services and policies, raise effectiveness of public administration at all levels, and increase the payment discipline of public sector entities. Continue reducing energy costs and make no new investments in energy infrastructure until energy sector debt is paid off. Strengthen market integration at the European level. Commission an in-depth survey on the efficiency of the judicial system by an outside firm to develop an assessment of the reality on the ground and propose next steps.
Spain	<p>Address labor market duality. Improve employability of long-term unemployed and unskilled youth.</p> <p>Enhance competition and facilitate innovation and growth of firms.</p>	<ul style="list-style-type: none"> Overall progress toward raising the efficiency and effectiveness of active labor market policies (ALMPs) has been limited. The authorities published a multi-year strategy on employment activation, which lists initiatives to improve ALMPs' effectiveness, including by conducting an external evaluation in 2018. The eligibility criteria for the Youth Guarantee scheme were rightly relaxed. A new bonus for the young working under apprenticeship contracts was introduced. The authorities also intensified inspections and increased sanctions to reduce the abuse of temporary contracts. The implementation of the Market Unity Law (MUL) has been slow. The recent decision by 	<ul style="list-style-type: none"> Reduce labor market segmentation by improving the attractiveness of open-ended contracts and reducing administrative and legal obstacles that add to the cost of such contracts. Ensure that ALMPs are better targeted, evaluated, and coordinated. Increase capacity of the public employment services. Improve the quality of education and training. Foster competition by swiftly implementing the MUL and liberalizing professional services. Stimulate firm growth and productivity by tackling the remaining size-related rules and regulations, including on reporting, auditing, and labor regulation. Enhance innovation capacity by increasing the efficiency of public R&D, improving public-

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

	Reform Priorities	Recent Progress	Staff Recommendations
	Strengthen access to finance for young firms and innovative start-ups.	<p>the Constitutional Court, which found one principle of the MUL to be in violation with the constitution, could delay its implementation. No actions have been taken to liberalize professional services or reduce non-tax size-related disincentives.</p> <ul style="list-style-type: none"> • Access of credit, including for SMEs, has improved. 	<p>private cooperation, and enhancing private R&D investment.</p> <ul style="list-style-type: none"> • Strengthen access to finance for young and innovative start-ups by enhancing market-based financing via alternative exchanges, venture capital, and securitization, and by promoting the judicious use of direct financing and guarantees through ICO.

Source: IMF country teams.

Annex I. Progress Against IMF Recommendations

Policies	2017 Article IV Policy Advice	Actions since 2017 Article IV
Structural Policies	Use the window provided by the cyclical recovery to undertake ambitious structural reforms that boost productivity and foster income convergence.	Compliance with the 2017 Country-Specific Recommendations (CSR) under the European Semester has been uneven. See Table 4 for country-specific information on reform progress.
	Instruments at the EU level should be used more effectively to incentivize reforms.	The European Commission has proposed a new reform delivery tool to bring direct financial support to national reform efforts, while also mooting more funding for its standing Structural Reform Support Program.
	Progress in completing the single market in services, energy, digital commerce, and transport, as well as ambitious trade agreements would increase competition and boost growth potential.	Some progress has been achieved in the energy union project, including in the areas of regional market integration and infrastructure development. There has been some movement on the EU's digital single market initiative, including the elimination of roaming charges for mobile telephone service and of geographic discrimination in electronic commerce ("geo-blocking"). The EU's free trade agreement with Canada provisionally entered into force in 2017. Trade negotiations have been concluded with Singapore and Vietnam, and are at an advanced stage with Japan, Mercosur, and Indonesia.
Fiscal Policies	Countries with fiscal space should use it to promote public investment and structural reforms, while high-debt countries should adjust now to rebuild buffers.	Policy actions have been mixed. Some countries with fiscal space eased their fiscal stance while others tightened. Some high-debt countries have made progress on fiscal adjustment, while others did not.
	Better compliance with the rules is essential to ensuring the credibility of the fiscal framework. Moreover, better adherence to the fiscal rules would build the political support and trust required to establish a central fiscal capacity (CFC). A CFC would then permit a more accommodative overall fiscal stance in a downturn, while supporting fiscal discipline in good times. Consideration should also be given to simplifying the fiscal framework and making enforcement more automatic.	There have been a number of proposals in the past year for greater fiscal risk sharing. The latest from the EC would establish a euro area stabilization budget line in the next EU budget. Compliance with the fiscal rules has been weak and enforcement has become increasingly discretionary, as exemplified by the lack of quantitative targets in CSRs for 2018. There are currently no proposals to reform the fiscal rules. But, in its first annual report, the European Fiscal Board made some suggestions, in line with past Fund advice, on how to improve the rules.
Monetary Policies	Monetary policy should remain accommodative until there is a sustained upward adjustment of euro area-wide inflation.	In October 2017, the ECB extended the asset purchase program (APP) to September 2018 (from December 2017), or beyond, if necessary, and in any case until a sustained adjustment in the inflation path is achieved. The monthly net asset purchases between January and September 2018 were set at €30 billion (down from €60 billion).

Policies	2017 Article IV Policy Advice	Actions since 2017 Article IV
	Developing a common securities-lending framework for national central banks would facilitate access to high-quality collateral, thereby improving market functioning and enhancing the effectiveness of monetary policy.	In December 2016, the ECB introduced cash collateral in the PSPP securities lending. The overall limit for securities lending against cash collateral was set at €50 billion for the Eurosystem. The cash collateral option will be offered at a rate equal to the lower of the rate of the deposit facility minus 30 basis points and the prevailing market repo rate.
Financial Policies	The ECB's guidance on NPLs needs strong follow up. Ambitious reduction targets should be agreed, with vigorous supervisory follow up. Measures to modernize and harmonize foreclosure and corporate insolvency frameworks across member countries would help lift NPL values, by improving the efficiency of judicial processes and providing more certainty in defaults. In parallel, an EU-wide NPL clearing house to facilitate information dissemination would be a useful initial step toward developing secondary distressed debt markets. Given heterogeneity in insolvency regimes and in distressed asset classes across countries, AMCs at the national level—guided by a “blueprint” established by the EC—are likely to be more useful than a pan-European AMC.	In March 2018, both the European Commission and the ECB proposed new risk reduction measures. The Commission's package includes measures to tackle both the flow and stocks of NPLs. These include changes to the Capital Requirements Regulation that would require for new unsecured loans to be fully provisioned no later than two years, and new secured loans no later than eight years, after they become nonperforming, with concomitant pillar 1 deductions from banks' own funds. It also seeks to provide banks with efficient out-of-court mechanisms for value recovery on secured loans while pushing the development of distressed debt markets supported by specialized credit servicers. A national blueprint for AMCs clarifies that, under exceptional circumstances, state aid may be permissible. The ECB's guideline sets provisioning expectations for all loans, new or existing, that become nonperforming going forward. As part of the supervisory dialogue, banks will be expected to cover the full value of unsecured loans no later than two years, and secured loans no later than seven years, after default, with more ambitious interim expectations than the binding requirements proposed by the Commission.
	Bank profitability needs to be enhanced. Banks supervised by the Single Supervisory Mechanism (SSM), may require greater supervisory efforts to adapt and consolidate.	Profitability continues to improve. The SSM notes that changes to business models needs to be market based. However, business models are part of the attributes that determine the SSM's SREP/Pillar 2 capital requirements. Moreover, analysis on profitability done in the FSAP suggests that the stock of NPLs is a robust determinant of profitability, especially for the least profitable banks. The SSM's new NPL guidance and the EC's proposals will help address both the stock and the flow of NPLs, which should improve profitability over time.

Policies	2017 Article IV Policy Advice	Actions since 2017 Article IV
	<p>Completing the banking union, by establishing a common deposit insurance scheme with a common fiscal backstop, would foster the free flow of liquidity and provide reassurance to supervisors that the bank-sovereign link is severed. Further integration would also be helped by corporate insolvency and foreclosure framework harmonization and a speedier implementation of the BRRD's minimum requirement for own funds and eligible liabilities (MREL) and related resolution planning.</p>	<p>Concrete advances are within reach. Political support for instituting a standing ESM credit line to backstop the Single Resolution Fund is building, and technical work is underway. Discussions on common deposit insurance are likely to continue, with a focus on agreeing a roadmap for risk reduction, even if some milestones could take years to reach.</p> <p>The Single Resolution Board is setting binding minimum requirements for own funds and eligible liabilities (MREL) for banks under its purview. These initially comprise so called "external MREL" at the level of ultimate parents of banking groups, but will later also include "internal MREL" at the level of subsidiary banks within groups. The process of setting these requirements, based on detailed resolution planning, is slow.</p>
	<p>Faster progress on the capital markets union (CMU) action plan would foster greater international private risk sharing.</p>	<p>More than half of CMU Action Plan items have been implemented. Progress includes securing agreement on a standard for simple, transparent, and standardized securitization aimed at diversifying funding options for SMEs. A new Prospectus Regulation has also been issued to streamline issuance norms and make it easier and cheaper for SMEs to raise funds. Some pending elements of the Plan—such as harmonized insolvency laws—would also support the banking union.</p>

Annex II. 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 European Central Bank (ECB) and the national central banks (NCBs), operate under separate legal frameworks reflecting their respective governance structures and cooperate closely when designing their respective statistical programs.² The European statistics produced by the two statistical systems are of sufficient coverage, quality, and timeliness for effective macroeconomic surveillance. This appendix provides an update on developments of statistical issues since the previous Article IV consultation with the euro area (EA).

1. Transition to the new international statistical standards is complete but minor enhancements are still expected.³ With regard to data availability, most countries received derogations from the European System of National and Regional Accounts (ESA) 2010 data transmission requirements up to 2020 based on justified requests. A review of the justifications of the derogations took place in 2018, which showed that data availability improved significantly between October 2015 and January 2018. In most cases, the Member States have resolved the issues that gave rise to the derogations. In addition, a significant number of Member States have started providing (part of) the data covered by derogations even before the first expected transmission date. In addition, there has been a strong effort on ensuring that globalization-related issues are properly reflected in the statistics, and a number of work streams are progressing.

2. Eurostat and the ECB continued working in 2017 on the 20 recommendations of the second phase of the G20 Data Gaps Initiative (DGI-2), as members of the Inter-Agency Group (IAG) on Economic and Financial Statistics.⁴ Following the conclusion of its first phase, work has been undertaken on DGI-2, with the main objective to implement the regular collection and dissemination of reliable and timely statistics for policy use and address evolving policymaker needs. The 20 recommendations are clustered under three main headings: (i) monitoring risk in the financial sector; (ii) vulnerabilities, interconnections and spillovers; and (iii) data sharing and communication of official statistics, setting specific objectives for G20 economies to compile and disseminate minimum common datasets. Substantial progress has been already achieved for DGI-2, despite

¹ Prepared jointly by the European Department (EUR) and the Statistics Departments (STA) of the IMF in consultation with Eurostat and the ECB. Florina Tanase acted as the STA coordinator.

² The ESS is defined by Article 4 of Regulation (EC) No. 223/2009 of the European Parliament and of the Council on European statistics. The ESCB performs its statistical function based on 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.

⁴ The IAG members are Bank for International Settlements (BIS), ECB, Eurostat, IMF (chair), Organisation for Economic Co-operation and Development (OECD), United Nations and World Bank.

challenges in the implementation of some recommendations. In particular, concerning recommendation II. 7 on securities statistics (BIS-ECB), all G20 and almost all non-G20 economies provided self-commitments on the reporting of specific data sets on debt securities. The 2018 DGI-2 work program will include further thematic workshops to support participating economies' efforts, and it is intended that all DGI-2 recommendations are fully implemented by 2021.

3. Eurostat and the ECB jointly support the Special Data Dissemination Standard Plus (SDDS Plus), the third and highest tier of the IMF's Data Standards Initiatives launched in November 2014. By April 2018, seven EA countries (and 11 European Union (EU) Member States overall) have adhered to the SDDS plus, showing the commitment of European countries to this initiative.

4. Eurostat and the ECB continued their efforts to ensure the quality of statistics underlying the Macroeconomic Imbalance Procedure (MIP). Eurostat publishes annually the indicators for the MIP Scoreboard, together with a set of auxiliary indicators. The MIP Scoreboard provides the statistical basis for the annual Alert Mechanism Report released by the European Commission (EC) at the start of the European Semester. In November 2017, the ESS-ESCB quality assessment report on statistics underlying the Macroeconomic Imbalance Procedure was published. In 2017, Eurostat and ECB/DG-Statistics have taken the necessary steps to fully implement the Memorandum of Understanding (MoU) on the quality assurance of statistics underlying the MIP that had been signed in November 2016.⁵ These steps consisted of ECB/DG-Statistics running a quality assurance procedure on the datasets reported by the NCBs and the subsequent transmission to Eurostat of a brief metadata report explaining major events and revisions of the datasets. In this context, pilot visits to Greece and Belgium took place in November and December 2017, and terms of reference for future visits have been finalized. In 2018 the ECB and Eurostat will start publishing harmonized domain specific quality reports for balance of payments (BOP) and international investment position statistics (IIP).

5. In various areas of statistics, both the ESS and the ESCB are working to achieve further improvements in timeliness, coverage, and quality.

5.1. Streamlining the flash releases of key national accounts (NA) indicators. Following the introduction of the preliminary (T+30) GDP flash estimates for the EU and the EA in April 2016, Eurostat continued to monitor closely the quality of these estimates. After a revision analysis confirmed the high quality of the published European GDP T+30 estimates, Eurostat and the ESS agreed on a mid-term strategy of further streamlining the releases of key European NA indicators such as GDP and employment. The aim is to move to a regular estimation schedule based on country estimates available after 30, 60 and 90 days. The

⁵ <http://ec.europa.eu/eurostat/documents/10186/7722897/Final-signed-MoU-ESTAT-ECB.pdf>

overall schedule of the flash releases will be reconsidered with the possible publication of an employment flash estimate that is currently under tests.

5.2. Improvements to quarterly BOP and IIP statistics are forthcoming with the amendment of the ECB Guideline on External Statistics.⁶ These changes will bring in 2021, amongst others: (i) more detailed information by sector, including a distinction between households and non-financial corporations and a more granular presentation of the financial sector; (ii) a comprehensive breakdown of the IIP by currency of denomination; (iii) bilateral data *vis-à-vis* all G20 countries for the main accounting entries; and, (iv) a complete instrument breakdown of the BOP and IIP to facilitate the link with NA.

5.3. Further improvements in timeliness of integrated sector accounts. The timeliness of the EA quarterly sector accounts substantially improved in 2016, from around T+120 days to around T+102, and has further accelerated in 2017 to around T+94. The new first aggregated release of non-financial sector accounts is based on the preliminary data transmitted by EA Member States by T+85 days after the reference period.

5.4. The first reporting exercise on the quality of ESA 2010 data transmitted by Member States to Eurostat was introduced in 2017 and concerned the 2016 data transmissions. National quality reports were completed in October 2017. The Eurostat assessment report prepared in December 2017 is currently under consultation and will be published around July 2018. The quality assessment showed that in 2016 quarterly and annual NA mandatory data had high completeness and that the punctuality of transmission of quarterly NA was relatively high, while the punctuality of transmission of annual data had to be improved. The national and regional accounts data remain highly relevant to users. Even though a vast body of information is available at national and Eurostat's websites, the online documentation on methodology, including metadata and implemented major revisions can be further enriched.

5.5. Eurostat concluded its Task Force on the recording of illegal economic activities in NA and BOP. The Task Force published its results in a Handbook in March 2018, providing the first comprehensive overview of conceptual and practical issues related to the compilation of statistics on illegal economic activities (IEAs) in the accounting frameworks. Estimating the extent or the value of IEAs is clearly problematic because a direct observation is often out of question. However, statistical institutions and data users have increasingly recognized the need for comprehensive, reliable and internationally available information on IEAs in NA and BOP. Therefore, the purpose of this Handbook is to provide a common definition of IEAs and guidance for collecting and compiling IEA statistics, in a consistent and coordinated way. The aim is also to contribute to improved collection and compilation and to a greater understanding of IEA transactions. This Handbook is the result of the joint work of the members of the Task Force on the Recording of IEAs in NA and BOP, consisting of

⁶ ECB Guideline ECB/2011/23.

experts from the European Commission, European national statistical institutes and central banks, as well as the United Nations Office on Drugs and Crimes (UNODC), ECB, OECD and European Parliament–European Parliamentary Research Service. Further, the Handbook provides input to the forthcoming work of the UNODC-UNCTAD Expert Group on the SDG Indicator on Illicit financial flows and the IMF Task Force on Informal Economy.

5.6. Following the entering into force of the new basic legal act on the Harmonized Indices of Consumer Prices (HICP) all EA Member States are transmitting to Eurostat their HICP flash estimates starting with the January 2017 index. The EA flash estimates are now based on aggregating country data and Eurostat has thus stopped using a model for estimating missing countries. Moreover, since March 2017, Eurostat is publishing the HICP all-items flash estimate rate of change by country of those countries that agreed to the dissemination. Currently Cyprus, Germany, Spain, France, Lithuania, Latvia, Italy, Malta, Poland, Slovakia and Slovenia figures are released.

5.7. The Eurostat has also started to release **more granular inflation data**. Since 2016 indices at the new sub-class level of the European classification of individual consumption according to purpose (ECOICOP) has been available at country level. In 2018 these data will be complemented with European aggregates.

5.8. Against the background of the increasing user demand at the EU level for **commercial real estate indicators**, in particular from the European Systemic Risk Board, ECB and Eurostat established a joint expert group (JEG) in 2017 to explore the further development of such indicators related to the physical market. The main tasks of the JEG were to conduct a stock-taking exercise of variables that already exist or being developed in Member States (including relying on commercial data providers) and to sketch out the way forward. The JEG submitted its [report](#) to the Economic and Financial Committee (EFC) in autumn 2017, underlining the need for an evolutionary approach in view of the high complexity of the market. Furthermore, the ESCB Statistics Committee’s Real Estate Task Force (RETF) analyzed the role of the AnaCredit dataset to provide comparable data for bank financing of commercial real estate. In the same field of work, Eurostat published in December 2017 in the Statistical reports series a book: "Commercial Property Price Indicators (CPPI): sources, methods and issues". This [CPPI Statistical Report](#) sets out the wide range of challenges linked to the measurement of commercial property. The text covers the conceptual framework, the purposes and uses of CPPIs, as well as other related indicators.

5.9. The EuroGroup Register (EGR)—the central European register for multinational enterprise groups managed by Eurostat—is constantly improving in coverage and quality. Based on the microdata sent by NSIs, around 100,000 enterprise groups active in the EU with a unique identifier are now part of this register. The production of the 2016 EGR data is now finalized and the output is increasingly used for statistical production. In the same vein, the ESCB is running a **“Register of Institutions and Affiliates Data (RIAD)” that supports statistics and other activities of European central banks and supervisors**, with data of key importance on entities and groups in the financial sector. A fourth

generation of the RIAD system has been delivered in March 2018 to support counterparts to the AnaCredit dataset (see below par. 6) with data to be frontloaded in 2018 Q2–Q3. More than 15 million entities will be recorded in RIAD and updated at high frequency.

5.10. There is an ongoing modernization of intra-EU trade in goods statistics. Following the demand from producers and users to substantially reduce the response burden on enterprises while maintaining a sound level of quality, international trade in goods statistics have been in the spotlight of modernization over recent years in the ESS. In order to address this challenge and based on the outcome of two complementary projects (Single Market Statistics (SIMSTAT) and REDESIGN), both successfully completed, the EU Member States provided in May 2016 a strategic orientation on the key elements of a modernized intra-EU trade in goods statistics. In order to implement in practice this strategic orientation, a deployment project 'Modernization of the system of compiling intra-EU trade in goods statistics' (in short, 'Intrastat Modernization') spanning over the period from 2017 to 2020 was set up. The work carried out in the context of this project in 2017 and 2018, focused on preparing, on the one hand, European legal provisions which would contain the key elements of such a modernized intra-EU trade in goods statistics, and on the other hand, the concrete technical implementation, including preparing from a statistical and IT-related point of view the exchange of micro-data on intra-EU exports. The new legal provisions have been incorporated in the Framework Regulation on Integrated Business Statistics (FRIBS) currently in discussion at the level of the European Council and Parliament.

5.11. Further progress has been made by the ESS in government finance statistics (GFS) to enhance economic and fiscal governance. Annual and quarterly ESA 2010-based GFS time series continue to be available for all countries. For most countries, the data are mapped, with additional information from countries, to the *Government Finance Statistics Manual (GFSM) 2014* framework and reported to STA. Quarterly non-financial accounts data by subsectors of general government are collected under the ESA framework and all countries supply detailed Classification of the Functions of Government (COFOG) data. Progress has also been made in national publication of monthly fiscal data based on public accounts, as required by Stability and Growth Pact measures that entered into force in 2011 (the so-called "Six-Pack") and Eurostat is publishing data on contingent liabilities and non-performing loans of the government. The contingent liabilities include government guarantees, liabilities related to public-private partnerships recorded off government balance sheets, and liabilities of government-controlled entities classified outside general government (public corporations).

5.12. European-level supply and use tables are being developed. The FIGARO⁷ project, a cooperative effort by Eurostat and the Joint Research Centre of the EC, aims to establish annual production of EU multi-country input-output tables and a five yearly production of EU multi-country supply, use, and input-output tables. The tables will support studies on

⁷ The acronym FIGARO stands for Full International and Global Accounts for Research in Input-Output Analysis.

competitiveness, growth, productivity, employment and international trade, and assessment of the position of the EU and the EA in the world. The first deliverables are experimental EU inter-country supply-use and input-output tables (EU-IC-SUIOT) for the year 2010, which will be available shortly.

5.13. The ECB has finalized a new regulation on statistical reporting requirements for pension funds (PF). The new regulation, published on 19 February 2018⁸, is aimed at increasing transparency and improving data comparability in this fast-growing sector of the financial industry. The regulation harmonizes and completes quarterly statistics on pension funds published since June 2011, in particular concerning data on transactions, security-by-security reporting, individual country counterparty data, investment fund data by investment asset classes, data on pension fund entitlements (by defined contribution and defined benefit & hybrid schemes) and the alignment of the new requirements with European and international statistical standards (ESA 2010 and the sixth edition of the IMF's *Balance of Payments and International Investment Position Manual (BPM6)*). Pension funds will also report to the European Insurance and Occupational Pensions Authority (EIOPA). With a view to minimizing the reporting burden for the industry, the relevant EIOPA and ECB bodies have cooperated closely to set up the definitions, the methodological framework and the preparation of the transmission format for both ESCB statistics and supervisory reporting. The reporting of the first PF data under the new regulation will start by end-2019.

5.14. The ECB published new annual data on Financial Corporations engaged in Lending (FCLs) in September 2017. FCLs are financial intermediaries principally specialized in asset financing for households and non-financial corporations, including activities such as financial leasing, factoring, mortgage lending and consumer lending. Balance sheet statistics on FCLs are provided to the ECB by NCBs on a best efforts basis, and currently cover the euro area except Finland, Ireland and Luxembourg.

5.15. In November 2016, the ECB started to publish a new Supervisory Banking Statistics dataset covering quarterly data on the financial soundness of significant banks directly supervised by the ECB. The statistics are based on standardized information submitted by significant institutions within the Single Supervisory Mechanism (SSM).⁹ The dataset includes figures on balance sheet items, profitability, capital adequacy, leverage and asset quality, as well as information on funding and liquidity. The data are presented by country, income sources, geographical diversification, size, sovereign exposures and an overall assessment of the banks' riskiness. The publication is completed by the collection of the solvency and leverage ratios as disclosed annually by significant banks in pursuant with Part Eight of Regulation (EU) No 575/2013. A forthcoming enhancement will provide the

⁸ ECB Regulation on pension funds statistics Regulation (EU) 2018/231 of the ECB of 26 January 2018 on statistical reporting requirements for pension funds ([ECB/2018/2](#)), OJ L 45, 17.2.2018, p. 3.

⁹ Pursuant to Commission Implementing Regulation (EU) No. 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No. 575/2013 and subsequent amendments.

users with a view based on the business models. Moreover, the disclosure of information on the overall quality of the data (an aggregate score) is also planned. The dataset is reviewed regularly to reflect changes in the regulatory environment and reporting frameworks, e.g., following the introduction of the IFRS 9 in the European Union. By gathering all these relevant figures in one place, the dataset informs the supervisors and the general public on the status of the compliance of reporting banks with the requirements of the regulation, offers bank analysts and market participants' complementary views on the banks directly supervised by the ECB and provides easy access to the relevant Pillar 3 disclosures of banks via links.

5.16. The ECB has initiated work to enhance the statistics on payment instruments and systems collected annually under Regulation ECB/2014/43. Having in mind the rapid changes in the payment landscape within Europe as well as regulatory changes, important new data requirements have arisen to support the Eurosystem's role as a catalyst for European financial market integration and the oversight of euro area payment systems. In addition, payment data may be required as input to the ECB's economic forecasting and for balance of payments and international investment position statistics. To this end, a merits and costs procedure has been launched to finalize the update of the ECB Regulation during 2019 so that data can be collected from 2020.

6. The ECB continued working on several projects to enhance the availability and quality of statistics based on new granular databases that are becoming increasingly necessary to support policy decisions.

- *Money Market Statistical Reporting (MMSR).* The regular publication of aggregated indicators on the unsecured market was started in November 2017; further segments will follow in 2018.
- *Unsecured overnight interest rate.* The Governing Council of the ECB decided to develop a euro unsecured overnight interest rate based on MMSR data. The interest rate, which would be produced before 2020, would complement existing benchmark rates produced by the private sector and serve as a backstop reference rate.
- *Securities holdings statistics.* As of October 2018, the list of reporting banking groups will be extended to cover all significant groups directly supervised by the ECB.
- *Analytical credit datasets (AnaCredit Project).* In May 2016, the ECB adopted the new legal act enabling the ESCB to collect granular information on credit granted from banks to financial and non-financial corporations and other legal persons based on a core set of harmonized concepts and definitions. To support reporting credit institutions, a Manual was published in three Parts, the last one by May 2017, still a year and a half prior to data delivery. Also, Q&As and Validation Checks are published to ensure effective communication. This endeavor aims to in particular monetary policy analysis and operations, risk management, financial stability surveillance, and macro-prudential policy. The first reporting will take place in mid-November 2018 based on data as of September 2018.

7. The ECB, Eurostat and the OECD actively cooperates on statistics and research concerning the joint distribution of income, consumptions and wealth (ICW) as well as linking macro and micro data on household wealth. The first meeting of the OECD/Eurostat Expert Group on Disparities in National Accounts took place in March 2018. Experimental results were presented and a work plan by end-2019 was discussed. Results from the second phase of the ECB Expert Group Linking Macro and Micro data, established to understand and quantify the differences between micro and macro data on household wealth, were presented in the March 2018 meeting of the Household Finance and Consumption Network. The 2017 biennial conference on household finance and consumption, jointly organized by the ECB and Banque de France, focused on empirical and theoretical research on how household heterogeneity affects the accumulation of assets and debt, consumption and saving behavior and monetary policy transmission.

8. Technical work by Eurostat is also ongoing towards modernizing and harmonizing public sector accounting standards in the context of the European Public Sector Accounting Standards (EPSAS). EPSAS is not a typical statistical project but would provide high quality and harmonized source data to the benefit of all statistical domains drawing on public sector. Six EPSAS Working Group meetings took place since September 2015. A two-phase approach is followed: (1) increasing fiscal transparency in the short to medium term, and (2) working towards comparability in the medium to the longer term. The current EPSAS work program comprises: (a) developing of the EPSAS framework (i.e., EPSAS governance, accounting principles and standards) and collection of information for impact considerations, (b) supporting the modernization of public accounting systems in the EU Member States, and (c) widening stakeholder engagement. The elements of the EPSAS framework are under construction using, among other inputs, small expert groups (“cells”). Technical work underway covers key public sector accounting issues from the EPSAS perspective, such as the accounting treatment of discount rates, grants and other transfers, loans and borrowings, concession arrangements, provisions, contingent assets and liabilities, financial guarantees. Further in the scope are impact studies such as on the opportunity cost of non-EPSAS, lessons learned from experiences of accruals implementations, skills and training issues related to the reform, and how EPSAS can support financial audit and control, including a tool for monitoring transparency of public sector financial reporting.

**Statement by Steffen Meyer, Executive Director for Germany
on behalf of the Euro Area Authorities
July 16, 2018**

In my capacity as President of EURIMF, I submit this Buff statement on the Article IV and FSAP consultations 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 fields of competence.

The authorities of the euro-area Member States and the EU Institutions are grateful for the open and fruitful consultations with staff and for their constructive policy advice. The authorities are in broad agreement with the findings and recommendations in the Article IV staff report and Financial System Stability Assessment. We welcome the acknowledgement of the progress achieved in institutional and risk-reduction reforms, while agreeing that risks have heightened recently in some areas and the work is far from done.

Let me refer to these two reports in turn:

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

Economic outlook

The authorities concur with the staff's assessment that economic growth remains strong, broad based and job friendly, even though underlying inflation has been subdued. Steady job creation underpins the robustness of the recovery while wage growth remained below 2 percent for most of the last six years. As highlighted by staff, the euro area is still reaping the fruits of wide-ranging policy efforts but most recent readings suggest that the recovery has passed its peak. Our real GDP growth projections for 2018 and 2019 are in fact very much aligned.

We agree with staff that downside risks have heightened significantly since last year. Yet, we believe that staff's assessment of the likelihood and impact of those risks does not take sufficiently into account the euro area's achievements and commitment to reforms and sound policies.

As regards Brexit, the authorities agree that the uncertainty surrounding the final outcome of the negotiations represents a downside risk. Addressing this would require negotiations to progress faster, and it should be understood that it is not possible to maintain all the current benefits while leaving the EU regulatory, supervisory, enforcement and judiciary framework. We agree that Brexit will have a negative macroeconomic impact for both the EU and the UK, albeit disproportionately larger for the latter and for some Member States. At the same time, we must caution against the estimates produced by staff, as these are highly speculative and suffer from important modeling limitations.

Our assessments of medium-term growth prospects are very much aligned. Potential growth is expected to ease amidst demographic changes, weak productivity growth and crisis legacies, including ongoing private sector deleveraging in some countries. This calls for responsible and growth-friendly fiscal policies, rebuilding buffers, prioritizing investment, and improving the quality of public expenditure and revenues. Stepping up the implementation of structural reforms will also be important to enhance productivity and reduce vulnerabilities.

Monetary policy and inflation outlook

With longer-term inflation expectations well anchored, the underlying strength of the euro area economy and the continuing ample degree of monetary accommodation provide grounds for confidence that the sustained convergence of inflation towards ECB's inflation aim will continue in the period ahead, and will be maintained even after the gradual winding-down of the net asset purchases. Underlying inflation has been increasing from earlier lows. However, the further build-up of domestic price pressures and headline inflation that we foresee over the medium term is still conditional on the support of a sizeable amount of monetary policy stimulus. This support will continue to be provided by the net asset purchases until the year end, by the large stock of acquired assets and the associated reinvestments, and by the enhanced forward guidance on the key ECB interest rates.

Fiscal policies

The authorities agree with staff's assessment that the distribution of national fiscal policies differs from recommendations. Member States with high public debts need to increase their efforts to improve the sustainability of their public finances, while continuing to strengthen economic growth potential, taking advantage of the still robust growth while financing conditions are favorable. Conversely, Member States with stronger fiscal positions and external surpluses could prioritize investments to boost potential growth, as advised by staff, while preserving long-term sustainability.

Consistent application of the fiscal rules continues to be warranted and, with negative output gaps finally closed according to most estimates, there may no longer be the same need—*ceteris paribus*—to use the flexibility provided by the fiscal rules, as done in 2018 to support the incipient recovery. We do not find sufficient recognition in the staff report that our public finances compare very favorably to those of other major jurisdictions, in aggregate, which can be partly attributed to the fiscal framework in place.

External sector policies

The authorities take note of staff's assessment of the euro area's external position, which is in line with the European Commission's. While much progress has been achieved among net debtor countries in correcting their external imbalances, large current account surpluses remain in some creditor countries. We agree that policy levers affecting the current account

are mainly at the national level and that countries need to take steps in this regard. The main drivers are levels of savings relative to investment in the non-financial corporate and household sectors, although government balances also play a role, as highlighted in the report. The underlying determinants of savings and investment in the non-financial corporate and household sectors should be further analyzed to support more tailored policy advice. Further integrating financial markets and the broader EU single market, in the context of deepening of the Economic and Monetary Union, will also help to reduce imbalances among Member States.

Paragraph 43 in the staff report singles out external surpluses as potentially fueling protectionism in deficit countries. Within the current context of growing trade tensions, there is a risk that this over-simplified message could be misused to validate irrational policies.

The EU is unambiguously committed to free and fair trade and to international cooperation based on common rules. We underline the importance of preserving and deepening the rules-based multilateral trading system. The EU is committed towards its modernization and calls on all partners to contribute to this goal. At the same time, we firmly reject measures taken on spurious grounds for protectionist purposes. The EU will respond to all actions of a clear protectionist nature in full respect of WTO rules.

Deepening of the Economic and Monetary Union (EMU)

The authorities take note of the staff assessment of financial architecture and EMU deepening reforms. The Euro Summit agreed in June to progress towards completion of the banking union, to strengthen the European Stability Mechanism (ESM) and to discuss all other relevant items. Following the agreement on 25 May, the adoption of a package of measures aimed at reducing risk in the banking industry is expected before the end of the year. The ESM will provide the common backstop to the Single Resolution Fund (SRF) and will be strengthened. Differences of views remain on the issue of a common fiscal capacity. Discussions will continue on the European Commission proposal and on other recent ideas for a common fiscal capacity to support investment, convergence and stabilization.

Continuing our efforts on completing the banking union, advancing the capital markets union and developing meaningful forms of private and public risk sharing, will help build collective resilience to future shocks, as also emphasized by staff. The Euro Summit will come back to these issues in December 2018, including on the basis of terms of reference for the common backstop, a terms sheet for the further development of the ESM. Work should also start on a roadmap for beginning political negotiations on the European Deposit Insurance Scheme (EDIS), while adhering to all elements of the 2016 Council roadmap.

This concludes my statement on the staff report for the 2018 Article IV consultation. I will now turn onto my statement on the Financial System Stability Assessment:

FINANCIAL SYSTEM STABILITY ASSESSMENT (FSSA)

In terms of financial sector oversight, the authorities welcome and broadly concur with staff's analysis and recommendations. The emphasis placed on anti-money laundering and cybersecurity is welcome. In the area of banking, some of the recommendations of the report are already covered in existing Union legislation. However, authorities do not concur with the statements referring to mandatory relocation of central counterparties (CCP). The European Commission's proposal does not refer to relocation, but rather to the ability to provide clearing services within the EU. Furthermore, the CCP supervision proposal aims to strengthen the EU regime for third countries in general and is not solely driven by Brexit.

Authorities welcome the recognition of the importance of the Capital Markets Union project. Further progress has been made recently through a significant number of legislation and non-legislative initiatives, which are not covered in the FSSA. While the authorities agree with the main messages on macro-prudential supervision, developing new instruments for the non-banking sector is at a preliminary stage as several Union pieces of legislation are still spreading their effects.

Authorities broadly concur with the main messages in the field of crisis management and bank resolution, such as the criticality of sufficient MREL for an effective resolution, and welcome the acknowledgement of the progress made in completing the crisis management infrastructure. Authorities wish to point out that while the recommendation to proceed quickly with the build-up of external and internal MREL is welcome and shared, it should also take into account the diversity of banking groups and recognize the merit of transitional periods. Authorities are nevertheless urging all banks to build up the needed MREL buffers without delay in order to allow for a credible implementation of the resolution plans. Authorities furthermore welcome staff's recommendation to establish the ESM as a common backstop for the SRF.

Authorities note that a Treaty change to grant to the Single Resolution Board (SRB) the status of an "institution" may not be feasible in the short term and the SRB is already an independent agency in line with the Key Attributes. Moreover, the endorsement of resolution schemes by the European Commission does not delay resolution decisions, as the timeframe imposed by the law is just 24 hours and the EU institutions have taken all necessary arrangements to comply with this deadline. As regards the recommendation for an administrative liquidation tool for the SRB, its legal and operational feasibility is doubtful. Authorities disagree with the FSSA recommending a financial stability exemption that would allow the departure from the 8% bail-in requirements for accessing the Single Resolution Fund (SRF) and public funds. The aim of the SRF has never been to replace the bail-in tool, but to ensure efficient application of the resolution tools.

On State aid, the authorities point out that its control derives directly from the EU Treaties. Hence, the EU's co-legislators have acknowledged the role of State aid control in the EU's

bank resolution framework, which is to ensure a level playing field between banks in- and outside the Banking Union. Whenever aid is needed, both in- and outside resolution, State aid control applies and ensures that the beneficiary bank is restructured or liquidated. Deposit insurance scheme (DIS) interventions beyond reimbursing depositors may fall under State aid control. Moreover, State aid rules require burden sharing and restructuring or market exit, thereby protecting the DIS. Finally, the application of State aid control is already fully transparent.

Regarding the withdrawal of the United Kingdom from the EU, potential financial stability risks are being monitored, including by a joint technical group between the ECB and the Bank of England. Each firm should take the necessary steps to ensure that it can continue to provide services to its clients. The financial services sector is accustomed to working in a cross-border environment, involving multiple jurisdictions.

The authorities welcome the comprehensive assessment undertaken by staff of the banking supervision methods and practices carried out by the ECB in close coordination with NCAs in the SSM. The authorities appreciate that staff recognize the increased level of supervisory intensity and intrusiveness, and the definition of clear supervisory methodologies and processes. The authorities concur with staff that the supervisory powers for relevant cross-border investment firms which carry out bank-like activities in the euro area needs to be addressed. On the EU prudential framework, the authorities welcome the recognition of the progress achieved, while they also agree that there are still important areas which are yet to be harmonized at EU level.

However, the authorities disagree with the assessment of BCP24 on Liquidity Risk as it severely misrepresents the intrusiveness, intensiveness, timeliness and efficiency of the ECB current supervisory practices and downplays its capacity and readiness to act when significant institutions' controls are not up to its standards and expectations. The ECB takes supervisory actions well ahead of the actual manifestation of any liquidity constraints, in order to ensure that in case an outright liquidity crisis eventually occurs all relevant stakeholders are sufficiently informed and the necessary decisions can be timely made.

The authorities generally agree with the general finding of an overall increase in banks' resilience, as concluded from their solvency and liquidity analyses of the largest euro area banks, and with the main findings of the liquidity stress-testing, albeit identified scenario specific liquidity shortfalls or vulnerabilities may often be attributed to very extreme or non-pragmatic scenario assumptions. Euro area banks have been consistently increasing their liquidity buffers as a response to regulatory changes, which appear to be one of the main drivers of the ample system-wide liquidity.

With regard to structural euro area bank profitability, the authorities broadly share staff's assessment of its main drivers and that improving macro conditions is not sufficient to fully address this problem. While banks have made some progress in improving efficiency and

tackling NPLs, high NPL stocks continue to adversely affect performance. The authorities highlight that the pace of NPL reduction is partly dependent on banks' capital position and their ability to raise capital, and that the pace of NPL stock reduction has been accelerating since 2017. Profitability levels of euro area banks have been recovering significantly in the last years. Fragmented banking structures, cost inefficiency and little income diversification, continue to drag on the long-term profitability prospects of European banks.

Related to systemic liquidity management, the authorities take note of staff's recommendation regarding the 'horizon scanning' arrangements to better detect emerging liquidity strains. These will need to be carefully considered in light of the already existing arrangements, also to avoid overlaps in the responsibilities of the two functions.