



EURO AREA POLICIES

July 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE EURO AREA

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 2016 Article IV consultation with euro area member countries, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 6, 2016 consideration of the staff report that concluded the Article IV consultation with euro area member countries.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 6, 2016, following discussions that ended on May 27, 2016, with the officials of euro area member countries on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2016.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for the euro area.

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

Selected Issues

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July 7, 2016

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IMF Executive Board Concludes 2016 Article IV Consultation on Euro Area Policies

On July 6, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Euro Area.

The recovery has strengthened recently. Lower oil prices, a broadly neutral fiscal stance, and accommodative monetary policy are supporting domestic demand. However, inflation and inflation expectations remain very low, below the ECB's medium-term price stability objective. Euro area GDP growth is expected to decelerate from 1.6 percent this year to 1.4 percent in 2017, mainly due to the negative impact of the U.K. referendum outcome. Helped by gradually rising energy prices, headline inflation is expected to increase from 0.2 percent this year to 1.1 percent next year.

At the same time, downside risks have grown. Externally, a further global slowdown could spill over and derail the domestic demand-led recovery. Domestically, the risks are largely political. Further spillovers from the U.K. post-referendum situation, the refugee surge, or a heightening of security concerns could contribute to greater uncertainty, hurting growth and hindering progress on policies and reforms. Other risks include banking and financial sector weaknesses in some countries. Moreover, prolonged low growth and inflation themselves make the euro area increasingly vulnerable to shocks. Policy buffers to counter these risks are low.

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.

Medium-term prospects are mediocre, with crisis legacies of high unemployment, elevated public and private debt, and deep-rooted structural weaknesses weighing on the outlook and productivity growth. As a result, growth five-years ahead is expected to be about 1.5 percent, with headline inflation reaching only 1.7 percent.

Comprehensive and more balanced policies taken collectively are needed to respond to these risks, helping to boost growth, rebuild buffers, and strengthen integration. Structural reforms to improve productivity and reduce macroeconomic imbalances need to be incentivized. Given limited fiscal space at the national level, an expansion of centralized fiscal support is needed, but should be accompanied by a stronger governance framework to ensure that members comply with the fiscal and structural rules. These measures would complement the current stance of monetary policy, providing a more balanced policy mix.

Executive Board Assessment²

The euro area recovery continues, supported by still low oil prices, a neutral fiscal stance, and accommodative monetary policy. Directors cautioned, however, that inflation and inflation expectations remain stubbornly low, raising adjustment challenges for debtors, and that crisis legacies of high unemployment and debt, alongside structural weaknesses and low productivity, continue to weigh on the medium-term outlook. They stressed that risks are increasingly to the downside and that policy buffers are limited. External demand could weaken, while political risks have risen significantly, particularly related to uncertainty regarding the outcome of the referendum in the U.K. and its new economic relationship with the European Union. Directors encouraged a smooth and predictable transition to reduce uncertainty. In addition, an intensification of the refugee surge could prompt additional border controls and hinder free movement within the single market.

Against this challenging backdrop, Directors urged strong collective actions to boost growth and strengthen the union, and cautioned that the cyclical recovery should not lead to complacency. Policies should prioritize structural reforms, enhancing investment and fiscal governance, maintaining supportive monetary policies, completing the banking union, and repairing balance

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

sheets. Directors warned that without decisive actions, the euro area will remain vulnerable to instability and repeated crises of confidence.

To raise potential growth and narrow imbalances, Directors stressed the importance of structural reforms such as reduced barriers to entry in retail and professional sectors, improved public administration, lower labor tax wedges, and reduced labor market duality. They encouraged use of outcome-based benchmarks to incentivize reforms and stronger enforcement of the Macroeconomic Imbalance Procedure.

Directors encouraged the authorities to pursue a more balanced policy mix through growth-friendly fiscal rebalancing, use of fiscal space where available, and an expansion of centralized investment schemes or funds for common projects. Countries without space should stick to consolidation plans and use interest savings to rebuild buffers. Directors noted that access to any new central fiscal support could be conditional on implementation of structural reforms and compliance with fiscal rules, which could be further encouraged by strengthening and simplifying the fiscal framework.

Directors concurred that monetary policy is appropriately accommodative, and that recent measures should help ease financial conditions. They viewed negative interest rates as having contributed to lower bank funding costs, higher asset values, and more bank lending. While most Directors considered that further rate cuts could entail diminishing returns by squeezing banks' net interest margins, a few Directors argued for a more holistic assessment that reflected possible valuation gains and improved asset quality. Nevertheless, Directors agreed that if the inflation outlook deteriorates, further easing, primarily through expanded asset purchases, would be warranted.

Directors urged faster balance sheet repair as part of a broader strategy to foster consolidation in the banking sector. They encouraged strong action by the ECB to set targets for banks to reduce impaired assets. This should be complemented by strengthening and harmonizing insolvency and foreclosure frameworks, and promoting distressed debt markets. Where appropriate, asset management companies could be used to kick-start markets, and in systemic cases, State aid rules could be applied flexibly.

Directors considered common deposit insurance and a common fiscal backstop as essential to completing the banking union. Deposit insurance should be accompanied by measures to reduce banking sector risks, and any changes to the prudential treatment of banks' sovereign assets should be consistent with global standards. Directors urged further progress on capital markets union to diversify financing sources and enhance private risk sharing.



EURO AREA POLICIES

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 20, 2016

KEY ISSUES

Context. The recovery continues with stronger growth in recent quarters, but downside risks have increased, amid growing political divisions and euroskepticism. Medium-term prospects remain weak, with high public and private debt and slow progress in structural reforms weighing on growth. And there is very little policy space to cope with adverse shocks.

Policies. The euro area is at a critical juncture. Without more decisive actions to boost growth and strengthen the monetary union, the euro area remains at risk of instability and repeated crises of confidence. Boosting growth and rebuilding buffers will require a comprehensive set of policies:

- **Prioritize structural reforms and their governance.** Stronger enforcement and the introduction of outcome-based benchmarks would help better incentivize structural reforms. Product and labor market reforms that support near-term demand, such as reducing business entry barriers and shrinking the labor-tax wedge, should be prioritized.
- **Promote investment and improve fiscal governance.** With national fiscal space limited in many countries, centralized investment schemes should be expanded. Countries with fiscal space should use it to promote investment and structural reforms, while stronger enforcement of the fiscal rules would bolster the framework's credibility and rebuild buffers. Greater compliance is crucial for building support for risk sharing and further integration.
- **Maintain monetary easing to boost inflation.** The ECB's monetary easing has improved financial conditions and expanded credit. The ECB should maintain its accommodative stance and stand ready to ease further if inflation remains below its anticipated adjustment path.
- **Complete the banking union and repair balance sheets.** A common deposit insurance scheme and a fiscal backstop for the banking union remain essential. Greater risk sharing should proceed hand in hand with reducing banking sector risks, including measures to accelerate non-performing loan resolution. Faster progress towards a capital markets union would promote greater private risk sharing.

Approved By
**Poul M. Thomsen and
 Hugh Bredenkamp**

Discussions took place during May 17–27, 2016. Mission members included M. Pradhan (head), K. Kang, S. Aiyar, J. John, A. Banerji, J. Bluedorn, C. Ebeke, A. Jobst, H. Lin (all EUR), T. Poghosyan (FAD), and J. Franks, B. Barkbu, and H. Schoelermann (all EUO). Executive Director H. de Villeroché and his Advisor B. Parkanyi, ECB Observer at the IMF R. Rüffer and his Advisor M. Bijsterbosch, and Advisor to the EU Delegation to the U.S. M. Bertoldi participated in some meetings. Support was provided from headquarters by T. Wu, K. Cincotta, X. Shao, and J. Siminitz (all EUR) and from Brussels by L. Hobbs (EUO).¹

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¹ The mission would like to thank euro area authorities, in particular President M. Draghi (European Central Bank), President J. Dijsselbloem (Eurogroup), Managing Director K. Regling (European Stability Mechanism), Chair D. Nouy (Supervisory Board), Chairperson A. Enria (European Banking Authority), President T. Wieser (Economic and Financial Committee of the European Union and the Eurogroup Working Group), Board Member M. Grande (Single Resolution Board), Head of Secretariat F. Mazzaferro (European Systemic Risk Board), and Director General M. Buti (European Commission), as well as their staff for their time, support, and accessibility. The mission has also benefitted from the Fund's bilateral Article IV consultations with euro area countries and from discussions with national authorities during meetings of the Eurogroup and the Eurogroup Working Group.

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KEY MESSAGE: EURO AREA AT A CROSSROADS

Growing political divisions and skepticism have put the euro area at a critical juncture. The usual approach of “muddling through” appears increasingly untenable, raising the risks of stagnation and further fragmentation. High public and private debt and large structural gaps leave the union with limited policy buffers to address shocks. To strengthen the union, more decisive collective actions are needed. These should include completing the banking union, expanding centralized sources of investment, and prioritizing structural reforms that can provide near-term demand support. Stronger enforcement of the fiscal and economic governance frameworks is critical for building support for greater risk sharing and centralized support. Faster cleanup of bank balance sheets would enhance the effectiveness of monetary policy and support corporate restructuring and deleveraging.

CONTEXT: RECOVERY CONTINUES, BUT RISKS RISING

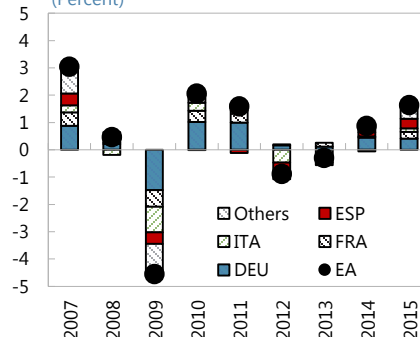
A. Recent Developments

1. **The euro area recovery strengthened recently.** Growth in 2015 picked up to 1.7 percent, led by domestic demand as net exports contributed negatively (Table 1; Figure 1). Private consumption was supported by lower oil prices and higher employment, while rising demand and easing financial conditions helped lift business investment. All of the large economies are contributing positively to regional growth (text figure). The fiscal stance remained broadly neutral in 2015, compared to the large drag on growth in 2011–13. Unemployment has fallen, but is also above pre-crisis levels (text figure).

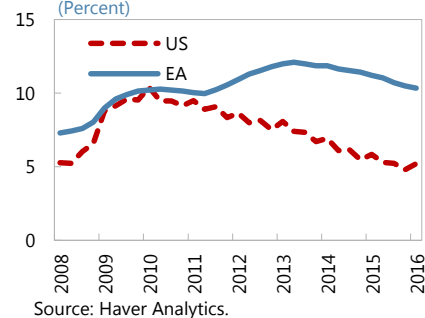
2. **Growth varied widely across countries.** Growth in 2015 accelerated or stayed steady across the four major euro area economies. Performance across the rest of the euro area varied more widely, with Ireland expanding by nearly 8 percent, while Greece lapsed back into recession. In nearly all countries, domestic demand was the main driver of growth. Despite the fastest expansion since 2012, overall euro area growth remained relatively subdued, especially when compared to the recoveries in the U.K. and U.S. (text figure).

3. **Recent data suggest that despite the financial turmoil earlier this year, the modest recovery is set to continue.** First quarter GDP growth came in stronger than expected at 0.6 percent quarter-on-quarter, the second straight quarter of faster GDP growth. High frequency indicators, including industrial production and PMI, point to a continued modest expansion, although at a slower pace than earlier in 2016, while confidence remains elevated.

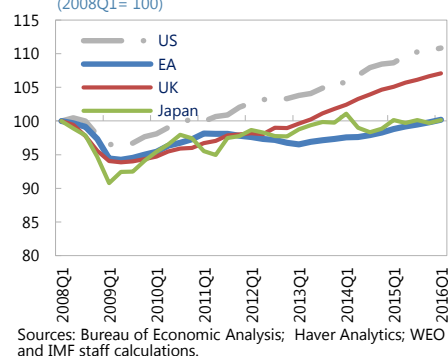
Euro Area: Growth Contributions
(Percent)



Unemployment Rate since the Financial Crisis
(Percent)



Real GDP
(2008Q1=100)

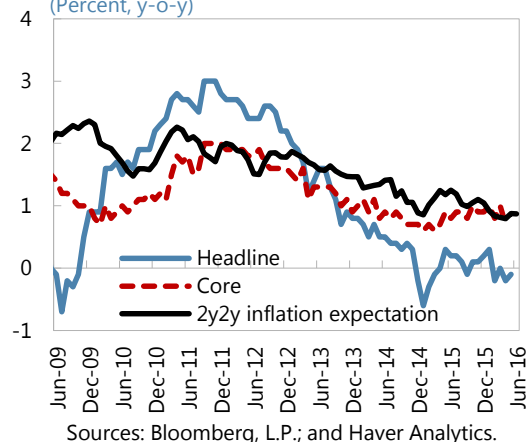


European financial markets have recovered after the sharp global selloff earlier this year, but are well below their 2015 peaks, lagging other advanced economies.

4. **Inflation remains stubbornly low** (Figure 2).

Euro area headline inflation was -0.1 in May 2016, reflecting mainly ultra-low oil prices throughout the year. Core inflation was 0.8 percent. Prolonged low inflation, far below the ECB's medium-term price stability objective, reflects both falling commodity prices and the large output gap, estimated at around -2 percent of GDP in 2015. Low inflation has also weakened inflation expectations, with the 2-year/2-year inflation swap rate hovering around 0.9 percent (text figure).

Various Inflation Measures
(Percent, y-o-y)



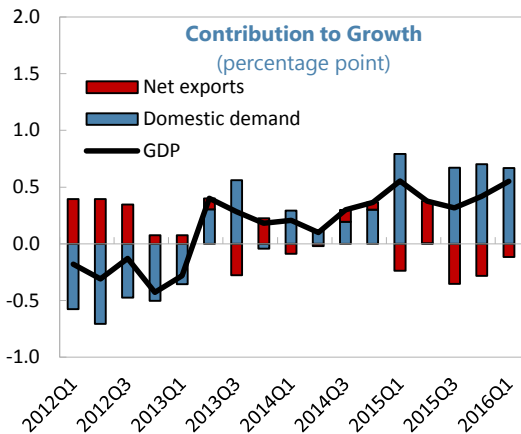
5. **The external position strengthened in 2015, supported by lower oil prices and a weaker euro**

(Figure 3). The euro area current account surplus rose to 3.2 percent of GDP in 2015, up 0.7 percentage points from 2014, led by the oil balance. Overall, the euro area's external position in 2015 remained broadly consistent with the level implied by medium-term fundamentals (Table 2). In 2015, the real effective exchange rate (REER) depreciated by some 8.5 percent, reflecting the euro area's weak cyclical position, low inflation, and accommodative monetary policy, ending broadly in line with the level consistent with medium-term fundamentals. So far in 2016, the REER has appreciated by some 2 percent.

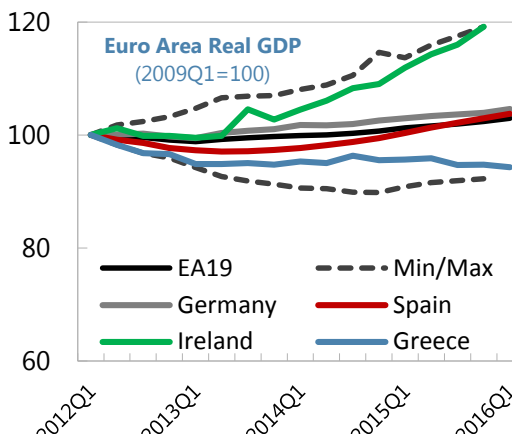
6. **Yet progress in external rebalancing remains slow** (Figure 3). The euro area current account improvement was broad-based but reflects different drivers at the national level. The current accounts of debtor countries, like Portugal and Spain, improved due to competitiveness gains from price adjustments. But surpluses of some large creditor countries, such as Germany, have moved further away from levels suggested by fundamentals due to weak investment and stronger fiscal positions. Stock imbalances remain large, varying greatly across countries; countries with sizeable net foreign liabilities may be vulnerable to a sudden stop in capital flows. Given sizeable imbalances at the national level, further adjustment is needed by external creditors to strengthen domestic demand (reducing surpluses) and external debtors to raise productivity and competitiveness (improving current accounts).

Figure 1. High Frequency and Real Economy Developments

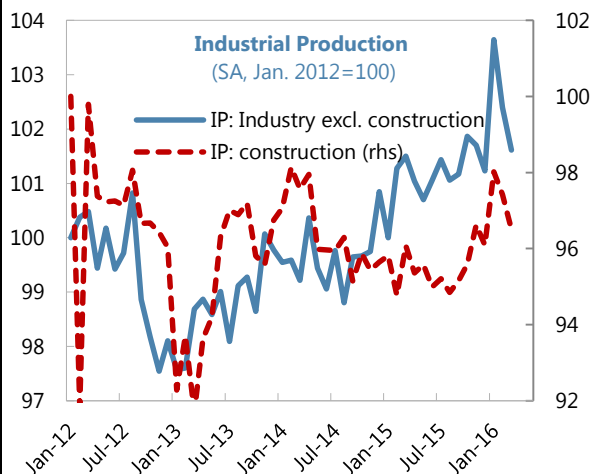
Growth has become predominantly domestic demand driven....



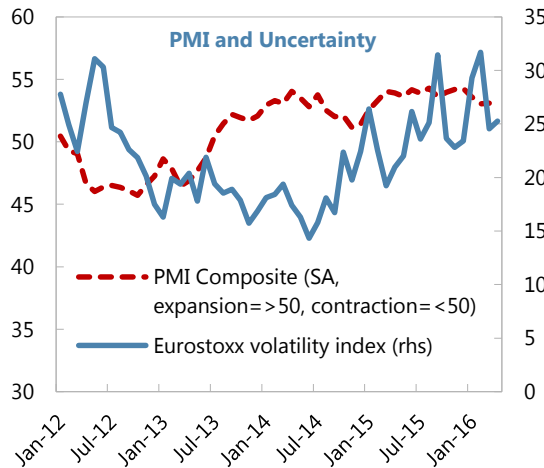
...while the divergence between countries continues to widen.



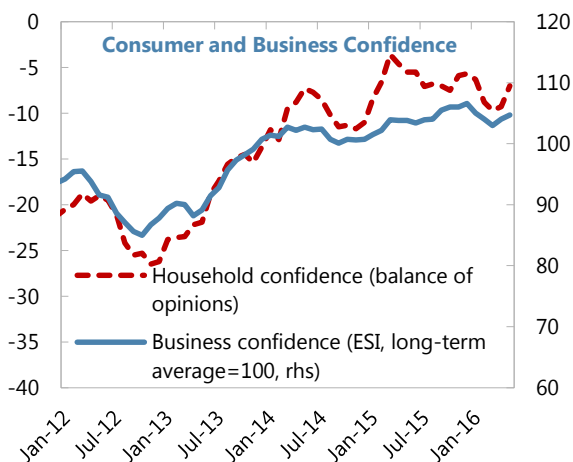
Industrial production has gradually picked up....



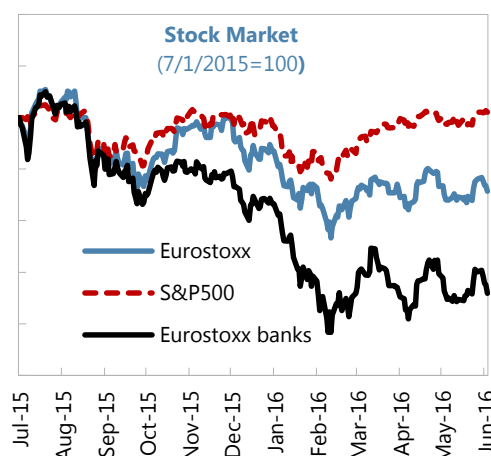
...but PMI has weakened some, while uncertainty rose in the first quarter of 2016.



Confidence has softened...



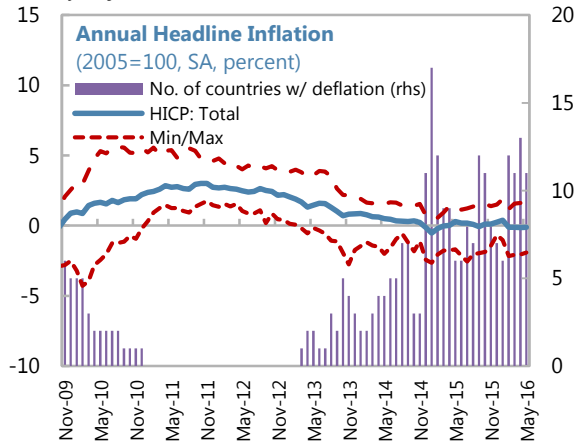
...mirroring the fall in equity markets earlier this year, which hit banks particularly hard.



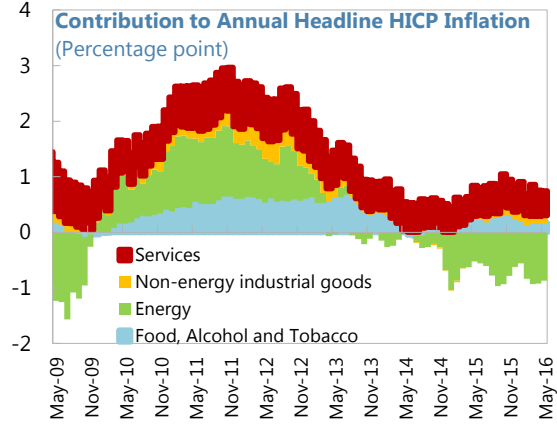
Sources: Haver Analytics; and Eurostat.

Figure 2. Inflation Developments

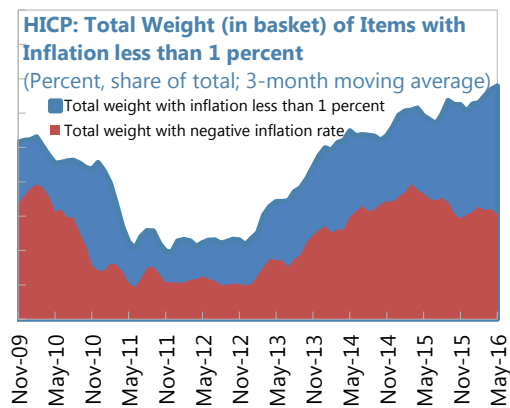
Inflation remains far below the medium-term price stability objective ...



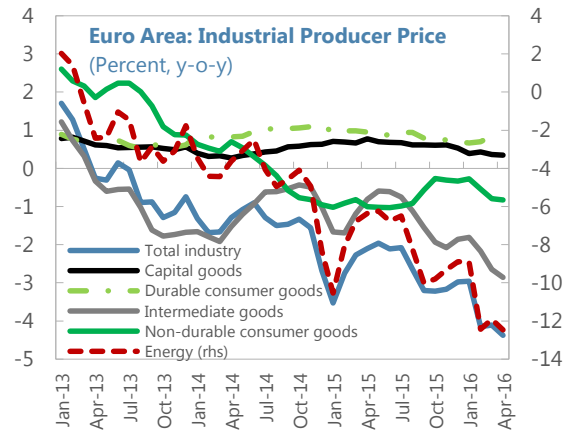
... reflecting falling energy prices.



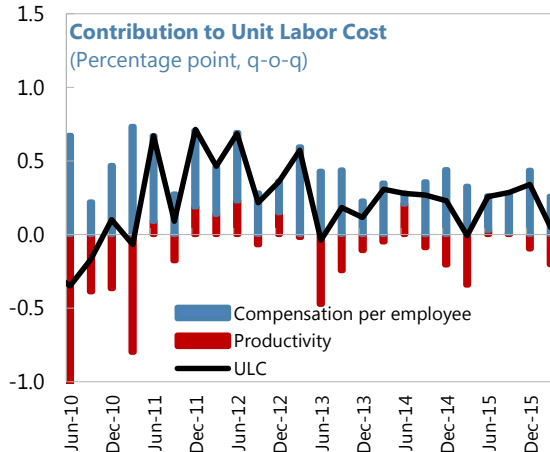
Low inflation is broad-based with 30 percent of items in deflation ...



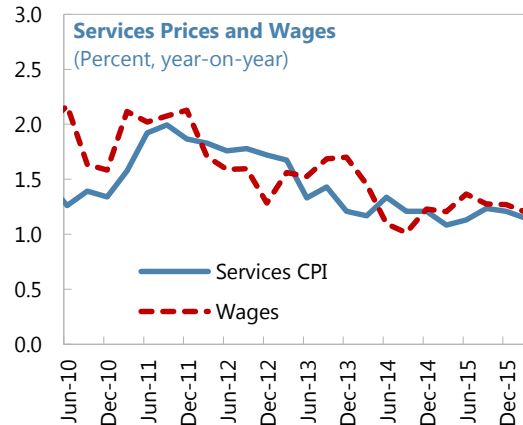
... and underlying price pressures remain weak, also for intermediate goods.



Despite a lack of overall productivity gains, labor costs have increased ...



... but overall wages remain subdued and provide very limited supply-side pressures on inflation.



Sources: ECB; Eurostat; Haver Analytics; and Fund staff calculations.

B. Near-term Outlook and Risks

7. **Growth is projected at 1.7 percent this year and next.** The near-term outlook depends crucially on the strength of domestic demand. The ECB's policies should support easier financial conditions and activity, while the fiscal stance is projected to turn mildly expansionary, mainly due to higher refugee-related spending in some countries and some relaxation of the fiscal stance elsewhere. After reaching 0.3 percent in 2016, headline inflation is anticipated to pick-up only gradually, reflecting the persistent output gap.

8. **Against this weak backdrop, downside risks have increased** (Table 3). Externally, a further global slowdown could spill over and derail the domestic demand-led recovery by reducing investment and employment. Domestically, the risks are mainly political: fallout from a "Leave" or marginal "Remain" vote in the U.K. referendum, insufficient progress on a common response to the refugee surge, and/or further terrorist incidents. A "Yes" vote for Brexit could trigger volatile currency movements and financial contagion in the near term.² Combined with the refugee surge and security concerns, a "Leave" or unconvincing "Remain" outcome could fuel euroskeptic sentiment with deteriorating trust between member states, increasing financial fragmentation and uncertainty.³ Domestic macroeconomic risks stem primarily from prolonged low growth and inflation, which leave the region inherently more vulnerable—even a small shock could tip the economy into recession. Other risks include banking and financial sector weaknesses in some countries.

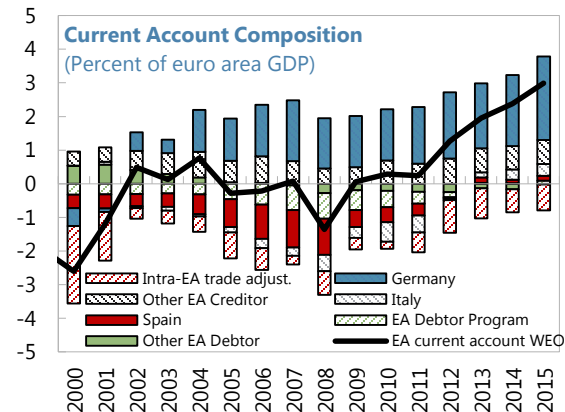
9. **The inflow of refugees could pick up again quickly and put at risk the free flow of goods and services within the union.** While the number of refugees traveling from Turkey to Greece has fallen sharply, it is too early to fully judge the March agreement's ultimate effectiveness in returning "inadmissible" new migrants to Turkey. Moreover, migration from North Africa could rise and conflicts in the Middle East could reignite, spurring new flows. An intensifying of the refugee surge could prompt additional border controls, curtailing the freedom of movement of people and goods within the EU. The impact on GDP from higher cross-border business costs could be significant, with estimates ranging from 0.4 to 1.2 percent of GDP, depending on the price impact (Box 1).

² The eventual change in regulatory treatment of U.K. assets on EU member balance sheets from "Brexit" could also entail widespread portfolio rebalancing and price volatility.

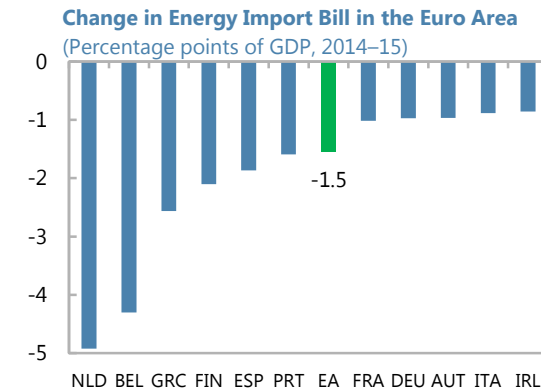
³ If needed, a staff statement will be issued after the referendum to provide an update.

Figure 3. External Sector Developments

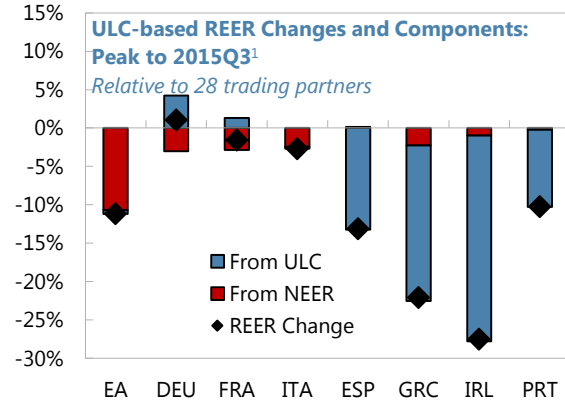
Current accounts continue to strengthen across the board.



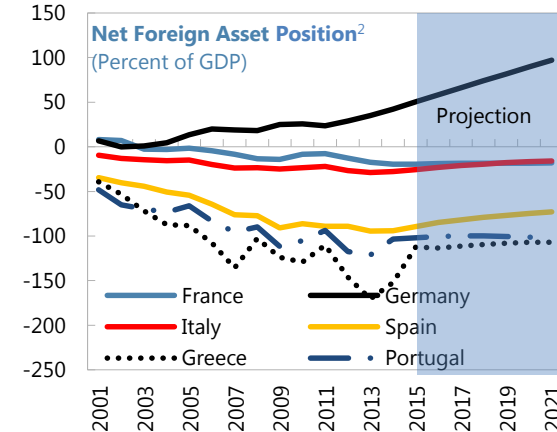
Oil price falls have helped reduce imports, but net exports' contribution to growth has still been negative.



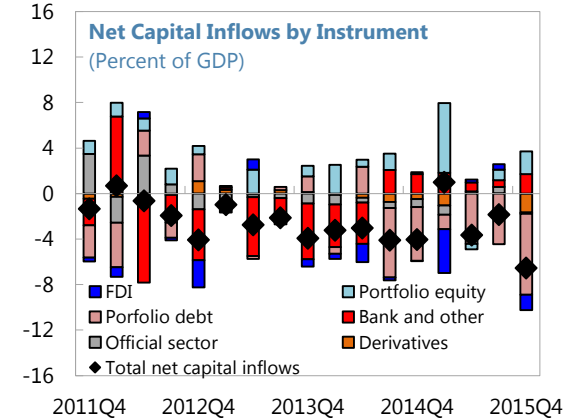
REER adjustment remains largely a net debtor country phenomenon...



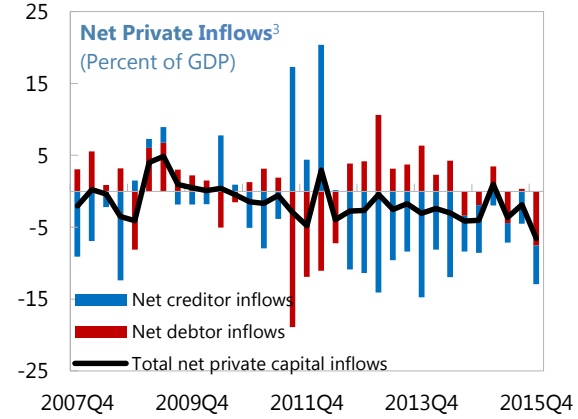
...and net external positions are expected to stabilize, except for large and persistent surplus creditor countries.



Portfolio debt now dominates capital outflows...



...which are largely coming from net creditor countries.



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

¹ REER Peaks: 08Q1 for ESP, 08Q2 for IRL and PRT, 09Q4 for EA, GRC, DEU, FRA, and ITA.

² NFA/GDP implied by WEO projections, assuming no stock-flow adjustments or valuation effects going forward.

³ Net private inflows, comprising debt and equity inflows, exclude inflows to the official sector. Debt inflows are the sum of portfolio debt, bank and other, and derivatives, while equity inflows are the sum of FDI and portfolio equity. Creditor countries include DEU, NLD, AUT, BEL, FIN, LUX, and MLT. All other euro area countries are classed as debtor economies.

Box 1. The Surge in Refugees in Europe—Economic Impact and Risks

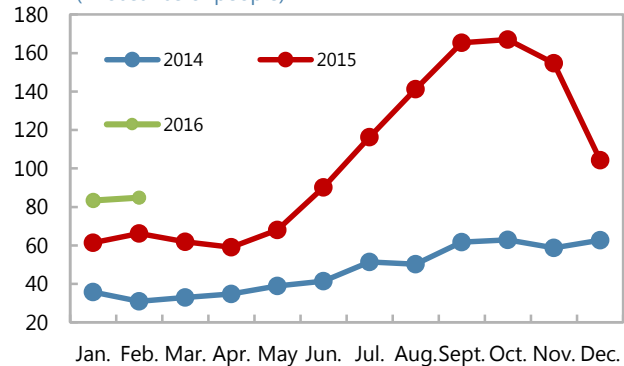
Unprecedented surge in refugees. Conflicts in the Middle East and North Africa have caused a sharp increase in the number of refugees, with the majority fleeing to nearby countries. The EU registered about 1,260,000 new asylum seekers in 2015, more than double the 2014 number. However, the number of refugees traveling to Greece from Turkey—a main gateway—has reportedly fallen considerably after the March EU-Turkey agreement.

Economic impact. In the short run, the fiscal outlays associated with providing for refugees will lead to a modest boost to GDP growth, raising EU GDP by some 0.1 percent by 2017, though the effects are more pronounced in the main destination countries such as Austria, Germany, and Sweden. International experience shows that rapid integration of migrants in the labor market is associated with better economic outcomes over the medium term. A recent Fund Staff Discussion Note finds that for the EU as a whole, GDP could be between 0.2–0.25 percent higher by 2020, depending on the speed of integration.¹

Downside risks. Continued inflows of refugees could further strain the systems for accommodating and processing asylum seekers in EU entry and destination countries. The lack of success in agreeing or implementing a comprehensive response could deepen political divisions in the EU and lead to the reestablishment of more permanent border controls. Such measures are unlikely to solve the challenges associated with the refugee surge, but could have considerable economic costs. The effects of a non-cooperative response could also spillover to countries outside the EU, as refugees are contained in conflict-neighboring countries and barriers to trade within the Schengen area rise.

Economic cost of reestablishing border controls. About 3.5 million persons cross internal Schengen borders every day and intra-EU goods trade amounts to €2,800 billion each year. Reestablishment of border controls within Schengen could create significant costs for road freight transport, cross-border passenger mobility, tourism, and border control administration. The European Commission estimates that such controls would generate direct costs between €5 and €18 billion annually (0.03–0.12 percent of GDP). The think-tank France Stratégie predicts that border controls would reduce trade between Schengen countries by 10–20 percent, lowering the GDP of EU Schengen countries by 0.9 percent by 2025. A study by the Bertelsmann Foundation assumes a 1–3 percentage points increase in import prices, reducing GDP for the EU by 0.4–1.2 percent by 2025.

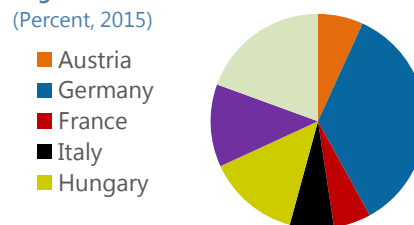
First-Time Asylum Applicants¹
(Thousands of people)



Sources: Eurostat.

1/ Data for Czech Republic, Denmark, Ireland, Greece, Spain, France, Cyprus, Luxembourg, Malta and Romania through December 2015. Data for Bulgaria, Croatia, Latvia, Lithuania, Austria, Portugal, Slovenia, Slovakia, Finland and the U.K. through January 2016.

Asylum Applicants in the EU-28 by Regional Breakdown
(Percent, 2015)



Sources: Eurostat; and IMF staff calculations.

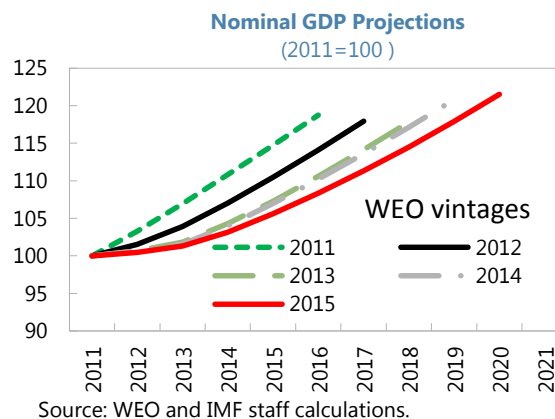
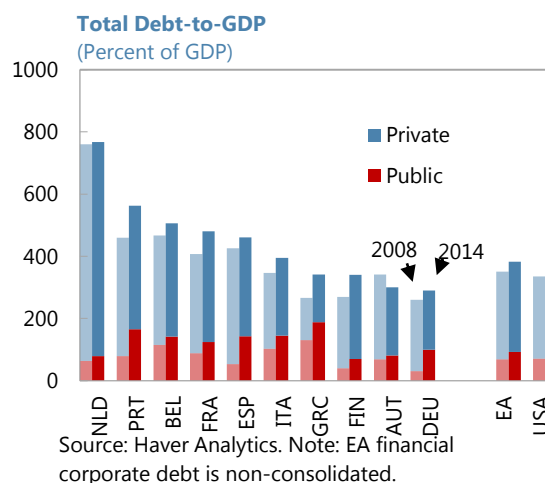
¹ See "[The Refugee Surge in Europe: Economic Challenges](#)," IMF Staff Discussion Note 16/2, January 2016.

MEDIUM-TERM PROSPECTS REMAIN MEDIOCRE

10. **Crisis legacies of high unemployment, high public and private debt, and deep-rooted structural weaknesses weigh on the outlook.** Business investment has started rising but lags the recovery, reflecting chronic weak demand, high corporate indebtedness, and weak growth prospects. Total debt (public and private) is above pre-crisis levels (text figure). Staff analysis indicates that the corporate debt overhang, particularly for SMEs, was a factor behind the decline in investment since the crisis, suggesting that slow progress in deleveraging is holding back investment (Box 2). Relatedly, high levels of nonperforming loans (NPLs) continue to undermine bank profitability and constrain new lending in some countries. Productivity also remains well below pre-crisis levels.

11. **As a result, growth five-years ahead is expected to be about 1.5 percent, with headline inflation reaching only 1.7 percent.** Average potential growth over the next five years has improved slightly, but remains subdued at 1.2 percent. Workforce aging is a drag through its impact on total factor productivity according to staff analysis.⁴ Unemployment is declining but only by 2021 does it reach its 2001–2008 average of about 8.5 percent. Without further reforms and faster growth, it will take several years to return unemployment to pre-crisis levels in hard-hit countries. Continued downward revisions to nominal GDP over the medium term have intensified debtors' adjustment challenge (text figure).

12. **Prolonged low growth and inflation leave the economy vulnerable to shocks with limited policy buffers.** Given low inflation, high debt, and low potential growth, the euro area is vulnerable to a demand shock that pushes the economy into a recession and low inflation.⁵ In a stagnation scenario where a demand shock lowers investment growth by $\frac{1}{4}$ percentage points annually for five years and pushes up spreads, growth and inflation could fall to about one percent, worsening public and private debt burdens and external imbalances. Fiscal space is limited and unevenly distributed with countries with large output gaps also burdened with high public debt. With limited national fiscal space and the lack of a euro area-wide countercyclical instrument, the burden would fall on the ECB to press further with unconventional policies.



⁴ See Selected Issues Paper on the “Impact of Aging on European Productivity Growth” for further details.

⁵ See “Risks of Stagnation in the Euro Area,” IMF Working Paper 16/9, January 2016.

Box 2. The Drag from Debt: Firm-Level Investment in the Euro Area

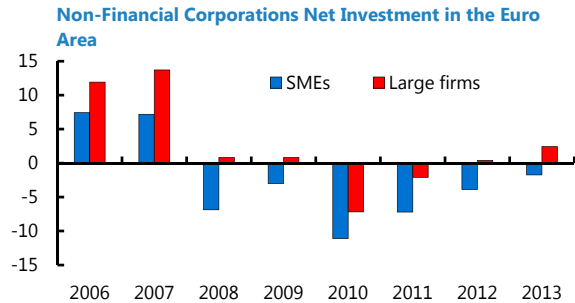
Business investment in the euro area since the crisis has remained weak.¹ Gross investment by non-financial corporations (NFCs) relative to GDP for the euro area fell with the global financial crisis, from about 24 percent of GDP in 2007 to a low of about 21 in 2009. The average euro area country saw investment drop almost six percentage points of GDP over the period 2007–2014. At the firm-level, the investment fall and slow recovery is most evident at small and medium enterprises (SMEs; see text figure).

High corporate indebtedness may partly account for the weakness of firms' investment. High debt may raise the risk of new lending, as more of a company's collateral is likely encumbered, raising their external finance premium. Without financing, firms may be unable to invest even when they see high return opportunities. Moreover, highly indebted firms may decide to invest less, as the returns from additional investment are used more to pay off existing debtholders rather than benefit shareholders. Leverage for SMEs rose with the crisis, while remaining stable for large firms. After peaking in 2010, SME leverage has come down, but only very slowly and remains above its pre-crisis level (text figure).

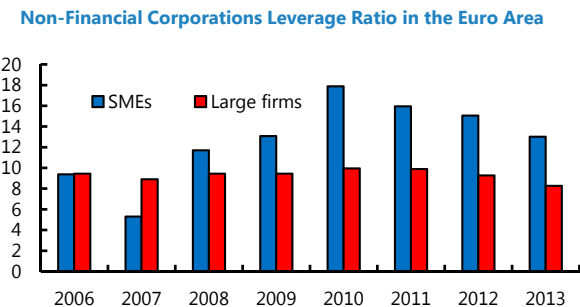
Staff analysis suggests that firms' investment ratio is about 3 percentage points lower on average across firm sizes for a 10 percentage point rise in leverage. The analysis draws on a large sample of firm-level data from the ORBIS database for eight euro area countries (Austria, Belgium, Germany, France, Finland, Italy, Portugal and Spain) from 2003–2013. Controlling for other determinants of investment, the estimated impact of leverage on investment is about 25 percent larger for SMEs than large firms.

High debt is also associated with a weaker response of firm investment to demand. The sensitivity of investment to sales growth (a proxy for demand) has declined, to only about a quarter of its level prior to the crisis—the firm investment ratio rises by about one percentage point for a 10 percentage point rise in sales growth, compared to a pre-crisis rise of over four percentage points. Post-crisis, investment by highly leveraged firms is much less responsive to demand.

Measures to reduce corporate indebtedness could help boost firm investment. It could also enhance the transmission of monetary and fiscal policies to investment. The shutdown of unviable firms and debt restructuring for viable but distressed firms (the flipside of some NPLs held by banks) could facilitate a more growth-friendly deleveraging and promote a reallocation of resources to more productive firms, providing new opportunities for investment.



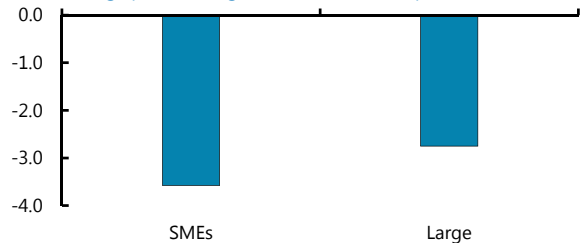
Sources: Orbis Database and IMF staff calculations.
Note: Euro area sample includes 8 countries (Austria, Belgium, Germany, France, Finland, Italy, Portugal, and Spain). The figure shows unweighted median of firms' real net investment as a percentage of firms' real lagged capital stock. SMEs include firms with less than 249 employees while large firms include firms with 250+ employees.



Source: Orbis Database and IMF staff calculations.
Note: Euro area sample includes 8 countries (Austria, Belgium, Germany, France, Finland, Italy, Portugal, and Spain). The figure shows unweighted median of firms' debt as a percentage of firms' total assets. SMEs include firms with less than 249 employees while large firms include firms with 250+ employees.

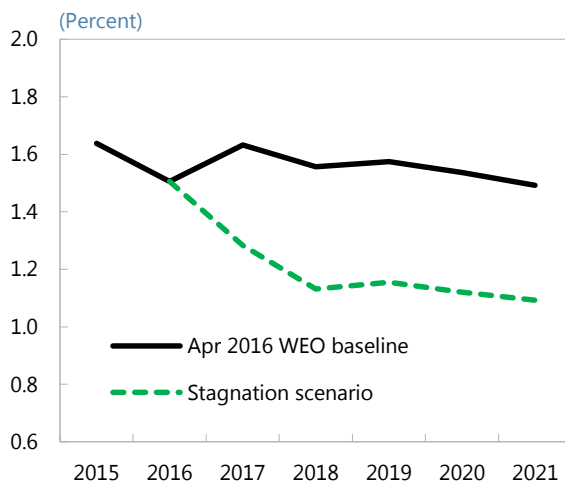
Impact on Investment Ratio of a 10pp Increase in Firm Debt-to-Asset Ratio

(Percentage points change in investment-to-capital ratio)

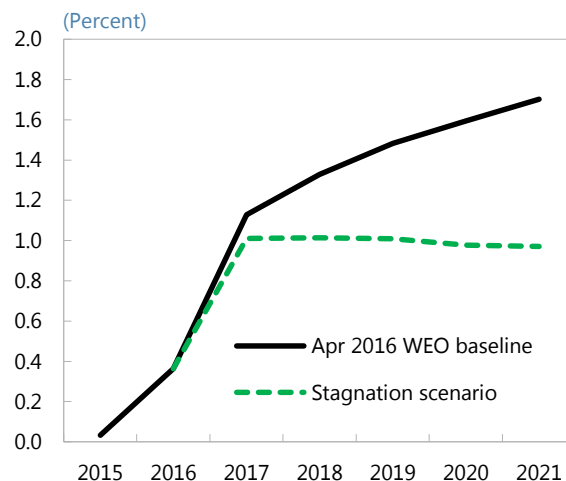


Source: Orbis (BvD Publishing) and IMF staff calculations.
Note: Estimates are based on a non-linear fixed-effects panel regression fitting the firm-level investment-to-capital ratio on leverage, sales, SME dummy, leverage interacted with firm-size class, sales growth interacted with leverage, sales growth interacted with firm size, and a triple interaction of leverage, SME dummy, and sales growth. The model also controls for long-term debt, the log of total assets, sector*country*time effects and firm-fixed effects. The sample is composed of Austria, Belgium, Germany, France, Finland, Italy, Portugal and Spain. The time dimension is 2000 to 2013. Firm level data are from Orbis, BvD Publishing.

¹ See Selected Issues Paper on "Investment, Firm Size, and the Corporate Debt Burden: A Firm-Level Analysis of the Euro Area" for further details.

Euro Area: GDP Growth Simulations

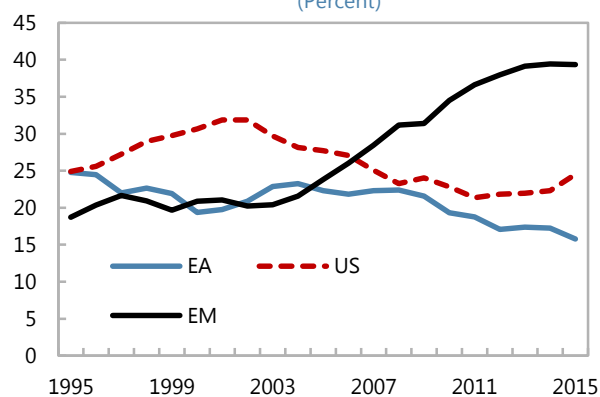
Sources: IMF, World Economic Outlook; and IMF staff calculations.

Euro Area: Inflation Simulations

Sources: IMF, World Economic Outlook; and IMF staff calculations.

13. Stagnation in the euro area would spill over to the global economy through weaker imports and higher global risk premia.

As the second largest economic bloc worldwide, a stagnating euro area would be a major drag on global growth and trade. The euro area still accounts for a significant share of global GDP (almost 17 percent), but its contribution to global growth has declined since the global financial crisis (text figure). Under a stagnation scenario, the euro area's current account would increase by 0.4 percent by 2021, with real imports contracting 2.8 percent in 2021. Other EU countries' exports would fall by 1.4 percent in 2021, while exports for the rest of the world would decline by 0.4 percent. Stagnation in the euro area could also lower confidence and raise global risk aversion.

Global Nominal GDP Share
(Percent)

Sources: WEO.

Authorities' views

14. The authorities were positive on near-term growth. Domestic demand—underpinned by low oil prices, a mildly expansionary fiscal stance, accommodative monetary policy, and employment gains—would continue to drive growth and put it slightly above staff's forecast by 2017. They agreed that risks remain to the downside, dominated by geopolitical factors, including the refugee surge and skepticism about Europe highlighted by the U.K. referendum.

15. Inflation is expected to rise more rapidly. The ECB expects oil price developments and monetary policy actions announced in March to support a faster recovery in headline inflation than expected by staff. Core inflation remains subdued so far. Although the labor market is improving, the shift towards low-paying service jobs and other compositional changes are holding down aggregate wage growth.

16. The authorities differed slightly in their assessment of the real exchange rate. The ECB viewed the current account in 2015 as broadly in line with fundamentals, while finding the real effective exchange

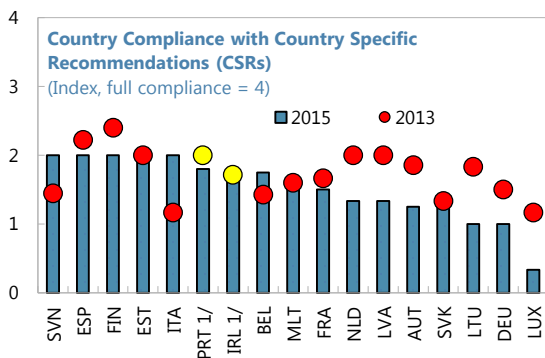
rate so far this year to be marginally stronger than implied by fundamentals. The European Commission (EC) projects it as somewhat undervalued for 2016. Both stressed stronger investment by creditor countries as necessary to narrow persistent external imbalances within the euro area.

17. **They concurred that the medium-term outlook is lackluster, with potential growth only around 1 percent.** Refugee inflows and higher participation will temporarily boost the labor contribution, but weak investment, aging, and limited total factor productivity improvements weigh on potential. The EC shares concerns about stagnation risks, as well as the possibility of more fundamental threats to the monetary union if divergent diagnoses about current challenges prevent steps toward further integration.

COMPREHENSIVE, MORE BALANCED POLICIES TO BOOST GROWTH AND STRENGTHEN THE UNION

A. Prioritize Structural Reforms and Strengthen Economic Governance

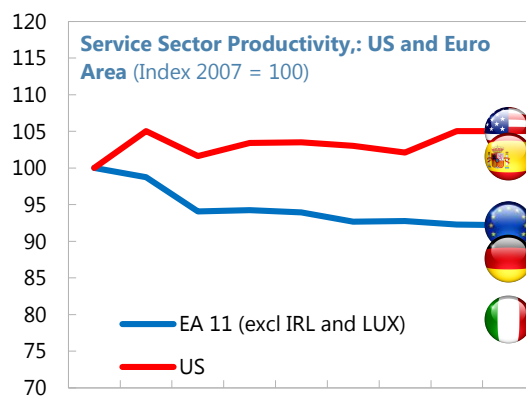
18. **Progress on structural reforms has flagged, holding back potential growth.** Reform progress has been notable in countries under adjustment programs, but the overall pace is too slow given the large structural gaps in many countries. Compliance with the 2015 Country Specific Recommendations (CSR) under the European Semester has worsened relative to that for 2013–14 CSRs (text figure). Implementation of the Services Directive, especially in retail and professional service sectors, has been slow, particularly in the larger economies. Sizeable cross-country differences in productivity persist, especially in services where productivity remains below pre-crisis levels, lagging other advanced economies (text figure). Without faster progress on structural reforms, potential growth in the euro area will remain low, limiting the ability of countries to rebuild buffers and address crisis legacies.



Source: European Commission.

Note: The EC assesses progress on CSR on the scale: none (0), limited (1), some (2), substantial (3), full (4).

1/ IRL and PRT data are for 2014 since these countries fell outside the Macro Imbalance Procedure framework in 2013.



Source: Haver Analytics.

19. **The cyclical recovery presents an opportunity to push forward on structural reforms, prioritizing those that provide demand support.**⁶ A mix of product market, labor market, and public

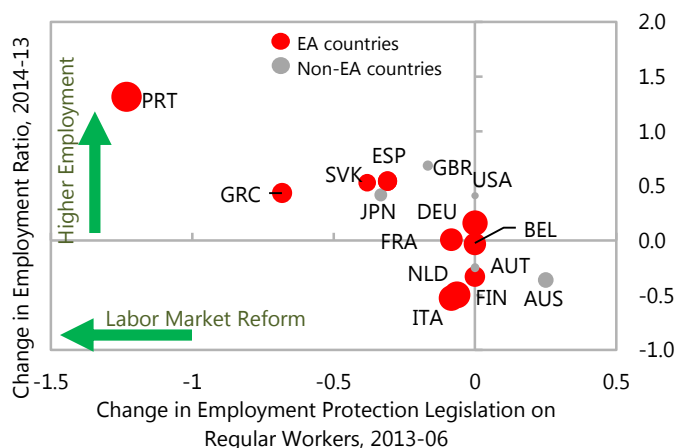
⁶ See Chapter 3 of the [April 2016 World Economic Outlook](#) and “[When Do Structural Reforms Work? On the Role of the Business Cycle and Macroeconomic Policies](#),” IMF Working Paper 16/62, March 2016.

administration reforms can significantly increase potential output over five to ten years and bring spending forward.⁷ Structural reforms have already paid dividends in some places, such as Spain and Portugal (text figure), although large rigidities remain. Drawing on national reform priorities (Table 4), the emphases should be on:

- *Product market reforms.* Product market reforms can boost medium-term output and employment regardless of cyclical conditions, with higher effects on employment when demand policies are supportive. Reducing entry barriers in the professional and retail sectors, improving the efficiency of public administration, and strengthening insolvency regimes can increase competition, improve the business climate, and facilitate investment. Completing the single markets in services, energy, digital commerce, and transport as well as an ambitious Transatlantic Trade and Investment Partnership (TTIP) agreement would enhance productivity and competition.
- *Labor market reforms.* Reforms should focus on lowering unemployment and increase labor force participation among the young, elderly, women, and the long-term unemployed. Priority should be given to shrinking the labor tax wedge and expanding cost-effective active labor market policies (ALMPs), since these reforms are likely to boost growth and employment even if budget neutral and with larger effects if accompanied by fiscal support. Reducing excessive protections for regular workers and excessive unemployment benefits may also help in some cases, but care must be taken when they are implemented, as they can exacerbate downturns. To achieve the medium-term benefits of these reforms while mitigating adverse short-term consequences, countries can make credible commitments to act, perhaps by introducing legal changes that become effective over time.

Euro Area: Labor Market Reform and Outcomes

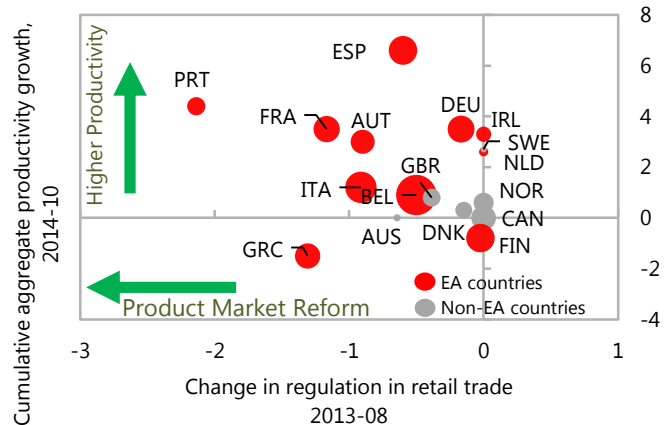
(Bubble's size indicates the level of labor market rigidity in 2013)



Sources: OECD and IMF staff calculations.

Euro Area: Product Market Reform and Outcomes

(Bubble's size indicates the level of product market rigidity in 2013)



Sources: OECD and IMF staff calculations.

20. **The economic governance framework needs to be strengthened significantly to better incentivize structural reforms.** Stronger enforcement of the current framework—including opening

⁷ See ["Raising Potential Growth after the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond,"](#) OECD Working Paper 835, January 2011.

the Excessive Imbalance Procedure (EIP) against repeat offenders—would increase compliance and build credibility.⁸ To improve enforcement, the 2016 European Semester and Macroeconomic Imbalance Procedure (MIP) should link country-specific recommendations (CSRs) to ambitious outcome-based structural reform benchmarks.⁹ Benchmarking will improve transparency and accountability by reducing scope for excessive discretion in enforcing the framework.¹⁰ These benchmarks should target euro area best practices to reduce structural gaps, foster convergence, and improve flexibility in factor markets (Box 3), while greater use of EU legislation in areas where it has jurisdiction would strengthen implementation. Flexibility under the SGP for structural reforms and targeted use of European Structural and Investment (ESI) funds and EU technical assistance (the 2015 Structural Reform Support Service) should be used to support reforms. To help incorporate euro area-wide priorities into national reform agendas, independent national competitiveness boards with a broad remit (as in Germany, the Netherlands, and Australia) could be created.

Authorities' views

21. **There was broad agreement on reform priorities.** Significant progress has been made on financial services and ALMPs, while regulatory reforms to strengthen the business environment and employment, increase female labor market participation, and reduce barriers to competition in the services sector have been slow. In response, the 2016 European Semester emphasizes removing barriers to investment, including through more efficient public administrations, lower regulatory burden for firms, improved regulatory frameworks in services and network industries, and effective insolvency regimes. TTIP negotiations have accelerated, a free trade agreement has been concluded with Vietnam, and, negotiations are underway with some ASEAN countries.

22. **The implementation of the macroeconomic governance framework has prioritized effectiveness over enforcement.** Instead of opening an EIP, which would be politically contentious, the EC will use the “specific monitoring” tool to assess reform implementation in countries with continued excessive imbalances, helping generate peer pressure for action. In line with the Five Presidents’ Report, the ECB suggested that a full and effective use of all instruments available under the MIP—including its corrective arm—could help spur reforms. The introduction of reform benchmarks is progressing slowly due to the need to build consensus among member states and data limitations in some areas (such as insolvency regimes). Nevertheless, in addition to the labor tax wedge, the EC is analyzing the scope for benchmarking in insolvency frameworks and reducing regulatory barriers in the service sector. The number of CSRs has also been further streamlined in 2016, but this has complicated the targeting of European Structural and Investment (ESI) funds to support reforms.

⁸ In its assessment of member state progress toward correcting imbalances identified in the 2015 CSRs, the EC failed to recommend opening an EIP against any of six countries with imbalances, including France, Italy, and Portugal. The latter had already been deemed to have excessive imbalances in 2014.

⁹ This is foreshadowed in the [Five Presidents’ Report](#), June 2015.

¹⁰ See “[Building a Better Union: Incentivizing Structural Reforms in the Euro Area](#),” IMF Working Paper 15/201, September 2015.

Box 3. Operationalizing Outcome-Based Structural Reform Benchmarks

Context. The Five President’s Report emphasizes the benefits of convergence of structural policies toward best practice in Europe.¹ In 2015, the Eurogroup agreed to benchmark the labor tax wedge to GDP-weighted EU averages for a single worker (in a budget neutral manner) as part of the European Semester. Considerations for selecting structural reform benchmarks to begin operationalizing the framework are offered below. Reform measures should be prioritized taking into account countries’ cyclical positions and policy space (paragraph 19).

Selection criteria.

- **Operational.** Reform benchmarks should be closely linked to the ultimate reform outcomes. To ensure transparency and accountability, the benchmarks should be sufficiently concrete and measurable, and directly under the control of policymakers to ensure they can be enforced. To move forward quickly, indicators should be selected from the existing pool of measures. They could be supplemented and improved over time. To assist monitoring, the data should be available at least on an annual frequency.
- **Economic.** To improve the resilience of the monetary union, benchmarks should focus on completing the single market and increasing product and labor market flexibility. This would facilitate faster adjustment to economic shocks, limiting negative spillovers to other member states, as well as boosting productivity, enabling members to thrive independently within the monetary union

Six priority benchmarks. The following six indicators—selected in key reform areas (Table 4)—meet the above criteria and could be prioritized: (i) OECD indices on regulatory barriers in professional services sectors; (ii) the licenses needed to engage in retail trade; (iii) employment protection in regular work contracts; (iv) the labor tax wedge; (v) the World Bank measure of the number of days to enforce a contract; and (vi) measures of public sector value added per employee. Figure 8 illustrates the cross-country gaps and the impacts of reforms for three of the six benchmarks.

“Best practice” threshold. For most of the selected indicators, OECD best practice lies within the euro area, making it a natural target towards which other euro area countries could converge. Reforms which have fiscal implications (like the labor tax wedge) could be implemented in a budget neutral manner (that is, with compensating fiscal measures) and over a longer horizon, especially in countries without fiscal space.

Example (labor tax wedge). The average labor tax wedge for the euro area is higher than that in non-euro area OECD countries (Figure 8). This has a bearing on labor force participation and employment, particularly among the young, elderly as well as women. Empirical analysis shows that a reduction in the labor tax wedge can boost employment and output in the short term as well as the medium term (Figure 8). For example, the estimates indicate that reducing the labor tax wedge by 1 percentage point can raise output and employment by 0.8 and 1.2 percent respectively after 4 years.

Consistent with this analysis and the above selection criteria, the Eurogroup agreement to benchmark the labor tax wedge is a good start. However, the target could be more ambitious as the benchmark remains above the euro area and OECD averages, and far exceeds euro area best practice.

¹ See the [Five Presidents’ Report](#), June 2015.

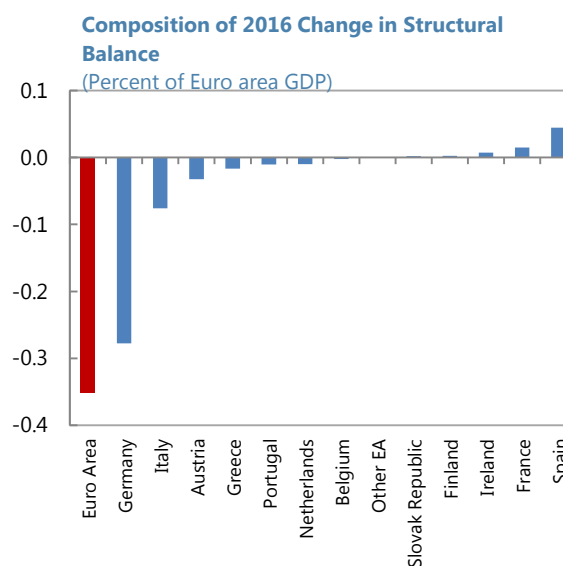
B. Promoting Investment, Rebuilding Buffers, and Improving Fiscal Governance

23. **Looking ahead, fiscal policy should aim for a broadly neutral stance to support the recovery while promoting sustainability.** After several years of consolidation, the fiscal stance turned mildly expansionary in 2016 (Figure 4 and text figure). Fiscal easing is coming mainly from Germany, and to a lesser extent, Austria and Italy. Beyond 2016, the overall fiscal stance for the euro area is projected to turn slightly contractionary as the impact from refugee-related spending wanes in some countries while others resume their consolidation plans.

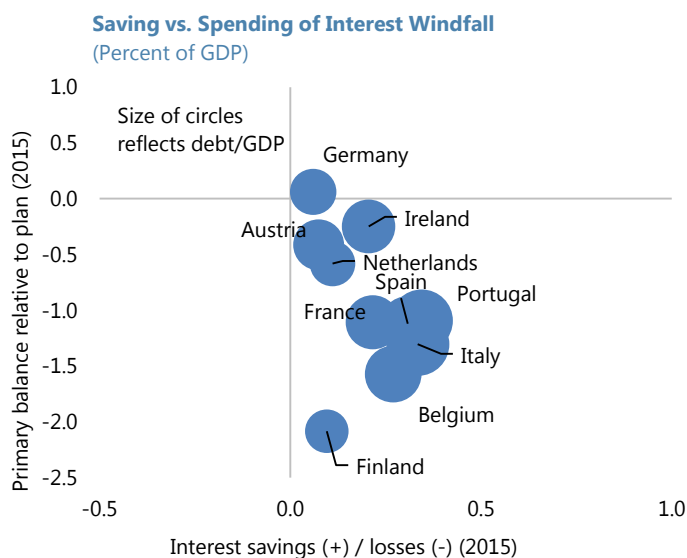
24. **Fiscal policy could be better targeted geographically, but fiscal space is limited in many countries** (Table 5). Taking into account debt sustainability, SGP targets, and national fiscal rules, fiscal space is scant or nonexistent at the country level. High debt constrains many countries, leaving fiscal space concentrated mainly in countries with small or no output gaps and little need for countercyclical support.

25. **At the same time, high debt countries have slowed their adjustment, leaving very limited policy buffers.** The pace of adjustment, as measured by changes in the structural primary balance, slowed in high debt countries, from an average of 1.4 percent of GDP over 2010–12 to near zero over 2014–15. This is despite the large windfall savings from lower interest rates which have been spent instead of used to repay debt (text figure). This has helped make adjustment less procyclical, but is also a missed opportunity to rebuild policy buffers and has undermined the SGP's credibility.

26. **To rebuild buffers and stimulate investment, countries should pursue more growth-friendly fiscal reforms.** Countries with fiscal space should use it to promote investment and structural reforms. Those without space should adhere to their consolidation plans and rebuild buffers. All countries should undertake growth-friendly fiscal rebalancing, boosting public investment and reducing high marginal tax rates on labor and capital, accompanied by cuts to unproductive



Sources: IMF, WEO; and IMF staff calculations.



Source: IMF staff estimates.

spending and steps to broaden the tax base.¹¹ In the event of a severe, euro area-wide downturn, the escape clause should be invoked to suspend temporarily the fiscal adjustment that would otherwise be required under the SGP. However, even setting aside the SGP, national fiscal space is limited given high debt burdens in several countries, underscoring the need for regional support mechanisms to address sharp downturns without raising country debt burdens.

27. **At the regional level, expanding centrally-financed investment schemes would lift both near-term and potential growth.** The European Fund for Strategic Investment (EFSI) has approved over €100 billion in projects so far, mainly in research, development, and innovation, but for the EU rather than targeted to the euro area. Accelerating project approvals and disbursements as well as removing structural barriers would help catalyze private investment. Additional centralized investment schemes, financed via an expanded EU budget or a new common fund, could invest in projects of shared interest such as the digital single market, energy union, climate adaptation and mitigation, refugee settlement, and European transportation and communication networks.

28. **To restore credibility and build support for further integration, the fiscal framework needs upgrading.** SGP compliance has been weak as countries renege on commitments and request more time to meet their targets.¹² To bolster the credibility of the framework and better ensure fiscal discipline, the EC will need to step up its enforcement procedures against countries that violate SGP rules. At the same time, the fiscal framework needs to be enhanced through simpler rules with more automatic enforcement and an independent fiscal board.

- *Adopting a simpler framework.* While successive reforms have improved parts of the framework, they have also added to its complexity, hampering effective monitoring, public communications, and compliance. Simplifying the framework should focus on two main pillars: a single fiscal anchor and a single operational target.¹³ Such targets would be easier to implement, less reliant on output gap estimates, and more aligned with national budget frameworks.
- *Ensuring the independence of the European Fiscal Board (EFB).* To enhance enforcement and monitoring, the European Fiscal Board (EFB), which is slated to start in 2016, should be made fully independent in assessing the aggregate fiscal stance and implementation of SGP fiscal rules. This could be achieved by separating the EFB from the European Commission which is in charge of enforcing the rules and by ensuring strong ties with national fiscal councils through the EU Network of Independent Fiscal Institutions (EUNIFI).

29. **Over the medium term, further fiscal integration should be pursued, conditional on stronger compliance with the fiscal rules and progress in structural reforms.** As described in the Five Presidents' Report, greater fiscal integration is key to longer-term European integration. A number of options could be considered, including a "rainy day" fund to cushion against country-specific shocks or a common unemployment insurance scheme that targets short-term

¹¹ As noted in the Fiscal Monitor, fiscal policy can stimulate innovation through its effects on research and development, entrepreneurship, and technology transfer.

¹² France secured another extension to meet its 2017 Excessive Deficit Procedure (EDP) exit date, while the EC recommended that Portugal and Spain receive additional time to bring their deficits down under the EDP without a final assessment on their fiscal effort to date. [Although its debt level is above the SGP reference value, Italy has been found compliant with the debt criterion and remains outside the EDP.](#)

¹³ See ["Reforming Fiscal Governance in the European Union,"](#) IMF Staff Discussion Note 15/09, May 2015.

unemployment to limit the scope for permanent transfers.¹⁴ Taken together, these elements of a fiscal union could form the foundation for a euro area treasury with limited revenue and expenditure functions that could also borrow to address large common shocks.¹⁵ Any new centralized financial support, however, would need to be conditional on adhering to fiscal and structural reform commitments to guard against moral hazard risks. Creating such an institution would also require some loss of sovereignty and ultimately treaty change to ensure its political legitimacy and accountability.

Authorities' views

30. **Public deficits and debt remain high due to the weak recovery and lack of national ownership, leaving some countries exposed to shocks.** Some countries in the corrective arm put more emphasis on compliance with nominal deficit targets, such as the 3 percent of GDP reference value, than on the structural adjustment targets. Without further adjustment, countries with high debt or financing needs are vulnerable to rises in interest rates or a growth slowdown. But the EC argued that without the SGP, fiscal positions would be much worse. The authorities acknowledged that the transparent, and consistent application of the SGP is crucial to maintain confidence in the fiscal framework. This will also enable countries, especially those with high debt, to achieve timely progress towards sound fiscal positions and build sufficient buffers in good times, reducing their vulnerability to future shocks. On the EFB, the EC plans to appoint members by the summer, indicating that the quality of the appointments would be more important in ensuring the board's independence than structurally separating it from the EC. The ECB highlighted that the mandate and institutional independence of the EFB could be clarified and strengthened further.

31. **Fiscal space is limited.** The authorities concurred that based on various sustainability measures as well as the SGP, national space is limited and unevenly distributed. They noted however that the rules were designed to protect against deficit bias in normal times, with monetary policy countering large common shocks. At this juncture, the authorities agreed that the few countries with fiscal space within the SGP should use it and that centralized fiscal support could be expanded to deliver a more balanced policy mix. At the same time, the ECB argued that all countries have scope for a more growth-friendly composition of fiscal policies—countries without fiscal space can still pursue fiscal policies which support both the recovery and medium-term growth in a budgetary neutral manner.

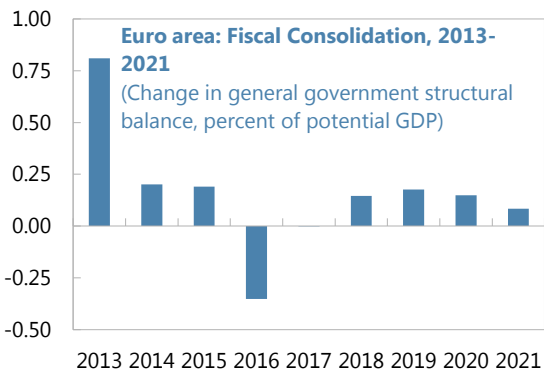
32. **A central fiscal capacity would improve the policy mix, but is politically difficult to achieve.** Given deep concerns over moral hazard and transfers outside of a political union, the authorities saw gradual moves toward greater fiscal integration as the best approach. Initially, existing centralized schemes such as the EFSI might be expanded. Linking centralized support to SGP compliance and structural reform implementation could address moral hazard concerns, while greater private risk sharing would reduce the burden on public risk sharing. An experts group will be formed later this year to consider how to move to the second stage under the Five Presidents' Report, including options for a fiscal stabilization function for the euro area.

¹⁴ See "[Toward a Fiscal Union for the Euro Area](#)," IMF Staff Discussion Note 13/09, September 2013.

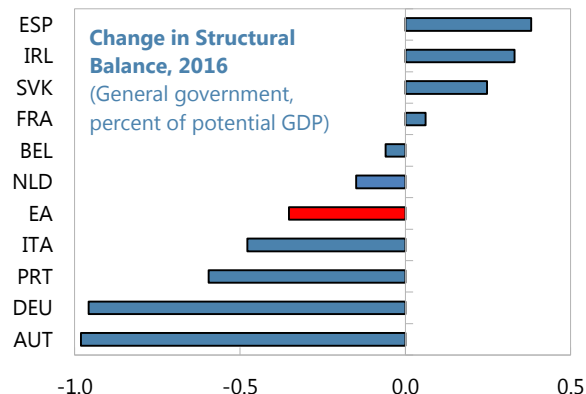
¹⁵ See Selected Issues Paper on "Options for a Centralized Fiscal Capacity in the Euro Area" for further details.

Figure 4. Fiscal Developments and Policies

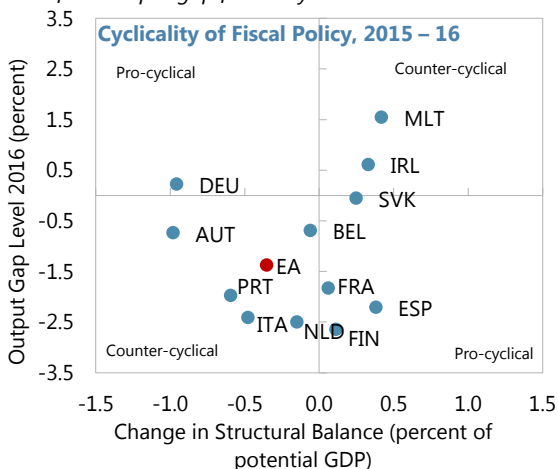
The fiscal stance turned slightly expansionary in 2016...



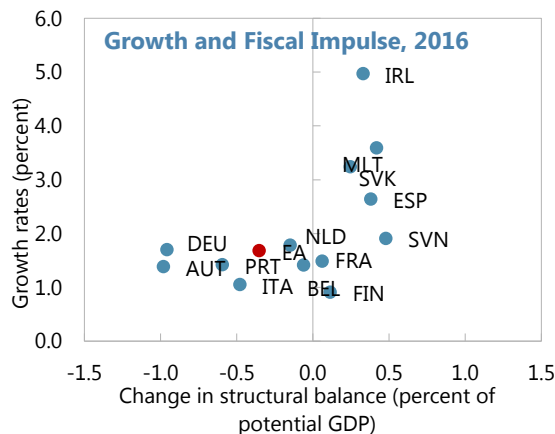
...with more moderate adjustment or slight expansions among countries.



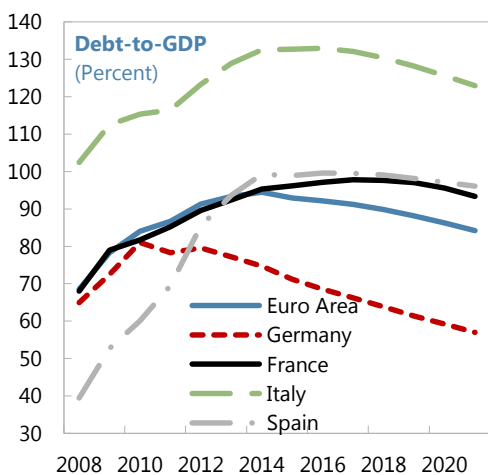
Fiscal Policy is now counter-cyclical with respect to the level of the output gap for many countries...



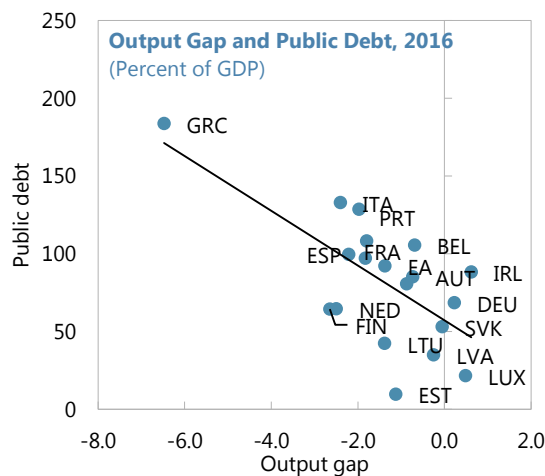
...generally providing support where growth is weaker.



Scope for additional fiscal support is limited, however, due to high public debt levels in many countries...



...especially those with larger negative output gaps.



Sources: IMF World Economic Outlook database; and Fund staff calculations.

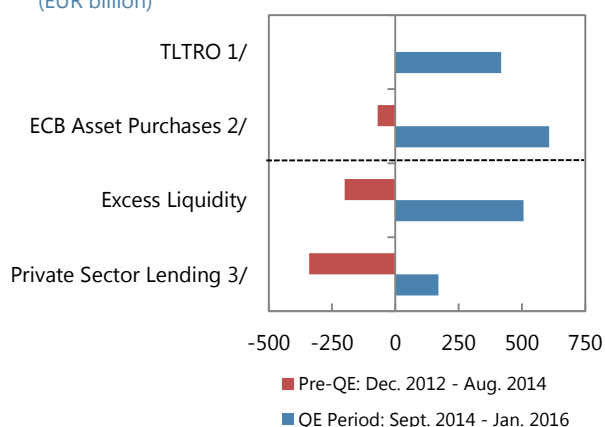
C. Maintaining Monetary Easing to Guard Against Low Inflation

33. **Monetary policy is appropriately accommodative and open-ended** (Figure 5). The ECB's March policy package—a further cut of all policy rates, an increase in monthly asset purchases to €80 billion, including for non-financial corporate bonds, and new targeted longer-term refinancing operations (TLTRO II)—which was reaffirmed in June, strongly signaled the ECB's commitment to meet its price stability objective. Linking the TLTRO II borrowing rate to new lending should expand credit supply, while mitigating the impact of negative rates on banks' interest margins (Annex 1). These credit easing measures will help stimulate demand by reducing bank and corporate funding costs.

34. **Monetary easing has improved financial conditions through various channels.**

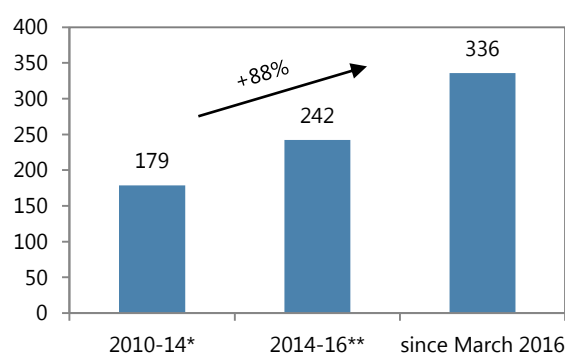
- *Asset purchases have compressed sovereign term premia and supported portfolio rebalancing.* Term spreads have fallen by 50 basis points and the euro has depreciated by 6 percent in real effective terms since President Draghi's Jackson Hole speech in August 2014 indicating that the ECB would pursue QE. Corporate issuance has also picked up significantly after the announcement of the corporate bond purchase program in March (text figure).

Impact of Policy Measures on Changes in Excess Liquidity and Private Sector Lending
(EUR billion)



Sources: Bloomberg, ECB, Haver and IMF staff calculations. Note: 1/ Most of the expiring funding via LTROs was absorbed by the first TLTROs starting in Sept. 2014; 2/ Securities held for monetary operations, including SMP; 3/ MFI loans to private sector.

Euro Area: Corporate Bond Issuance
(EUR billions, annualized)

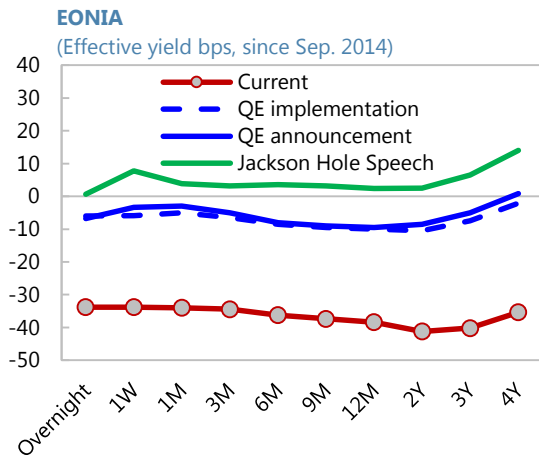


Sources: Dealogic and IMF staff calculations. */ ending at the start of QE (Sept. 2014); **/ Sept. 2014-Feb. 2016.

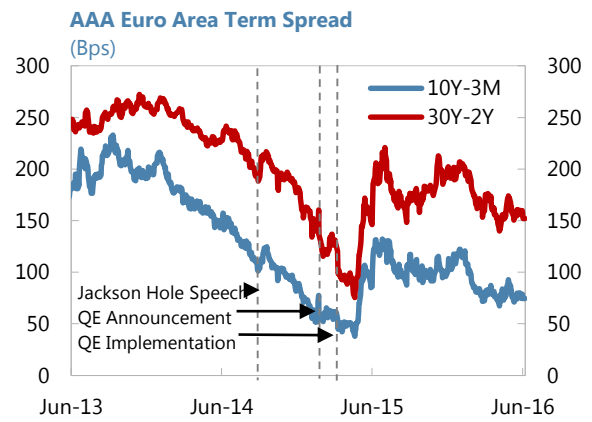
- *Bank lending rates have declined and credit picked up modestly.* SME lending rates have fallen across the euro area, while credit standards and conditions have eased. The ECB's *Bank Lending Survey* suggests that most banks used TLTRO I funds to increase corporate and household lending (text figure).

Figure 5. Monetary Policy Channels

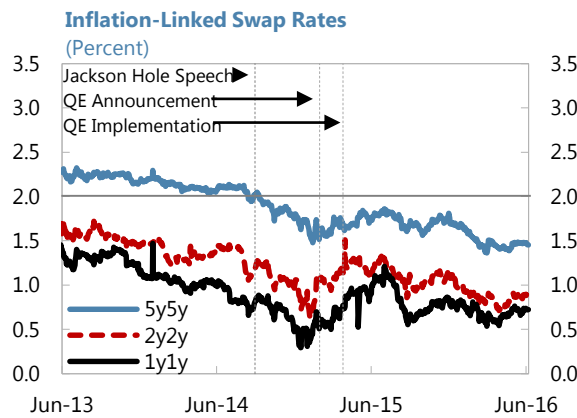
Very low money market rates confirm the strong signaling effect of the recent rate cut over the medium term.



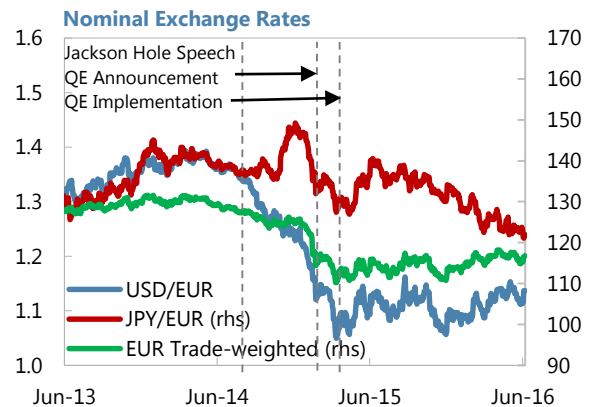
Term spreads have compressed again in the wake of the recent easing measures, though still wider than at the time of implementation.



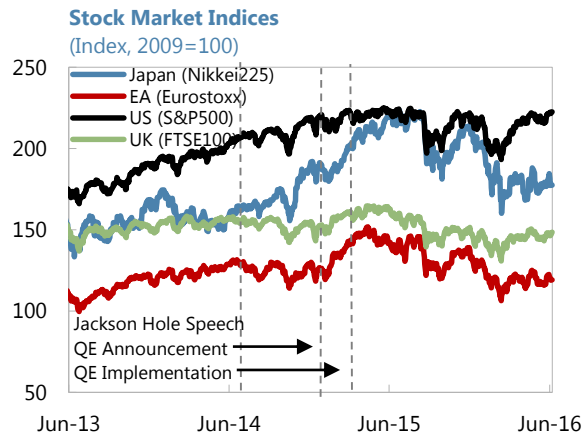
Inflation expectations remain low and have fallen in recent months ...



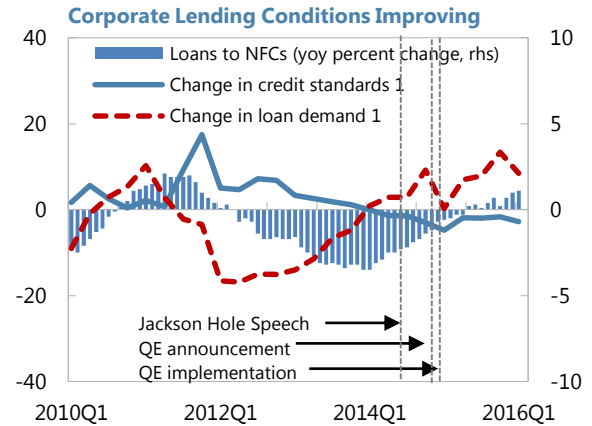
... and the euro has strengthened slightly year to date following a significant depreciation last year.



Equity markets have recovered only partly from the market turmoil earlier this year ...



... but credit standards are easing and loan demand is increasing.



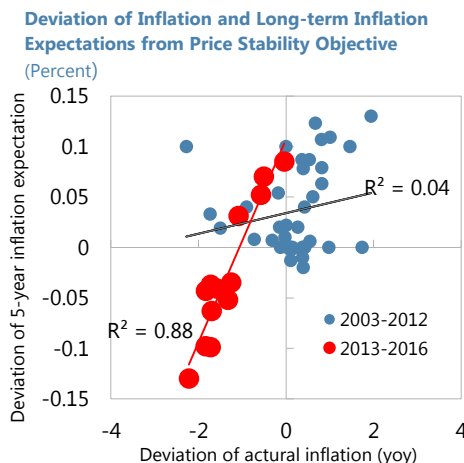
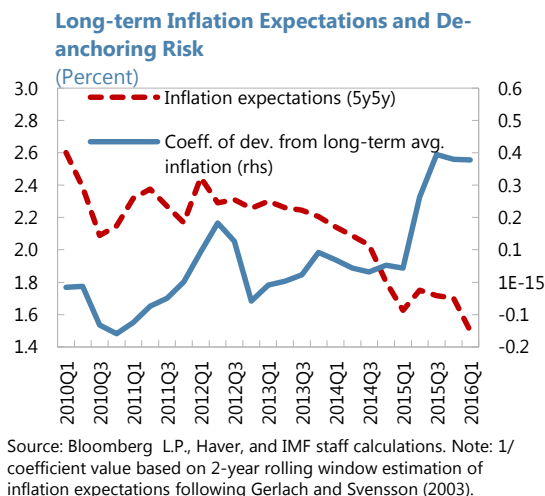
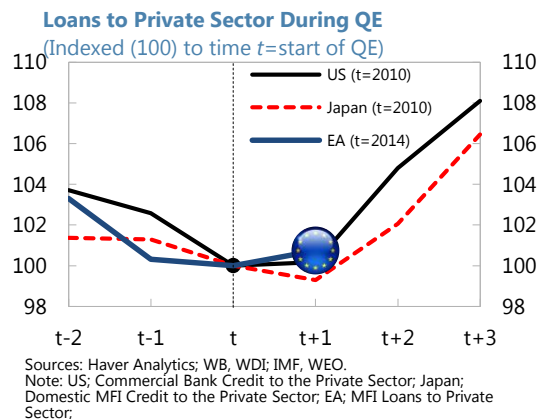
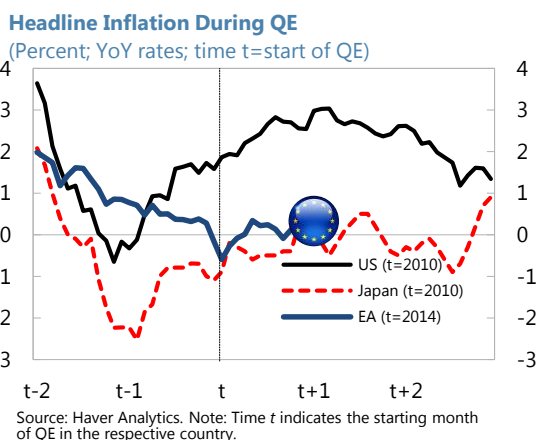
Sources: ECB; Haver Analytics; and Eurostat.

¹ Greater than or equal to zero implies tightening of credit standards / rising loan demand.

- *International experience suggests that pass-through to the real economy will take time.* Despite the turnaround in lending, full credit recovery after QE typically takes more time. In Japan (2010) and the U.S. (2010), credit continued to pick-up several years after the start of QE (text figure). In the euro area, credit growth has already turned positive after one year but remains weak.

35. **Measures to improve market functioning could enhance the effectiveness of asset purchases and monetary transmission.** The growing gap between the ECB’s deposit rate and the overnight German bund repo suggests potential scarcity of some sovereign bonds under QE (text figure). This in part has been exacerbated by the different modalities for re-lending purchased securities across national central banks (NCBs). Developing a common securities lending framework for NCBs, similar to the ECB’s own lending framework, would facilitate access to high quality collateral. To alleviate potential shortages, the ECB should encourage NCBs to lend securities via multiple central counterparties to better distribute collateral through the system.

36. **But given the very weak outlook for inflation, the ECB should stand ready to ease further if inflation remains below its anticipated adjustment path.** Disinflationary pressures remain strong, with 11 countries reporting negative inflation in May (Figure 2). Inflation expectations seem increasingly influenced by commodity prices and low headline inflation, with second-round effects weighing on core inflation. Staff analysis suggests that de-anchoring risks have increased, highlighting the need for greater sensitivity to inflation developments (text figures).



37. **However, further deposit rate cuts face limits.** To date negative interest rates have had an overall positive effect, helping to lower bank funding costs and boosting asset values. In some countries, the rate cut has passed through to corporates and households, thereby contributing to a modest credit expansion and bolstering the economic recovery. However, looking forward further cuts could weigh on bank profitability if deposit rates remain sticky while lending rates fall (Annex 1). This is particularly relevant in banking systems with high shares of variable rate loans and wide deposit bases, such as Italy, Portugal, and Spain. Moreover, banks in surplus countries where excess reserves are concentrated would bear a disproportionately higher cost from negative interest rates.

38. **Additional monetary easing—if needed—should therefore rely more on expanding asset purchases.** Staff analysis suggests that after applying various limits and the ECB's capital key, an additional €2.4 trillion of assets after planned purchases through March 2017 would be available, which could more than accommodate a one-year extension of the program (equivalent to about €960 billion in purchases; text figure). Modest changes to the program could dramatically increase the scope for more purchases. For example, allowing the purchase of bonds with yields below the deposit rate would increase the pool of short-dated sovereign debt, permitting purchases to be more evenly distributed across the yield curve.

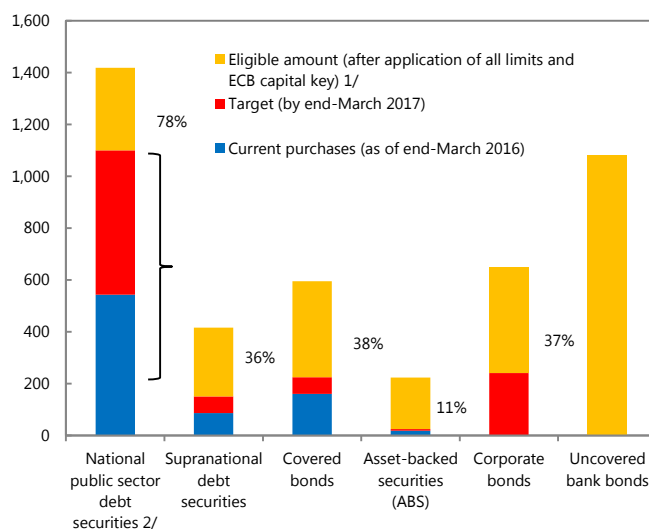
Authorities' views

39. **The ECB views current easing measure as effective.** Asset purchases have compressed the term premium significantly, eased lending standards, and reversed the contraction in loan growth. QE may have contributed to the buildup of excess liquidity in creditor countries, but the associated portfolio rebalancing has also helped reduce financial fragmentation, benefiting lending in debtor countries.

40. **The ECB encourages a more holistic assessment of negative rates' impact on the bank lending channel.** Negative rates have complemented asset purchases by further flattening the yield curve. Further rate cuts might entail diminishing returns due to lower bank profitability as deposit rates in some countries might fail to adjust. However, the impact of negative rates on bank profitability would be mitigated by valuation gains and improved asset quality (as borrowers' debt service burdens decline). TLTRO II can further help reduce the potentially adverse impact by lowering funding costs.

41. **The ECB concurred with the need for effective securities lending programs across the Eurosystem to avoid collateral scarcity.** No shortages were currently evident, as most NCBs have initiated active securities lending programs. The ECB noted that further enhancements towards collateral accessibility and common principles could improve efficiency while recognizing the heterogeneity of underlying markets.

Scope of Available Assets after Completion of Current Asset Purchase Program (APP) as of end-March, 2016 (EUR billion)



Source: Bloomberg L.P., Dealogic, ECB, and IMF staff calculations. Note: 1/ The values are reported in nominal terms and take into account existing and planned purchases until March 2017 as well as issuer/issue limits (incl. SMP), and exclude government debt securities outside the eligible maturity range of between 2 and 30 years and securities trading below the deposit rate (as cap on the eligible market for each asset class); the amount is also reduced by further by the allocation of purchased based on the pro-rated ECB capital key (without Greece and Cyprus); 2/ includes sub-national and agency debt securities. For all securities, only the non-encumbered market was considered.

42. **The ECB stands ready to ease further if needed to ensure inflation stays on the adjustment path towards its price stability objective.** The TLTRO II and corporate sector purchase program (CSPP) implemented in June 2016 are expected to provide additional stimulus. The ECB remarked that it closely monitors current inflation dynamics, including the risk of second-round effects entrenching low inflation expectations into the wage and price-setting mechanisms. If warranted to achieve its objective, it will act by using all the instruments available within its mandate.

D. Repairing Balance Sheets and Completing the Banking Union

43. **The financial sector in Europe is struggling to adjust to a prolonged period of low growth and inflation** (Figure 6). Bank profitability remains low, partly reflecting the anemic recovery and flattening yield curve, but also the lingering effects of crisis legacies and the slow adaptation of business models to the new environment, including from the rise of fintech. High NPL ratios weigh on banks in several countries, including Cyprus, Greece, Ireland, Italy, and Portugal, while large banks in France and Germany face challenges from high leverage. Many banks are engaging in a process of derisking, including reducing the size of their correspondent bank networks, which could have spillovers elsewhere. This reflects both tighter regulatory requirements and a more challenging economic environment, particularly for large global banks. More generally, European banks' low price-to-book values and the euro area's large size of bank assets to capital markets compared to other banking systems suggest that many countries suffer from "overbanking," pointing to a need for further consolidation and restructuring. Low investment returns have also affected pension funds and life insurers, eroding their ability in some cases to meet their guaranteed commitments.

44. **Bank balance sheet repair has been slow in several countries.** Write-off rates increased in 2015, helping to bring down NPL ratios for the first time since the global crisis, but their pace remains too low given the stock of NPLs. High NPLs inhibit credit growth, reduce bank profitability, and impair monetary policy transmission. Waiting for a strong recovery to resolve NPLs appears unrealistic and there will need to be some recognition of losses. Staff analysis suggests that in some countries, banks would need to expand lending significantly under difficult conditions to offset the drag on profitability from NPLs (Annex II).

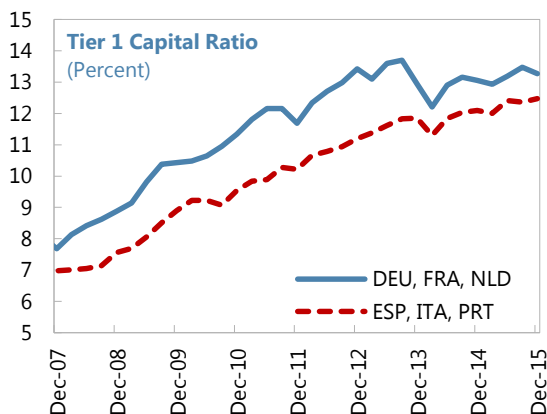
45. **A comprehensive approach to accelerating NPL resolution is needed to help raise bank profitability, stimulate lending, and facilitate consolidation.** The SSM has set up a task force to formulate best practices for NPL resolution across member states, as well as identify problem banks for enhanced supervision, but much more needs to be done. A time-bound, comprehensive strategy is urgently needed to address the NPL problem and can be part of a broader strategy for promoting consolidation in some banking systems:¹⁶

- *Incentivize faster resolution through stricter supervision.* More conservative provisioning and collateral valuation, capital surcharges, and time limits on NPL disposals, would incentivize banks to resolve NPLs more quickly, while nonviable banks should be restructured or liquidated. The SSM should set aggressive time-bound NPL disposal targets following up on the results of the EU stress test that informs the Supervisory Review for Evaluation Process (SREP).

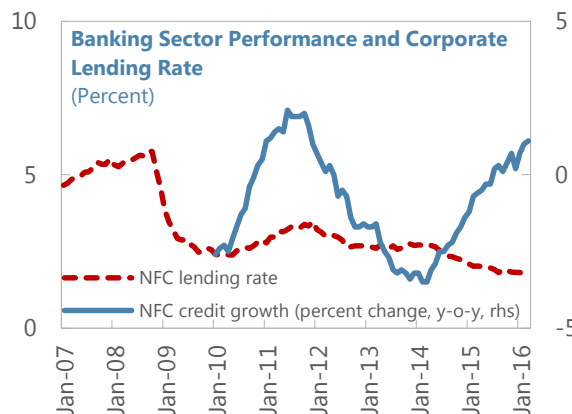
¹⁶ See "[A Strategy for Resolving Europe's Problem Loans](#)," IMF Staff Discussion Notes 15/19, September 2015, and "[Tackling Small and Medium Sized Enterprise Problem Loans in Europe](#)," IMF Staff Discussion Note 15/04, March 2015.

Figure 6. Banking Developments

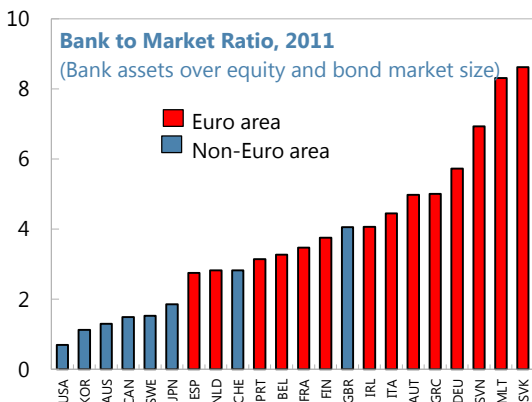
Capital has been gradually improving....



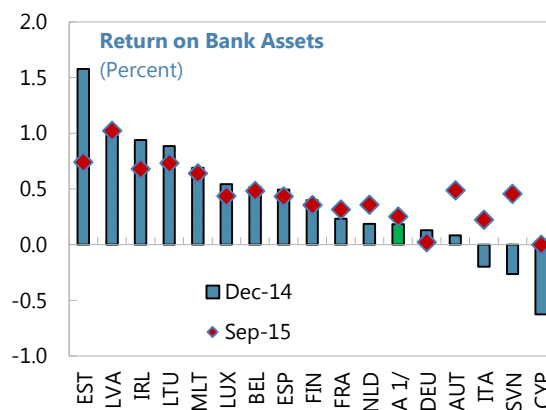
...with lower lending rates and higher credit growth.



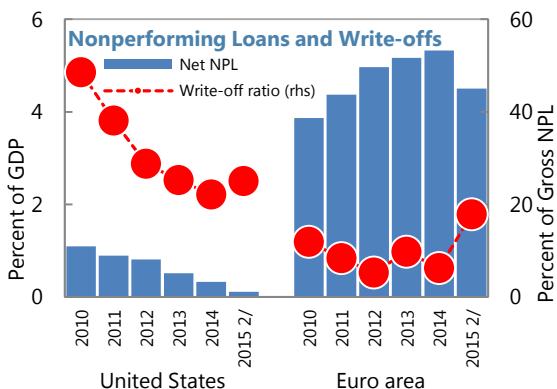
Many European countries are more dependent on banks for financing than other advanced economies.



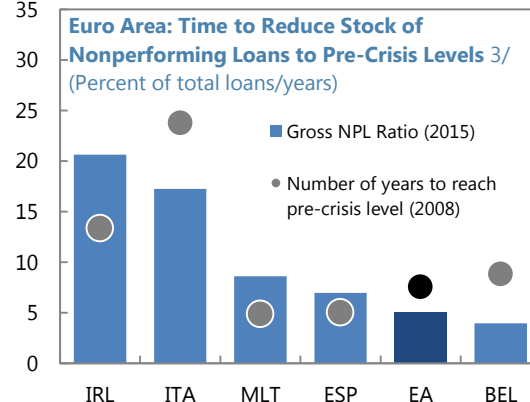
Bank profitability is still low...



...partly due to high NPLs and a slow pace of write-offs.



Without tougher action, the NPL issue looks set to persist a long time in several countries.



Sources: Bloomberg; Dealogic; ECB; EBA Transparency Exercise (2015); U.S. Federal Reserve; Extract from Figure 5, [Langfield and Pagano \(2016\)](#); IMF FSI database; IMF WEO; national authorities; and IMF staff calculations.

Notes: ¹ Euro area ROA is weighted by country bank assets.

² As of End-Sept. 2015 for the United States and End-June 2015 for the Euro area.

³ As of end-Q2 2015 (for IRE and ITA, end-2014); assumes unchanged write-off rate, future loan growth in line with nominal GDP, and non-performance of new loans at pre-crisis default rates.

- *Strengthen and harmonize corporate insolvency and foreclosure frameworks.* Lengthy court procedures should be shortened and out-of-court arrangements encouraged. Such reforms would increase the value of collateral and help close the pricing gap holding back NPL sales.
- *Promote active markets in distressed assets.* Stricter supervision and insolvency reforms should be accompanied by measures to develop distressed debt markets to facilitate NPL disposals. International experience suggests that private and publicly supported asset management companies (AMCs) can play a role in kick-starting such markets by facilitating the sale of impaired assets to specialist investors. In systemic cases where state intervention may be warranted, EU State Aid rules should be exercised flexibly as permitted, recognizing that the correct determination of “market prices” is difficult without a functioning market.¹⁷ AMCs should be open to foreign participation, including by pan-European institutions, which could assist in funding and governance.

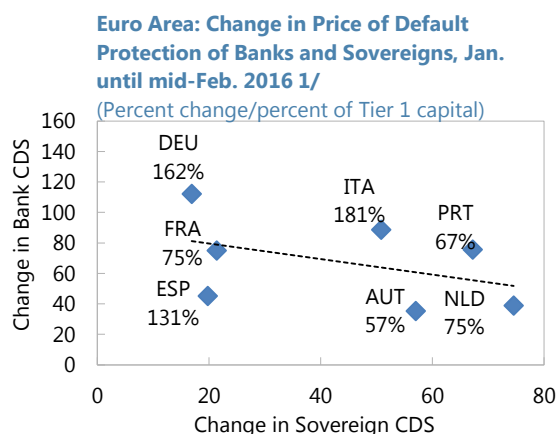
46. **Completing the banking union requires establishing a common deposit insurance scheme while also mitigating banking sector risks.** There has been some notable progress, with the financing of the Single Resolution Fund (SRF) to back the year-old Single Resolution Mechanism (SRM). However, the final pillar of a common deposit insurance system is still missing, leaving bank-sovereign risk links largely intact. The European Deposit Insurance Scheme (EDIS) proposed by the EC in November 2015 is a step in the right direction, linked to member states’ implementation of the Deposit Guarantee Scheme Directive (DGSD) and with a gradually increasing insurance coverage. But until banking sector risks have been reduced to the satisfaction of all member states, agreement on the proposal is likely to prove elusive.

47. **Greater risk sharing should proceed hand in hand with measures to reduce banking sector risks.** Risk sharing, without risk reduction, may lead to moral hazard and unintended transfers, while risk reduction alone fails to address the need for a common backstop in a systemic crisis. The solution is to proceed simultaneously on both fronts. In addition to swifter NPL resolution, further risk reduction could include:

- *Capital.* Extending the recently announced agreement between the ECB and national competent authorities on national options and discretions to less significant institutions would further harmonize and strengthen the definition of capital.

¹⁷ Model-based or alternative approaches to estimating market prices might be required if markets are illiquid. To ensure there is no undue advantage from state intervention, AMCs could use equity warrants or clawback contracts to fully compensate the state for any realized transfers after an NPL sale.

- *Recovery and resolution.* To enhance the effectiveness of the Bank Recovery and Resolution Directive (BRRD) and curtail bail-in surprises, differences in creditor hierarchies across countries in bank resolution should be clearly communicated to investors or a common hierarchy established. The SRB and national resolution authorities (NRAs) should deploy more quickly the BRRD's minimum requirements for own funds and eligible liabilities (MREL) to clarify how bank losses could be absorbed. In general, regulatory uncertainty regarding new requirements should be reduced to allow banks to plan for a smooth transition. To ensure that the BRRD functions smoothly in a crisis, supervisors and resolution authorities should test how bail-in and cross-border coordination would work, especially for large and complex banks.
- *Sovereign exposures.* A more risk sensitive prudential treatment of banks' sovereign exposures could be considered, phased-in gradually and following the guidelines of the international review being undertaken by the Basel Committee.



Sources: Bloomberg LP, EBA Transparency Exercise (2015) and IMF staff calculations.

¹ Senior CDS contracts at 3-year maturity; banks CDS is weighted by total assets of each bank; the percentage value shows the indicates net domestic sovereign exposure relative to Tier 1 capital of each sample bank.

48. Greater risk sharing in the banking sector also requires a common fiscal backstop.

A common fiscal backstop, such as a credit line from the ESM, is needed for both the EDIS and the SRF to minimize the chances that bank-sovereign risk links reemerge, particularly during the transition to being fully financed (see text figure). In times of systemic stress, the ESM could be empowered to engage in precautionary direct bank recapitalizations of viable banks to safeguard financial stability as allowed under BRRD, with the appropriate conditionality.

49. Faster progress on the capital markets union would also spur greater private risk sharing and non-bank financing alternatives. Some headway has been made with the changes to insurers' capital changes for infrastructure investment under Solvency II and the proposal for simple, transparent, and standardized (STS) securitization, which should be swiftly adopted. Beyond these measures, a more ambitious and clearer timeline for deeper institutional changes, such as the harmonization of insolvency regimes, would be beneficial.

50. Macroprudential policies may need to be deployed in some countries, to address nascent real estate bubbles as well as weaknesses in the insurance sector (Figure 7). Marked house price appreciation may require some macroprudential measures, such as limits on loan-to-value ratios. In some countries, the life insurance sector is vulnerable to investment returns falling under guaranteed minimums. Supervisors should respond by encouraging business models to shift towards products less reliant on guarantees and monitor the situation closely. Although it is not vested with supervisory powers regarding anti-money laundering and combating the financing of terrorism (AML/CFT), the ECB could also consider entering into memorandums of understanding

(MoUs) with the designated national authorities to ensure effective AML/CFT supervision and cooperation in line with international standards.

Authorities' views

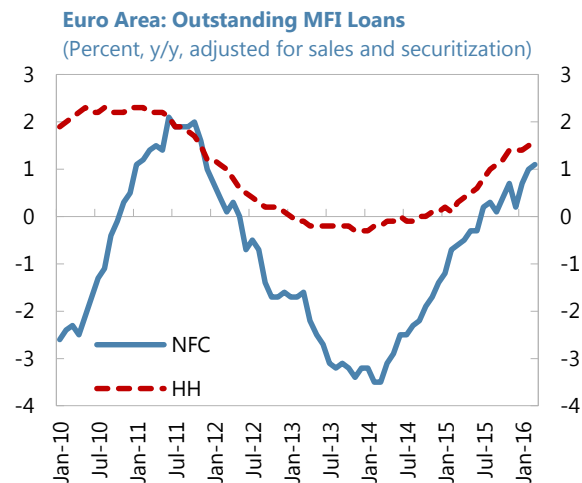
51. **The authorities agreed that the banking system's high NPLs and persistent, low profitability are priorities and stated that tailored approaches are required.** Banks have also responded to the weak earnings environment and heightened regulatory uncertainty by derisking, including by reducing their correspondent bank networks. To restore profitability, banks will need to grow their non-interest income, reduce costs, and adapt their business models to the tougher regulatory and supervisory environment. On NPLs, the ECB will request banks to implement tailored NPL reduction strategies and communicate their plans to address NPLs. However, the pace of NPL reduction will likely be gradual to mitigate the risk of market disruptions and a credit squeeze. Consolidation is also needed, but should be done properly through a mix of mergers, portfolio divestments, and exits, based on sound business plans. Expanding private risk sharing through a capital markets union would be another means of improving the economy's robustness and reducing its reliance on banks.

52. **Deep concerns over moral hazard and possible transfers by some member states have held up progress on banking union.** Further risk sharing through EDIS and a fiscal backstop for the SRF was seen as necessary, even though it may take some time before banking sector risks and moral hazard were deemed sufficiently addressed by some member states. However, the authorities cautioned against holding up completing the banking union by making risk reduction a precondition. They also believed that it was important that any steps to reduce sovereign risk exposures be aligned with global standards.

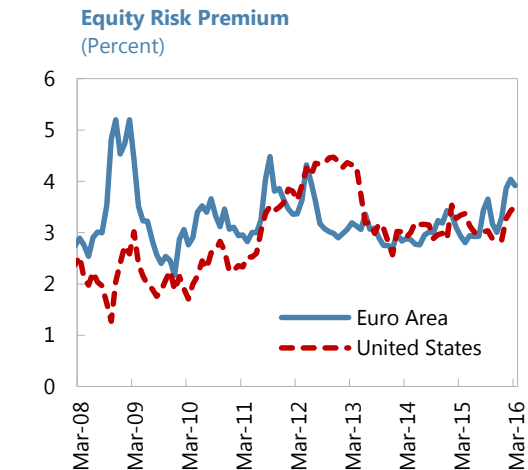
53. **Although financial stability has improved, the authorities highlighted some area for close scrutiny, including real estate and life insurance in some countries.** The authorities also thought that the financial system was more resilient, with higher capital levels and more robust regulatory and supervisory frameworks, in both bank and non-bank financing. However, the challenge of low interest rates for life insurers and pension funds was recognized as a possible issue, but primarily for the medium-term.

Figure 7. Financial Stability

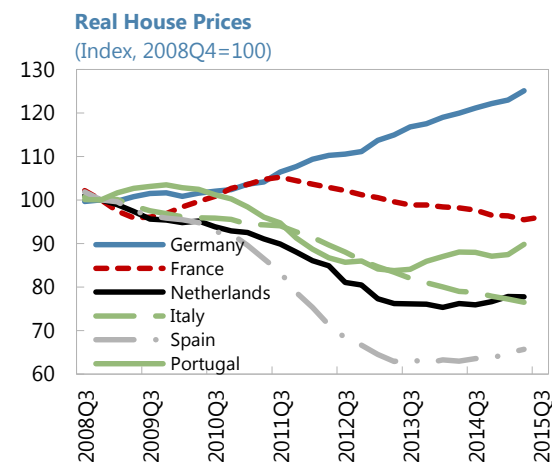
Lending to both households and businesses has risen...



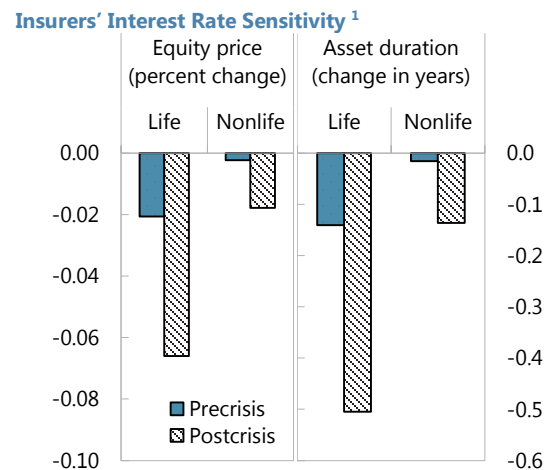
...and the equity risk premium has risen.



House prices have risen in some countries post-crisis.



Life insurers in some countries continue to be vulnerable.



Sources: Bloomberg; Haver Analytics; Eurostat; ECB; IMF, RES-MFU; Figure 3.15, [GFSR \(2016, April\), Chapter 3](#); and IMF staff calculations.

Notes:

¹ The interest rate sensitivity is a measure of the change in the indicated variable for a one percentage point fall in the policy rate.

SYNERGIES FROM COMPREHENSIVE, MORE BALANCED POLICIES

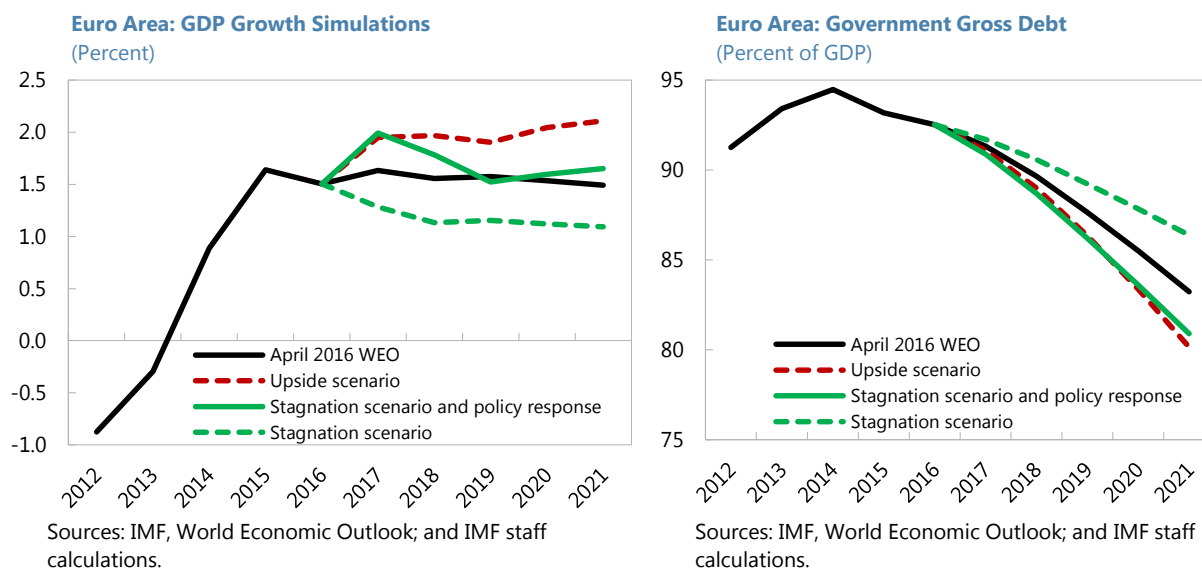
54. **Combining structural, fiscal, and monetary policies would capitalize on important synergies.** Structural reforms—by raising potential output and strengthening the monetary union’s capacity to respond to shocks—can reduce the burden on countercyclical demand policies. Some structural reforms can also bring forward spending by raising expected future output. Faster NPL resolution would enhance the effectiveness of monetary policy by unclogging the credit channel and reducing private debt overhangs. Greater public investment by countries with fiscal space and more growth-friendly fiscal policy would boost both demand and supply, generating positive spillovers within the union. Centrally-financed investment schemes can overcome national fiscal constraints, providing more targeted support to affected countries without increasing national debt stocks and also supporting needed consolidation in high debt countries as recommended by the Fund in some cases. Take together, a collective effort to close output gaps more quickly would lift overall inflation, pushing down real interest rates across the area. Higher inflation and growth in turn would facilitate external rebalancing through relative price adjustments, rather than further painful internal devaluations.

55. **The gains from a comprehensive, more balanced policy mix would be substantial, for Europe and the world.** Using the IMF’s EUROMOD macroeconomic model, staff assessed the impacts of a comprehensive approach, including: (i) continued monetary accommodation by the ECB; (ii) use of existing fiscal space including flexibility under the SGP for structural reforms, amounting to around 0.4 percent of euro area GDP over 2017–18;¹⁸ (iii) centrally-financed investment in the euro area of around 1 percent of GDP for 2017–21 similar to the current EFSI, with some targeting to countries with larger output gaps; (iv) reduced credit risk premia from a cleanup of bank balance sheets, and (v) implementation in 2018 of product and labor market reforms per the G20’s 2014 Comprehensive Growth Strategy. Taken together, the main findings relative to the April 2016 WEO were (text figures):¹⁹

- *Higher growth and inflation.* Euro area growth would be 0.3 percentage point higher on average in 2017 and 2018, closing the euro area output gap by 2018—about two years earlier than currently projected. By 2021, output would be 2.2 percent higher than the baseline, equivalent to another one and a half years of growth at current rates (text figure). Headline inflation would reach 2 percent by 2019 compared to a baseline of only 1.7 percent by 2021.
- *Stronger fiscal positions.* Aggregate euro area public debt would be 3 percent of GDP lower by 2021, with declines larger in high debt countries (4 percent of GDP on average). Fiscal deficits in these countries would also be about 0.4 percent of GDP lower each year, helping to rebuild buffers to guard against future shocks.

¹⁸ Of the 0.4 percent of GDP, about $\frac{3}{4}$ comes from higher spending in Germany due to use of discretionary fiscal space and SGP flexibility. About $\frac{1}{4}$ comes from use of SGP flexibility by non-EDP countries except Italy, which has already made use of SGP flexibility.

¹⁹ See Selected Issues Paper on “Comprehensive, Integrated Policies to Boost Euro Area Growth” for further details.



- *External spillovers.* The euro area's current account surplus would decline to 2.2 percent of GDP by 2021, generating positive spillovers to the rest of the world. Germany's current account surplus would be average of 0.3 percent of GDP lower each year.

56. **A comprehensive approach would also provide valuable insurance against the risk of stagnation.** A similar coordinated policy response applied to the downside stagnation scenario outlined in the previous section would help maintain growth and policy buffers. The results highlight how even a small centralized fiscal capacity can enhance the union's resilience to shocks by complementing common monetary policy and better targeting stimulus. By providing insurance against large shocks through a centralized fiscal capacity linked to a stronger governance framework, countries would have greater incentives to pursue major fiscal and structural reforms, paving the way for further integration and risk sharing.

Authorities' views

57. **A more comprehensive policy approach is desirable but not straightforward to achieve.** The authorities agreed that a more balanced policy mix, including from centralized investment, would be preferable and could have significant benefits for growth and inflation, including in the event of a downturn. However, there is limited appetite in countries with fiscal space to use it, and the challenging political environment would make it difficult to create new mechanisms for centralized or targeted investment support. Political support for such centralized initiatives would require stronger compliance with the fiscal rules and progress in structural reforms.

58. **Nevertheless, the results of staff's comprehensive policy scenario are broadly consistent with the authorities' analysis.** They noted though the potential gains could be lower if inflation expectations were to become unanchored, the costs from balance sheet cleanup were higher, or structural reforms have a disinflationary impact, although this could be mitigated by careful sequencing or other complementary demand support.

STAFF APPRAISAL

59. **The euro area recovery continues with stronger growth in recent quarters.** Domestic demand is leading the recovery, supported by low oil prices, a neutral fiscal stance, and accommodative monetary policy. Exports have slowed in line with weakening external demand. Inflation is extremely low, with disinflation in several countries and inflation expectations adjusting downwards.
60. **The external position has strengthened, but imbalances persist.** The euro area current account surplus rose further, buoyed by a weaker euro and an improved oil balance, and is broadly consistent with its medium-term fundamentals. But progress on external rebalancing within the euro area has slowed. While the current accounts of debtor countries, such as Portugal and Spain, have improved due to competitiveness gains, the surpluses of some large creditor countries, such as Germany, continue to grow.
61. **The medium-term outlook is for steady but modest growth.** Growth remains weighed down by crisis legacies including high unemployment and non-performing loans in some countries. Business investment, particularly by SMEs, is recovering slowly, held back by corporate debt overhangs, while productivity remains well below pre-crisis levels. With the output gap closing only slowly, inflation pressures are expected to remain subdued, raising the adjustment challenge for debtors.
62. **The risks to the baseline have increased markedly.** An external slowdown could disrupt the domestic demand-led recovery. Moreover, political divisions from the refugee surge could deepen, putting at risk the free movement of goods and services within the single market. A “leave” or marginal “remain” vote in the U.K. referendum could lead to heightened uncertainty and fuel further euroskepticism.
63. **The euro area has reached a critical juncture, with strong collective actions needed to strengthen the union.** Monetary policy alone cannot address structural gaps and imbalances. Without more decisive actions to boost growth and strengthen the monetary union, the euro area will remain vulnerable to instability and repeated crises of confidence. And the current “muddling through” policy approach will become increasingly untenable.
64. **Ambitious structural reforms are essential to raise potential growth in the face of demographic headwinds, and to reduce macroeconomic imbalances.** A stronger governance framework, with CSRs linked to outcome-based benchmarks, could better incentivize reforms. Benchmarks should be concrete, measurable and clearly linked to the ultimate reform objective. Candidates include the labor tax wedge, OECD indices on regulatory barriers in professional services, employment protection, and other business climate indicators. Progress towards meeting common benchmarks could also be a precondition to accessing centrally-financed support.
65. **Fiscal support should come from countries that have fiscal space and from an expansion of centralized investment schemes.** Countries with fiscal space should use it to promote public investment and structural reforms, while high debt countries should use interest savings from QE to reduce debt. Centrally-financed investment schemes could provide additional

fiscal support. The EFSI could be enlarged, or new centralized funds established for common projects such as the energy union, refugee settlement, and climate adaptation and mitigation. Over the longer term, a centralized fiscal capacity, such as a euro area treasury, would make the euro area more resilient, helping address large country-specific and common shocks.

66. **Generating political support for expanding centralized investment will require stronger SGP compliance and enforcement.** Stricter adherence to the fiscal rules is critical for rebuilding trust in the fiscal framework and backing for more centralized initiatives. This could be supported by simplifying the fiscal rules, making their enforcement more automatic, and establishing an independent European Fiscal Board. To incentivize adherence to the rules, a country's access to centrally-financed investment schemes could be linked to SGP compliance and implementation of structural reform recommendations.

67. **Monetary policy is appropriately accommodative.** The March easing measures—scaled-up monthly purchases, corporate bond purchases, and the updated TLTRO—should further ease financial conditions and expand credit. Negative interest rates to date have helped lower bank funding costs, improve asset quality and ease lending standards. However, the burden of negative deposit rates falls disproportionately more on banking systems with large excess reserves, while further rate cuts may unduly squeeze banks' net interest margins, especially in countries more dependent on deposit funding, and where large variable-rate mortgage portfolios are prevalent.

68. **If the inflation outlook deteriorates or fails to converge more quickly to the anticipated adjustment path, further easing would be warranted.** This should come primarily from expanding the scope of asset purchases, which would allow scaling-up monthly purchases and/or extending the life of the program.

69. **Bank balance sheet repair should be accelerated.** Bank profitability remains weak, reflecting the mediocre recovery, low rate environment, legacy problems and regulatory uncertainty. The SSM's NPL taskforce should act aggressively to set targets for banks to reduce their impaired assets. This should be accompanied by insolvency reforms and efforts to facilitate distressed debt markets, including through AMCs. In systemic cases where state intervention may be warranted, the EU State Aid rules should be exercised flexibly as permitted. NPL resolution could be part of a broader strategy to foster consolidation in the banking sector and facilitate the exit of nonviable banks.

70. **A common deposit insurance scheme (EDIS) and a common fiscal backstop are essential to complete the banking union.** In parallel with the implementation of EDIS, measures to reduce banking sector risks could be considered, including the prudential treatment of sovereign risk, which should be closely coordinated with global standards. Further progress on the capital markets union could also reduce risks by helping diversify financing sources and fostering greater private risk sharing.

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

Table 1. Euro Area: Main Economic Indicators, 2013–2021

	2013	2014	2015	Projections 1/					
				2016	2017	2018	2019	2020	2021
Demand and Supply									
Real GDP	-0.3	0.9	1.7	1.7	1.7	1.7	1.5	1.5	1.5
Private consumption	-0.6	0.8	1.7	1.7	1.6	1.6	1.5	1.5	1.5
Public consumption	0.2	0.8	1.3	1.5	1.1	0.8	0.6	0.6	0.6
Gross fixed investment	-2.6	1.3	2.9	3.0	2.8	2.7	2.6	2.5	2.5
Final domestic demand	-0.9	0.9	1.9	1.9	1.8	1.7	1.5	1.5	1.5
Stockbuilding 2/	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand	-0.7	0.9	1.8	2.0	1.8	1.7	1.6	1.6	1.5
Foreign balance 2/	0.4	0.0	-0.1	-0.2	0.0	0.1	0.1	0.1	0.0
Exports 3/	2.1	4.1	5.3	3.2	4.2	4.2	4.1	4.1	4.1
Imports 3/	1.3	4.5	6.1	4.1	4.6	4.5	4.3	4.3	4.4
Resource Utilization									
Potential GDP	0.5	0.7	1.0	1.0	1.1	1.2	1.3	1.3	1.4
Output gap	-2.9	-2.6	-2.0	-1.4	-0.8	-0.4	-0.1	0.1	0.2
Employment	-0.7	0.6	1.0	1.1	0.9	0.7	0.8	0.7	0.6
Unemployment rate 4/	12.0	11.6	10.9	10.2	9.8	9.4	9.0	8.7	8.5
Prices									
GDP deflator	1.3	0.9	1.3	1.0	1.0	1.2	1.4	1.5	1.6
Consumer prices	1.3	0.4	0.0	0.3	1.2	1.4	1.5	1.6	1.7
Public Finance 5/									
General government balance	-3.0	-2.6	-2.1	-2.0	-1.7	-1.3	-1.0	-0.7	-0.6
General government structural balance	-1.2	-1.0	-0.8	-1.2	-1.2	-1.0	-0.9	-0.7	-0.6
General government gross debt	93.4	94.5	92.9	92.2	91.2	89.9	88.1	86.3	84.2
External Sector 5/, 7/									
Current account balance	2.2	2.5	3.2	3.1	2.9	2.7	2.6	2.5	2.5
Interest Rates 4/, 6/									
EURIBOR 3-month offered rate	0.3	0.1	-0.1	-0.3	...	...	...	...	...
10-year government benchmark bond yield	3.3	1.5	1.2	1.0	...	...	...	...	...
Exchange Rates 6/									
U.S. dollar per euro	1.37	1.23	1.09	1.13	...	...	...	...	...
Nominal effective rate (2000=100)	108.4	105.5	101.4	104.0	...	...	...	...	...
Real effective rate (2000=100) 6/	96.1	91.3	86.2	87.6	...	...	...	...	...
Sources: IMF, <i>World Economic Outlook</i> , Global Data Source, DataStream, and Eurostat									
1/ Projections are based on aggregation of WEO projections submitted by IMF country teams for Jul 2016.									
2/ Contribution to growth.									
3/ Includes intra-euro area trade.									
4/ In percent.									
5/ In percent of GDP.									
6/ Latest monthly available data for 2016.									
7/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.									

Table 2. 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 deteriorated to -17 percent of GDP in 2009, but has since recovered to around -4 percent in 2015. The improvement was driven by stronger current account balances and modest nominal GDP growth. On a gross basis, the steady rise in both asset and liability positions in the pre-crisis period reversed sharply in 2008, due to a sudden stop of financial flows. Since 2009, gross positions have rebounded, reaching 225 percent of GDP for assets and 229 percent of GDP for liabilities in 2015.</p> <p>Assessment. Projections of continued current account surpluses suggest that the NIIP-to-GDP ratio will continue to improve at a moderate pace, while gross positions will likely remain sensitive to swings in asset prices. Despite recent improvements, some countries with sizeable net foreign liabilities still remain vulnerable to a sudden stop in capital flows.</p>	<p>Overall Assessment: <i>The external position of the euro area in 2015 was broadly consistent with the level implied by medium-term fundamentals and desirable policies. In 2016, the current account is projected to remain broadly unchanged.</i></p> <p>Given still sizeable imbalances at the national level, further adjustment is needed by net external creditors to strengthen domestic demand (reducing surpluses) and net external debtors to raise productivity and competitiveness (raising surpluses or lowering deficits).</p> <p>Potential policy responses: Continued monetary accommodation is appropriate to lift inflation closer to the ECB's medium-term price stability objective, which should also help increase demand and facilitate relative price adjustments at the national level. Monetary easing should be complemented with policies to strengthen private sector balance sheets, structural reforms to enhance productivity and improve competitiveness, and more growth-friendly fiscal policy. Countries should fully use fiscal space where available to expand investment and promote structural reforms, while those without fiscal space should continue consolidating. At the regional level, centralized investment schemes should be explored to support growth. A more balanced policy mix would better boost domestic demand, lift inflation, and rebuild policy buffers, helping to reduce external imbalances, including within the euro area.</p>
Current account	<p>Background. The current account (CA) balance for the euro area strengthened in 2015 to 3.2 percent of GDP (cyclically adjusted 2.6 percent), up from 2.5 percent of GDP in 2014, with two-thirds of the improvement reflecting a higher energy balance from lower oil prices. The CA increase was broad based but reflects different drivers at the national level. The current account of debtor countries, such as Spain and Portugal, improved during the crisis but mainly through import compression. More recently, external competitiveness gains from price and wage adjustments have strengthened these current accounts. On the other hand, the surpluses of some large creditor countries, such as Germany, continue to grow, reflecting still-weak investment and stronger fiscal positions.</p> <p>Assessment. The EBA model estimates a CA gap of -0.3 percent of GDP for 2015, with a CA norm of 2.9 percent of GDP. This calculation of the CA norm, however, does not fully account for factors such as the recent improvements in Germany's demographic outlook reflecting in part the recent refugee wave or the still-large need in Spain to improve the NIIP. Taking into account these factors and the uncertainties in model-based estimates, staff assesses the CA gap to be in the range of -0.5 to 1.5 percent of GDP for 2015, leaving the underlying CA broadly consistent with the level implied by medium-term fundamentals and desirable policies.^{1,2}</p>	
Real exchange rate	<p>Background. The CPI-based real effective exchange rate depreciated by 8.6 percent from 2014 to 2015, reflecting the euro area's weak cyclical position, lower inflation, and the accommodative monetary policy. Compared to the 2015 average, the REER has appreciated by 1.9 percent as of May 2016, as the modest nominal effective appreciation has been offset only partly by weaker inflation in the euro area relative to its trading partners.</p> <p>Assessment. The EBA index REER model points to an overvaluation of 1.3 percent, while the level REER model suggests an undervaluation of around 6 percent; the CA regression model using standard trade elasticities indicates a modest overvaluation. On balance, staff assesses the euro area average real exchange rate in 2015 to be undervalued by 0–10 percent. The REER gaps are large in many member countries, ranging from an undervaluation of 10–20 percent in Germany to an overvaluation of 5–10 percent in Spain. The large differences in REER gaps within the euro area highlight the continuing need for debtor countries to improve their external competitiveness and for creditor countries to boost domestic demand.</p>	
Capital and financial accounts: flows and policy measures	<p>Background. The rise of the CA surplus in 2015 was mirrored by financial outflows on a net basis. In particular, the financial account deficit was driven predominantly by portfolio debt outflows, which were partly offset by increases in portfolio equity inflows.</p> <p>Assessment. The trend of financial flows has followed closely developments in the current account. Capital outflows arise in the context of easing financial conditions due primarily to the ECB's monetary accommodation. Looking ahead, reducing capital outflows would depend crucially on improving domestic growth prospects and institutional and structural reforms that strengthen the resilience of the EMU and raise potential growth.</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, as well as from estimates for the euro area as a whole.</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 (for which no such correction is available).</p>	

Table 3. Risk Assessment Matrix¹

Sources of Risk	Likelihood of Risk (high, medium, low)	Expected Impact of Risk (high, medium, low)	Policy Response
Structurally weak growth in key advanced and emerging economies relative to baseline	High • Weaker than expected demand and inflation due to a failure to fully address crisis legacies and undertake structural reforms.	High • 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. • Increased risk of debt-deflationary spiral.	<ul style="list-style-type: none"> Ease monetary policy to raise inflation, support demand. Repair bank, corporate, and household balance sheets to enhance monetary transmission. Use fiscal space within SGP framework, more centralized investment, and fiscal rebalancing to support demand and promote structural reforms. In an adverse scenario, invoke systemic escape clause in SGP to provide near-term demand support while strengthening medium-term fiscal commitments.
Significant slowdown in China and other large emerging market economies	Low-Medium • Slowdown triggered by corporate distress, deleveraging, uncertainty and capital outflows in China, and the turning of the credit cycle, and disorderly deleveraging of excess leverage in other large emerging market economies.	Medium • Slower export growth, higher output gap. • Lower growth and inflation weakens public debt sustainability and private balance sheets.	<ul style="list-style-type: none"> Accelerate structural reforms to spur investment, productivity and competitiveness, advance rebalancing.
Persistently lower energy prices	High • Persistently low energy prices triggered by supply factors reversing only gradually.	High • Downward pressure on already low inflation. • Somewhat higher growth because of positive impact on disposable incomes.	<ul style="list-style-type: none"> Further monetary policy accommodation (asset purchases by ECB) to address lower inflation, risk of deflation and anchor inflation expectations.
Heightened risk of fragmentation/security dislocation in Europe	High • Slow implementation of the modest EU-level agreements on relocating refugees could deepen political divisions.	High • Lack of refugee integration 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. • Increased investor uncertainty, exacerbating low investment, weak productivity and tepid growth.	<ul style="list-style-type: none"> Refugees should be rapidly integrated into host country labor markets. Collective agreement should be reached on reforming the EU's common border and asylum policy. Temporary costs related to refugee expenditures should be accommodated within current fiscal targets case-by-case.
British voters elect to leave the European Union in the referendum on June 23, 2016.	High • Protracted post-exit negotiations of trade, financial and migration relationships, elevated financial volatility and heightened uncertainty.	High • Escalation of euroskepticism, leading to less cooperation and a reversal of integration.	<ul style="list-style-type: none"> Robust contingency planning for operational risks that may arise in the event of heightened market volatility. Re-double efforts to secure the benefits of economic integration and cooperation across EU.
Sharp asset price decline and decompression of credit spreads	Medium • Investors reassess underlying risk and respond to unanticipated changes in growth and financial fundamentals in large economies, with poor market liquidity amplifying volatility. Weaknesses in the financial and banking sectors become more acute.	Medium • Tightening of financial conditions and deterioration of bank balance sheets. • Bank-sovereign-real economy links could re-intensify via loss of market confidence. • Negative shocks to growth, worsening an already weak growth outlook.	<ul style="list-style-type: none"> Accelerate balance sheet repair to enhance monetary transmission and support credit The ECB should stay the course on asset purchase program and look through temporary episodes of market volatility to focus on its price stability objective
Euro area insurance sector stress from low interest rates	Medium • Stress on life insurer balance sheets due to investment returns falling below minimum return guarantees.	Medium • Absent a unified supervisory or resolution regime, the failure of a mid-size insurer could trigger an industry-wide loss of confidence.	<ul style="list-style-type: none"> Restrict the use of guarantee-based products in favor of unit-linked instruments and encourage alternative long-term, higher-yielding investments subject to proper supervision. Transition to Solvency II framework requires periodic review and regular system-wide stress testing.

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>Reform government spending to reach medium term fiscal objective.</p> <p>Improve labor market functioning to re-absorb the unemployed, especially among the young and low-skilled.</p> <p>Increase competition in service sectors with high economic impact.</p> <p>Pursue business friendly policies.</p>	<ul style="list-style-type: none"> • Pension reform in 2014–15 (higher rates, longer contribution period for full pension, supplementary pension). • Targeted expenditure reviews. • Social security contributions cuts (Responsibility Pact) in 2015–16. • Tax credit (CICE) on firms' payroll on wages below 2.5*minimum wage progressively introduced from 2013–14. • Flexibility on hours and pay for firms in difficulties. • Subsidized jobs for young and low-skilled. • Reduced judicial uncertainty around individual dismissals through reform of the prud'hommes system (Macron law). • Reform of union representation and streamlining mandatory discussions between social partners (Rebsamen law). • Liberalization of legal professions, coach transport, retail trade opening hours. • Expansion of Competition Authority competencies (Macron law). 	<ul style="list-style-type: none"> • Limit general government spending growth to inflation, with burden sharing mechanism. Institutionalize broad spending reviews to improve efficiency at all levels of government. Reverse the growth in public employment at all levels of government. Further raise the effective retirement age and streamline special pension regimes. Tighten caps on local taxes and borrowing, and eliminate "universal competency" clause for municipalities. Improve the targeting of professional training. Alleviate constraints on the supply of affordable housing and improve targeting of benefits. • Improve targeting of social benefits. Tighten eligibility for unemployment benefits and job search requirements for unemployment and welfare benefit recipients. Change the minimum wage formula to limit indexation to inflation while unemployment is high • Further reduce disincentives for SMEs to grow above certain employee thresholds. Enhance effectiveness of Business Simplification process. Align regulated savings rates to market rates and review tax incentives for savings and insurance products.
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>Clarify future energy policy with respect to pricing and infrastructure.</p>	<ul style="list-style-type: none"> • Progress in extending child care provision. Government review of professional regulations and submission of action plan to the EC in January 2016. • Several policy measures were taken in 2015–16 to broaden access to training and active employment services to refugees and some asylum seekers. • The Act to Strengthen Competition in the Railway Sector approved in draft form by the federal cabinet in January 2016. • The Federal Government adopted measures in 2015 to improve environment for venture capital and start-ups. • A draft bill (October 2015) gives priority to underground cables instead of overhead lines for some electricity transmission lines, paving the way for a faster grid expansion. • The cabinet agreed to remove financial disincentives to work after pensionable age (deduction of earnings from pensions and ineligibility to further pension increases from further pension contributions) in May 2016. 	<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.
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 authorities have largely completed OECD recommendations aimed at enhancing competition in key sectors (e.g., sales period, trucks, tourist rentals, milk, bakeries, pharmacies, beverages and petroleum products) and are proceeding with the opening up of some restricted professions (notaries, bailiffs) and liberalization of the market for tourist rentals. • Concrete measures to liberalize a few restricted professions (e.g., engineers), reduction of administrative burdens, and simplification of the licensing system are under discussion. • An independent review of labor market frameworks is underway with recommendations expected in September 2016. 	<ul style="list-style-type: none"> • Preserve recent labor market reforms, including on the minimum wages, which on a GDP per capita basis, is at the top end of the EU countries. Keep the subminimum wage as youth unemployment is high. Adopt legislative changes to align framework on collective dismissals and industrial actions with EU best practices. • Continue opening up regulated professions, giving priority to macro-critical professions (engineers, lawyers and stevedores); Implement pending OECD recommendations to reduce barriers to competition and expand the work to additional sectors (wholesale trade, construction, e-commerce, manufacturing); Continue to reduce administrative burdens. • Continue overhauling the licensing system in line with international best practice targeting food and beverage as well as tourism sectors.

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

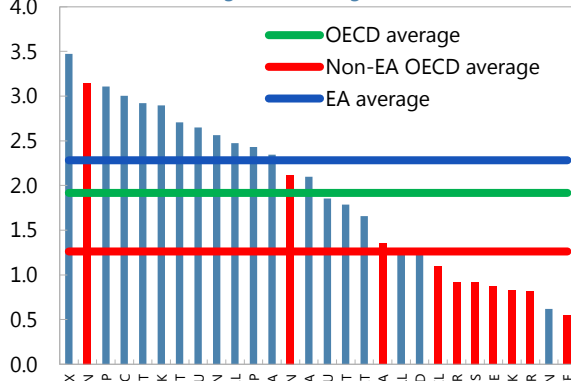
	Reform priorities	Recent progress	Staff recommendations
Italy	<p>Raise public sector efficiency.</p> <p>Civil justice and insolvency reform.</p> <p>Labor market reform.</p> <p>Increase competition in product and services markets.</p>	<ul style="list-style-type: none"> Enabling law on public administration reform approved in 2015 (with plans to accelerate and simplify decision-making processes, rationalize local public enterprises, improve public procurement, etc). Some implementing decrees have been issued; others are planned for 2016. New mandatory mediation schemes, measures to deal with backlog of pending cases and speed up processing (2013). Judicial reform including, reducing leave for judges, better information technology; law on civil liability of judges (2015); procedural reforms and extension of competence of specialized commercial chambers (2015). Provisions to speed up insolvency and liquidation procedures introduced. Improved tax treatment of NPL write-downs and write-offs (June 2015). New reforms include out-of-court mechanisms to enforce secured credit over immovable assets in commercial loans; flexible forms of non-possessory security interests over enterprise assets; and a national registry for insolvency and enforcement procedures (2016). The Jobs Act (Dec 2014) is a comprehensive overhaul of the rigid labor market, reducing duality by introducing a new standard employment contract in which protection increases with tenure, expansion of the social safety net and plans to strengthen active labor market policies. All implementing decrees were approved in 2015. The Annual Competition Law, which proposes measures to address existing regulatory barriers to entry and competition in a wide range of sectors, was approved by the Lower House of Parliament in 2015 and is now under discussion in the Senate. 	<ul style="list-style-type: none"> Implementation and constant monitoring of public administration reform. Enhance the (independent) role of the competition authority to expedite deregulation. Improve the skill-mix in the public sector, match positions with skills, align wages with productivity, simplify functions and procedures, rationalize procurement, and tackle privileges and employment in public enterprises, including through privatization. Further improve the efficiency of civil justice: rationalize types of cases that reach the Supreme Court; further strengthen enterprise courts, translate the specialization afforded by the enterprise courts into more efficient commercial justice (corporate litigation and insolvency). Continue the reform of civil procedure to simplify and reduce enforcement time for secured and unsecured claims. Reinforce resources of the courts and extend best practices in court management across the country. Further decentralize wage setting by reducing constraints to firm-level wage bargaining to align wage increases with productivity growth and alleviate regional disparities in labor outcomes. Strengthen provisions of the annual competition law in line with the recommendations of the competition authority, and ensure an annual process of adopting pro-competition laws. Enhance competition in other areas, including in local public service provision, transport, legal and professional services, as well as fully implement existing legislation (e.g., retail sector).
Portugal	<p>Alleviate impediments to external competitiveness and potential growth.</p> <p>Continue to improve the functioning of labor and product markets.</p>	<ul style="list-style-type: none"> The planning unit of Ministry of Finance has been given a formal mandate by the Council of Ministers to monitor, evaluate, and coordinate structural reforms. 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 3 years. New by-laws for 18 services and regulated professions approved and published. 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. 	<ul style="list-style-type: none"> Revisit reforms that have not yielded the hoped-for results, fully implement already initiated reforms, and address remaining bottlenecks through fresh reforms. Preserve recent and complex structural reforms to improve labor market flexibility and avoid diminishing medium-term prospects for growth, employment and income. Promote managerial skills; more inclusive labor support system; avoid excessive minimum wage increases and find alternative policy tools to fight poverty (e.g., the minimum wage was raised by 5 percent in 2016 with further increases under consideration, and four public holidays eliminated under the program are being restored.) Upgrade the quality of public services and policies, raise effectiveness of public administration at all levels, reviewing the functioning of the courts, and increasing the payment discipline of public sector entities. Continue reducing energy costs and make no new investments in transport infrastructure until energy sector debt is paid off. Strengthen market integration at the European level.
Spain	<p>Address labor market duality and reduce high structural unemployment (especially among the youth and unskilled).</p> <p>Boost productivity and competitiveness particularly for small firms.</p> <p>Facilitate further private sector deleveraging</p>	<ul style="list-style-type: none"> The 2012 labor reform reduced severance payments and eased the use of fair dismissals; facilitated firm-level agreements. Progress toward raising the effectiveness of Active Labor Market Policies has been slow. The implementation of the Market Unity Law is ongoing, but differences in regulatory norms and practices across Spain remain. No actions have been taken to liberalize professional services or reduce size-related disincentives. Insolvency regime: introduction of a “fresh start” for individuals and entrepreneurs; amendments to the out-of-court restructuring mechanism for SMEs, restructuring and liquidation procedures. 	<ul style="list-style-type: none"> Ensure wage growth in line with productivity and external competitiveness, allowing differentiation across firms and sectors; the use of firm-level wage bargaining and opt-out, particularly by small firms; closing the gap between the dismissal costs of temporary and permanent contracts. Reduce legal and administrative uncertainties in collective dismissals and streamline the application of objective criteria for fair dismissals. Strengthen ALMPs and training. Reduce obstacles to firm growth by reducing regulatory burden; swiftly implementing the Market Unity Law; eliminating tax and size-related rules and regulations disincentivizing firm growth; liberalize professional services. Support the internationalization SMEs by helping reduce high fixed costs of exporting. Facilitate private sector deleveraging through legal reform: improving the efficacy of the “fresh start” insolvency framework; facilitating in-court and out-of-court agreements to rehabilitate viable firms; and harmonizing all processes in light of recent changes.

Source: IMF country teams

Figure 8. Structural Reform Benchmarks

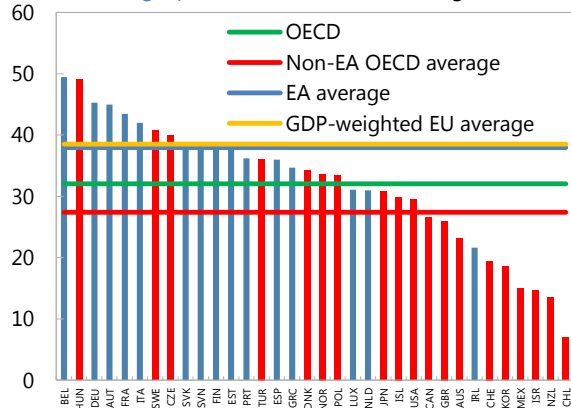
Euro area countries have significantly higher regulatory barriers than other OECD countries.

Regulatory Barriers in Professional Services, 2013
(0 - 6, with 6 being the most regulated)



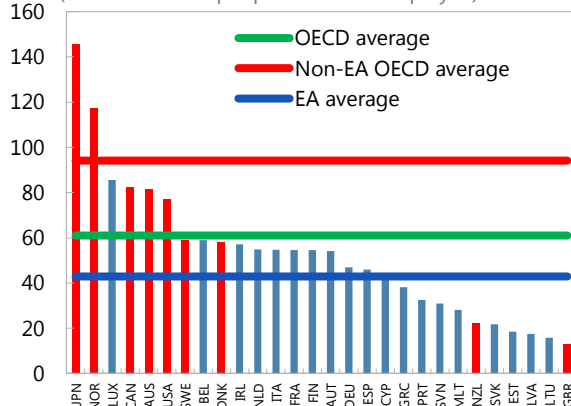
The average labor tax wedge in the euro area lies well above the OECD average.

Low Wage Earner Labor Tax Wedge, 2015
(Percent, single person/no child at 67% average)



Public sector efficiency in the euro area lies well below the OECD average.

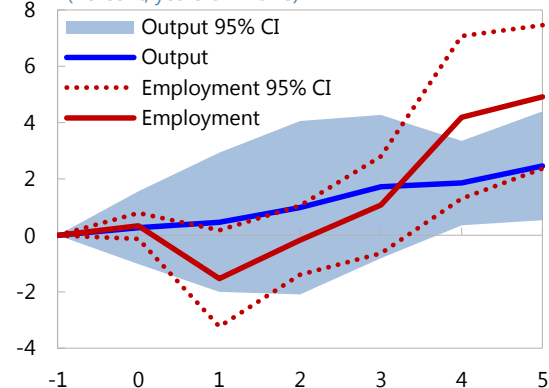
Public Sector Value Added, 2014
(Thousands EUR per public sector employee)



Sources: OECD, Product Market Regulation Database; OECD/IDB Employment Protection Database; Haver Analytics; and IMF staff calculations based on Chapter 3 of the [April 2016 World Economic Outlook](#) (Appendix 3.2 has definitions and methodology) and [IMF Working Paper 16/62](#).

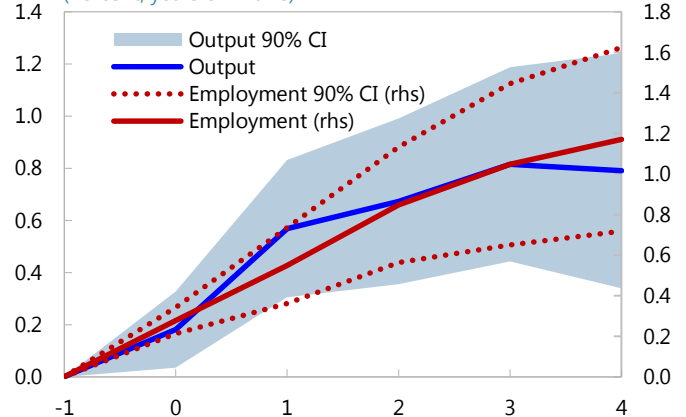
Lower regulatory barriers in professional services would increase output and employment over the medium-term.

Impact of Reducing Regulatory Barriers in Professional Services Sector
(Percent, years on x-axis)



Labor tax wedge cuts can boost output and unemployment significantly.

Impact of Labor Tax Wedge Cuts
(Percent, years on x-axis)



A boost in the quality of public administration can improve output and employment.

Impact of Improving Public Sector Value Added
(Percent, years on x-axis)

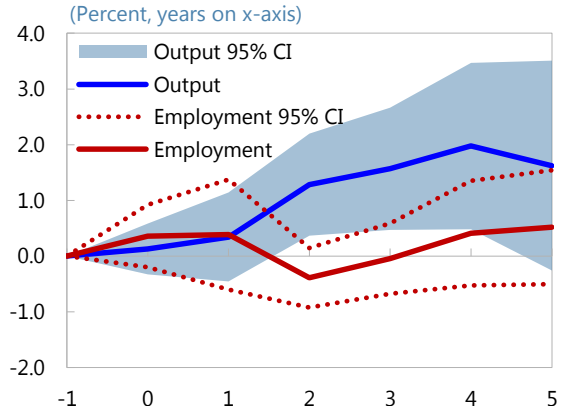


Table 5. A Scorecard Approach to the Near-Term Fiscal Stance¹

	1 - Cyclical Conditions				2 - Sustainability Indicators						3 - Fiscal Stance				
	Output gap	Output gap Change	Unemployment	Real GDP growth	Debt sustainability		10-year bund spreads	Fiscal balances			Change in Overall Structural Balance			Deviation from MTO 9/	Debt rule triggered? 7/ 8/
					stock	flow		Overall	Structural	Under EDP?	WEO baseline	IMF advice over baseline 6/	EC recom. 7/		
	%	%	%	%	GG debt % GDP	MT primary gap 2/ % GDP	bp	% GDP	% pot. GDP		% pot. GDP	% pot. GDP	% pot. GDP	2015	2015
2015	2015-16	2015	2015	2015	2015	2015	2015	2015	2015	2015	2015-16	2015-16	2015-16	2015	2015
Euro area	-2.0	0.5	10.9	1.6	93	2.4	...	-2.0	-0.9	No	-0.2	0.14	0.37		
Germany	-0.1	0.1	4.6	1.5	71	3.0	...	0.6	0.7	No	-0.6	-0.35	0.0	1.2	Yes
France	-2.2	0.2	10.4	1.1	97	1.3	26.9	-3.6	-2.1	Yes	0.0	0.31 4/	0.8	-2.1	No
Italy	-3.3	0.8	11.9	0.8	133	2.6	114.1	-2.6	-0.8	No	-0.4	0.68	0.1	-0.8	No
Spain	-3.5	0.9	22.1	3.2	99	1.0	116.6	-4.5	-2.4	Yes	0.5	0.3 5/	1.2	-2.4	No
Netherlands	-3.6	0.7	6.9	1.9	68	1.9	11.6	-1.9	-0.3	No	-0.2	0.00	0.0	0.2	No
Belgium	-0.8	0.0	8.3	1.4	106	1.4	29.8	-2.8	-2.3	No	-0.1	0.70	0.4	-3.1	No
Austria	-1.3	0.4	5.7	0.9	86	2.4	14.8	-1.6	-0.2	No	-0.9	-0.30	0.1	0.3	No
Finland	-3.1	0.5	9.3	0.4	62	1.1	14.9	-3.3	-1.0	No	0.1	0.00	0.5	-0.5	No
Ireland	-0.5	1.4	9.4	7.8	95	3.2	53.5	-1.6	-1.2	Yes	0.6	0.00	0.6	-1.2	No
Portugal	-3.2	1.2	12.4	1.5	129	2.2	184.9	-4.4	-1.5	Yes	-0.5	0.80	0.60	-1.0	No
Luxembourg	0.7	-0.2	6.9	4.5	22	1.8	-19.7	1.0	0.7	No	0.0	-0.50	0.0	1.2	No
Greece	-6.6	-0.6	25.0	-0.2	178	5.5	933.2	-4.2	-1.1	...	1.2	...	...	-1.1	...
Estonia	-1.3	0.2	6.8	1.1	10	0.6	...	0.5	0.8	No	-0.3	0.00	0.0	0.8	No
Latvia	-0.3	0.2	9.9	2.7	35	1.3	...	-1.5	-1.4	No	0.3	0.20	...	-0.9	No
Lithuania	-1.4	0.9	9.1	1.6	42	0.2	44	-0.7	-0.5	No	-0.2	-0.25	-0.2	0.5	No
Cyprus	-2.8	1.0	15.3	1.6	109	...	...	-1.7	...	...	...	...	...	...	...
Malta	1.7	-0.1	5.3	5.4	64	0.7	...	-1.4	-2.5	...	0.4	...	...	-2.5	...
Slovak Republic	-0.3	0.3	11.5	3.6	53	0.4	31.0	-2.7	-2.6	...	0.5	...	...	-2.1	...
Slovenia	-1.6	0.7	9.1	2.9	83	0.5	...	-3.3	-2.1	...	0.3	...	...	-2.1	...
Memo															
US	-1.6	0.5	5.3	2.4	106	...	156.1	-3.7	-3.0	...	-0.3	...	...	...	...
Thresholds 3/															
Strong tighten	Above 3	Above 1	Below 3	Above 3	Above 100	Below -3	Above 100	Below -3	Below -1		Above 1	Above 1	Above 1	Below -1	
Modest tighten	1 to 3	0.5-1	3 to 5	2-3	90-100	-1 to -3	80-100	-1 to -3	-0.5 to -1		0.5-1	0.5-1	0.5-1	-0.5 to -1	
Neutral	+/-1	+/- 0.5	5-7	1-2	80-90	+/-1	40-80	+/-1	+/-0.5		+/- 0.5	+/- 0.5	0-0.5	+/-0.5	
Modest stimulus	-1 to -3	-0.5 to -1	7 to 10	-1 to 1	70-80	1 to 3	20-40	1 to 3	0.5 to 1		-0.5 to -1	-0.5 to -1		0.5 to 1	
Strong stimulus	Below -3	Below -1	Above 10	Below -1	Below 70	Above 3	Below 20	Above 3	Above 1		Below -1	Below -1		Above 1	

1/ Figures in this table are based on the April 2016 WEO.

2/ Primary gap is P-P*, where P is the structural primary balance as % pot. GDP and P* is the debt stabilizing primary balance in the medium term defined as (r-g)*d, where d is for 2014 and (r-g) is for 2020.

3/ The values for each variable are colored depending on: (i) their signal for the fiscal stance based on the thresholds for sections 1-2, and (ii) change in fiscal stance for section 3.

4/ Enough to exit EDP in 2017.

5/ Enough to exit EDP in 2016.

6/ Source: EUR desks.

7/ Source: EC assessment of draft 2016 budgetary plans (November, 2015).

8/ SGP debt rule is triggered 3 years after a country with debt/GDP > 60 percent reaches its MTO. It requires an annual debt/GDP ratio reduction of at least 2/20 of the difference from the 60 percent target.

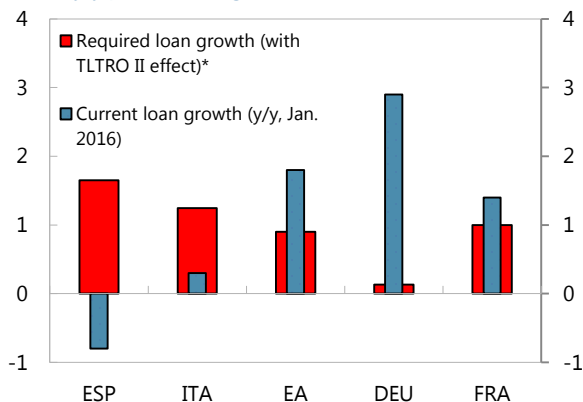
9/ Note: MTO is defined as percent of GDP, while structural balance is defined as percent of potential GDP.

Annex I. The Impact of Negative Interest Rate Policy on Bank Profitability¹

1. **The transmission of negatives rates to the financial markets and broader economy so far has been smooth.** Money markets in the euro area have quickly adjusted to modestly lower deposit rates on banks' excess reserves under the ECB's negative interest rate policy (NIRP), showing that the zero lower bound is less binding than previously thought. Negative policy rates have also passed on to the wider economy by lowering lending rates for both firms and households.
2. **However, going forward, sticky deposit rates could diminish bank profitability and impair pass-through to lending rates.** The transmission of a lower negative marginal policy rate to lending rates reduces bank profits from intermediation unless deposit rates can adjust downwards. So far, many banks have been able to offset declining interest income with higher lending volumes, lower funding costs via capital markets, lower provisioning and capital gains from investments. There has also been some room for deposit rates to adjust downwards, preserving bank profitability, but there is likely to be a lower bound below which disintermediation occurs. This is particularly relevant in countries with high shares of variable rate loans and high dependence on deposit funding, such as Italy, Spain, and Portugal (text figure). Excess bank reserves facing a negative ECB deposit rate are also concentrated in banking systems of surplus countries.
3. **Bank profitability is likely to suffer if low lending growth does not offset diminishing interest margins.** Based on the historical interest pass-through and term premia effects of easing measures, it is possible to determine the minimum annual increase in lending over the average maturity term of the current loan portfolio required to offset the projected decline in net interest margins (NIMs). It is estimated that the combination of NIRP and the recently expanded asset purchase program lowers NIMs of euro area banks in 2016 by 11 basis points on average, with a larger decline in countries with a higher proportion of variable rate loans and a higher cost of risk (such as Italy and Spain). Based on staff analysis, aggregate lending would need to increase 2.3 percent annually (up from 1.8 percent at end-January) for banks to maintain current profitability over the amortization period of their current loan book (text figure, chart 5). The calculation ignores possible improvement in asset quality and increase in asset prices associated with monetary easing.
4. **The ECB's TLTRO II may mitigate the potentially adverse impact of NIRP on bank profitability.** Granting banks access to cheap funding facilitates pass-through of the marginal policy rate to the wider economy. Moreover, it helps maintain profitability in countries where banks face a high cost of risk and/or would refrain from lowering lending rates to preserve profit margins (text figure). In some countries, however, current lending growth remains low and falls below the required benchmark to access TLTRO II funding at the most favorable terms. Therefore, lower funding costs through TLTRO II would benefit only new lending and does not offset the negative impact of asset re-pricing on existing loans.

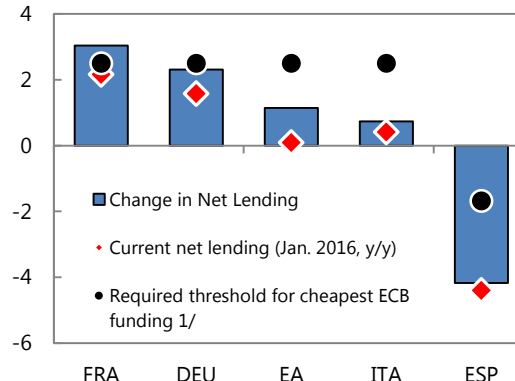
¹ See Selected Issues Paper on "Negative Interest Rate Policy (NIRP): Implications for Monetary Transmission and Bank Profitability" for further details.

Annual Loan Growth Required to Maintain Net Interest Margin, end-2015
(y/y percent change) 1/



Sources: Bloomberg L.P., EBA Transparency Exercise (2015), ECB, SNL, and IMF staff calculations. Note: 1/ based on the historical pass-through of policy rates and the elasticity of net interest margins to changes in term premia between Jan. 2010 and Feb. 2016; total mortgage and corporate loans at end-2015 to EA residents.; scenario assumes an increase of monthly asset purchases (until Sept. 2017) by the ECB and a deposit rate cut of 10bps (as per ECB decision on March 10); */ assumes that new lending is fully funded using TLTRO- I funds at a weighted average borrowing rate of -20bps.

ECB TLTRO-II Benchmarking: Net Lending to Non-Financial Corporates and Households, Dec. 2014-Jan 2016 (Percent)



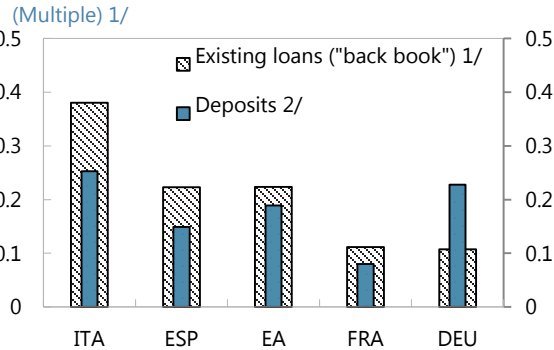
Sources: Bloomberg L.P., Haver, and IMF staff calculations. Note: 1/ Net lending growth required to qualify for TLTRO II borrowing at the ECB deposit rate (-0.4%).

Figure A1. The Impact of Negative Rates on Bank Profitability and Credit Growth Implications

Within the euro area, banks in selected economies will likely reprice lending quicker than deposits, reducing margins ...

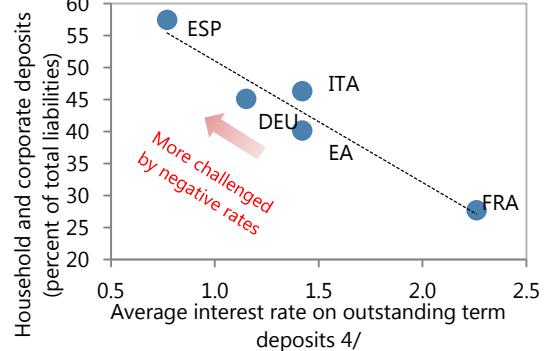
... given the high reliance on a wide deposit base amid rising pressure to rollover expiring term deposits.

Estimated Sensitivity of the Average Rate of the Loan Book and Deposit Rates to a Change in the Interbank Rate, 2006-2015



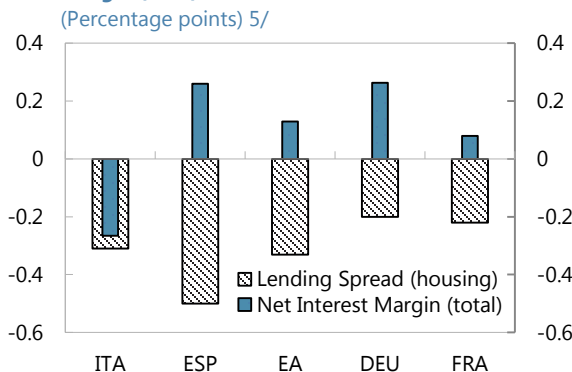
As a result, lending margins have compressed most in countries with high asset re-pricing and stickier deposits ...

Non-MFI Deposits as a Share of Total Liabilities and Interest Rates on Deposits, January 2016 3/



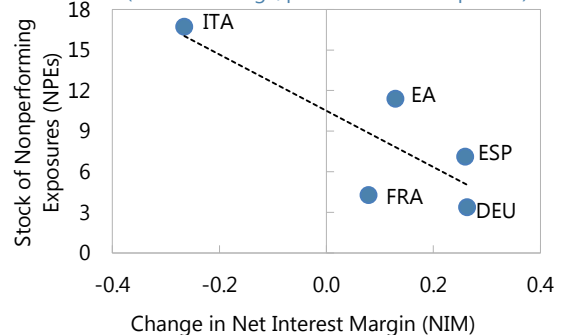
... with higher levels of underprovisioned impaired assets weighing on the capacity of banks to maintain their NIMs.

Change in Lending Spread and Net Interest Margin (NIM)



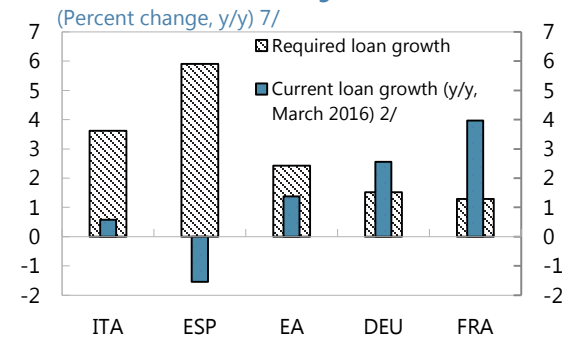
Current loan growth in selected economies is insufficient to offset the impact of declining margins ...

Change in Net Interest Margin and Nonperforming Exposures 6/

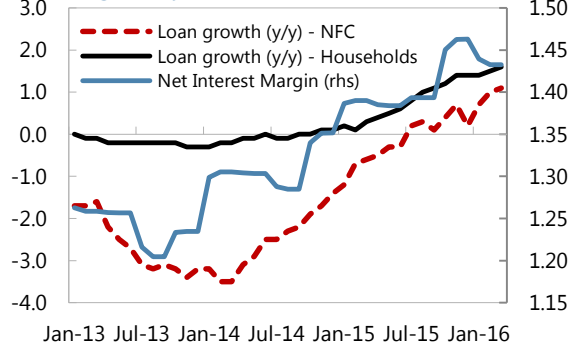


... and recent history suggests that it is unlikely that credit will pick up under these conditions.

Annual Loan Growth Required to Maintain Net Interest Margin, end-2015



Euro Area: Average Net Interest Margin and Credit Growth



Sources: Bloomberg L.P.; Haver Analytics; EBA Transparency Exercise (2015); ECB; SNL; and IMF staff calculations.

Notes: 1 Volume-weighted average based on lending to both non-financial corporates and households.

2 Deposit rate less three-month money market rate.

3 MFI=monetary financial institutions.

4 Other household and non-financial corporates.

5 Calculated for new agreements between June 2014 and Jan. 2016 (lending spread) and June 2014 and March 2016 (NIM). Lending spread is calculated as the difference between the lending rate for new business less the three-month money market rate; the only until Jan. 2016.

6 NPEs as of End-June 2015; change of NIM between June 2014 and March 2016.

7 Based on the historical pass-through of policy rates and the elasticity of net interest margins to changes in term premia between Jan. 2010 and Feb. 2016; total mortgage and corporate loans at end-2015 to EA residents; scenario assumes an increase of monthly asset purchases (until Sept. 2017) by the ECB and a reduction of the deposit rate by 10bps (as per ECB decision on March 10).

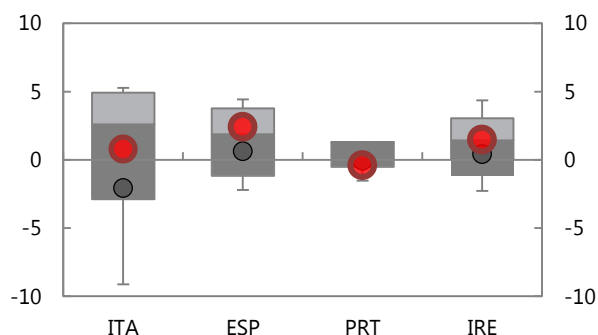
Annex II. Can European Banks Grow out of their Problems?

High levels of NPLs continue to constrain bank profitability and new lending. Staff analysis suggests that while banks in a baseline recovery would be able to generate profits on new lending, thin capital buffers and the legacy burden of NPLs would limit banks' ability to expand credit to realize these profits and support the recovery.

1. **High NPLs continue to weigh on bank profitability and their capacity to grow out of their problems.** For the euro area as a whole, the current stock of NPLs has only declined marginally to €900 billion as of end-June 2015 (down from €932 billion or 9.2 percent of GDP at end-2014), and still more than double the level in 2009. NPL ratios are elevated in some countries, including Cyprus, Greece, Ireland, Italy, and Portugal. At the same time, limited capital buffers and low profitability (owing to weak loan demand and compressed interest margins) undermine banks' capacity to clean up their balance sheets and support the economic recovery.

2. **Most European banks are still able to generate a profit on new lending but the overall returns are low.** To assess the profitability of new lending, staff calculated the net return on equity (RoE) based on publicly reported lending spread component of current net interest margins (NIM), commissions/fee income, and operating expenses of 34 banks in euro area countries with elevated NPLs, using the firm-specific capitalization as implied regulatory leverage.¹ The loan loss provisions were calibrated to the average default risk implied by the firm-specific credit risk weights published in the European Banking Authority's latest Transparency Exercise² and reflect expected losses (consistent with the forthcoming accounting standard IFRS 9) (see text figure).³ Based on this analysis, current lending would be profitable for most banks even under the assumption of forward-looking provisions.⁴ The weighted average net RoE is positive for banks in Ireland, Italy, and Spain, and ordering banks by profitability relative to their contribution to the total lending suggests that nearly all of them generate profits from lending (see text figure). However, the average net RoE of

Estimated Net Return on Equity of Current Lending for Net Interest Margin and Cost of Provisions* as of end-2015 (percent) 1/



Sources: Bloomberg LP, EBA, ECB, SNL, and IMF staff calculations. Note: 1/ Boxplots include the mean (black dot), the 25th and 75th percentiles (grey box, with the change of shade indicating the median), the 90th and 10th percentiles (whiskers) of the sample, and the average value weighted by the share of total loans in each country (red dot). */ provisions are assumed to be forward-looking and calibrated to the expected losses implied by the risk-weighting of domestic credit risk as reported in the EBA Transparency Exercise (2015). For Italy, end-Q3 2015 values were chosen due to significant one-off items in Q4 2015.

¹ The results for Cypriot and Greek banks are not discussed in detail in this Annex.

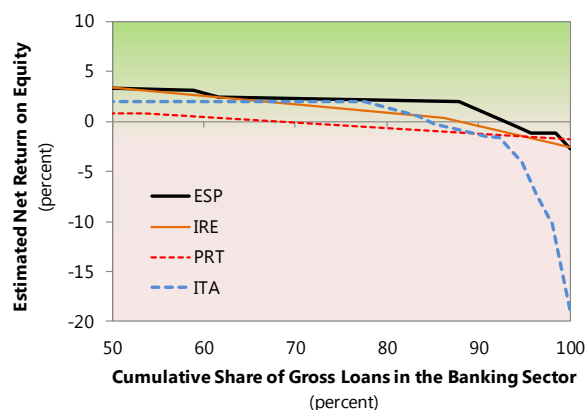
² See European Banking Authority, [2015 Report on EU-wide transparency exercise](#).

³ In the case of Italy, data for end-Q3 2015 was chosen since most banks reported significant one-off increases in LLPs due to the ECB's on-site requests or management decisions to increase coverage.

⁴ The assumption of forward-looking provisions using past loan performance reflected in RWs assumes that (i) banks do not change their loan origination to improve the average credit risk of their banking book, and (ii) debt service capacity of borrowers remains unchanged relative to the historical experience.

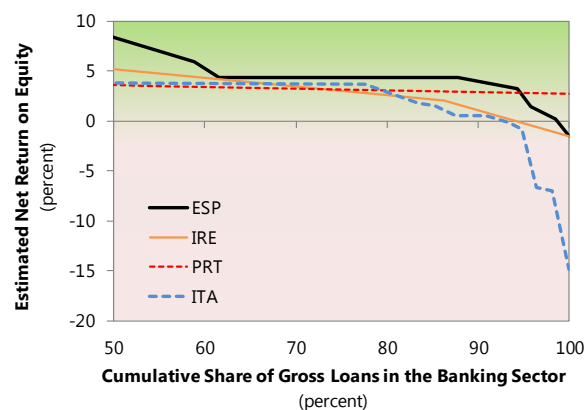
banks in Portugal is negative. While Italian banks are profitable on average (at a net RoE of 0.7 percent), some of the 15 institutions included in this analysis—accounting for about 15 percent of the banking sector (in terms of total outstanding loans)—would incur losses from new lending due to a relatively high cost of risk.⁵

Estimated Net Return on Equity of New Lending at Current Net Interest Margin and Expected Loss Provisioning
(percent), ordered by profitability, end-2015 1/



Sources: Bloomberg L.P., EBA, ECB, SNL and IMF staff calculations. Note: 1/ calculations assume that banks maintain the current net interest margin and capital adequacy ratio as of end-2015, and provision for new loans according to the expected losses implied by the risk-weighting of domestic credit risk as reported in the EBA Transparency Exercise (2015). For Italy, end-Q3 2015 values were chosen due to significant one-off items in Q4 2015.

Estimated Net Return on Equity of New Lending at Current Net Interest Margin and Expected Loss Provisioning (TLTRO II Scenario)
(percent), ordered by profitability, end-2015 1/

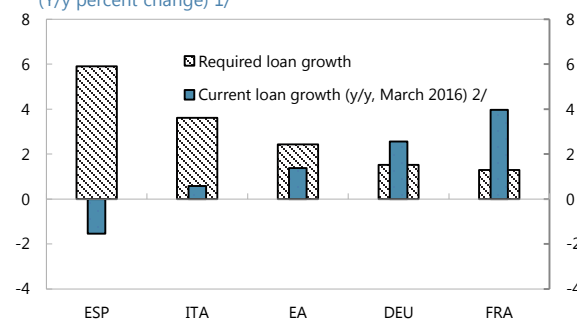


Sources: Bloomberg L.P., EBA, ECB, SNL and IMF staff calculations. Note: 1/ calculations assume that banks maintain the current net interest margin and capital adequacy ratio as of end-2015, and provision for new loans according to the expected losses implied by the risk-weighting of domestic credit risk as reported in the EBA Transparency Exercise (2015). For Italy, end-Q3 2015 values were chosen due to significant one-off items in Q4 2015.

3. The ECB's credit easing would improve euro area bank profitability, but some smaller Italian banks would continue to make losses. In a sensitivity analysis, all sample banks are assumed to participate in the ECB's TLTRO II program as of June 2016 and cease to remunerate deposits, reducing their average funding cost to the ECB's marginal refinancing rate of 0 percent.⁶ Lending rates are considered variable and adjust to the current marginal policy rate and the expected term spread compression consistent with other recent estimates.⁷

Staff calculations show that bank profitability from lending would improve in all euro area countries under these conditions. The average net RoE of Portuguese banks would turn positive. However, lending would remain

Annual Loan Growth Required to Maintain Net Interest Margin, end-2015
(Y/y percent change) 1/



Sources: Bloomberg L.P., EBA Transparency Exercise (2015), ECB, SNL, and IMF staff calculations. Note: 1/ assumes that new lending is fully funded using TLTRO I funds at a weighted average borrowing rate of -20bps.1/ based on the historical pass-through of policy rates and the elasticity of net interest margins to changes in term premia between Jan. 2010 and Feb. 2016; total mortgage and corporate loans at end-2015 to EA residents; scenario assumes an increase of monthly asset purchases (until Sept. 2017) by the ECB and a deposit rate cut of 10bps (as per ECB decision on March 10).

⁵ If reported provisioning according to the existing accounting standard (IAS 39) is applied, the number of loss-making banks declines to three (accounting for about 5 percent of the outstanding stock of loans in Italy).

⁶ This assumption generalizes changes in the cost of funding, which might overstate the actual benefit from improved funding conditions in some countries. For instance, in the case of Italy, only the largest banks in the sample can access capital markets, and many (smaller) banks face tighter liquidity conditions.

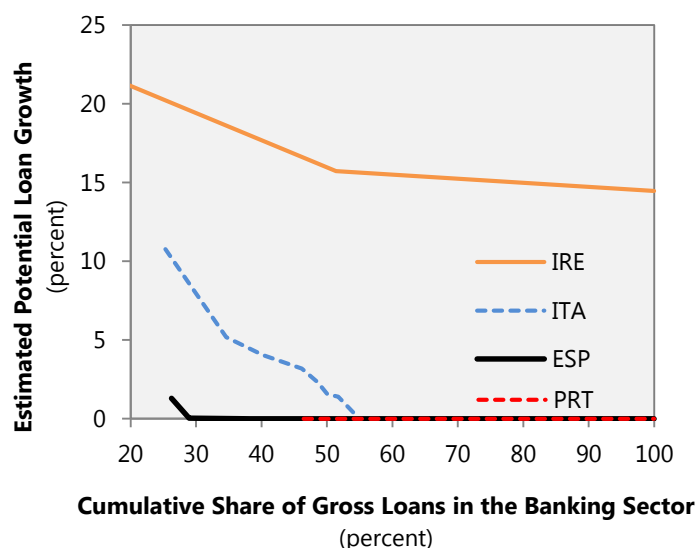
⁷ See Chapter 1 and Box 1.3 of the [April 2016 Global Financial Stability Report](#).

unprofitable for five Italian banks (presenting about 7 percent of the total loan volume of sample banks).

4. **A scenario-based assessment of Italian banks suggests that new lending in a gradual economic recovery would remain profitable in the near term** (see Figure A1).⁸ The procyclicality of credit risk is used to forecast changes in provisioning to cover future expected losses consistent with staff estimates of the current baseline and two adverse macro scenarios for Italy. In addition, both lending rates and funding costs were aligned to the projected changes in short-term and long-term interest rates, after accounting for the funding mix of banks at end-2015. Results for the baseline scenario show that banks would make profits from any new lending over the next five years (at an average net RoE of 3.8 percent), even under more conservative provisioning. However, the additional provisioning cost of legacy loans would remain a considerable drag on expected profitability. Under the stagnation and downside scenarios the average net RoE declines to 0.9 and -5.5 percent, respectively.

5. **However, small capital buffers limit the capacity of banks to offset declining interest margins through higher credit growth.** According to staff estimates, current monetary easing measures could lower the NIM by up to 7 basis points on average during the first half of 2016. This suggests that aggregate lending growth would need to increase to at least 2.4 percent annually (or about 0.6 percentage point above current credit growth) for banks to maintain current profitability over their loan amortization period. However, in most countries, small capital buffers limit the scope for new lending, especially for banks that could earn greater profits. Assuming no change to the current capitalization and credit quality of loan portfolios, only a few banks hold surplus capital in excess of the regulatory minimum.⁹ In fact, capital constraints are highest in those countries where new lending seems more profitable, such as Spain (and to a lesser extent in Italy) (see text figure). Moreover, the continued lack of sufficient credit demand could further delay the improvement of banks' earnings capacity.

Potential Loan Growth Exhausting Available Capital Buffer (CAR)



Sources: Bloomberg L.P., EBA, ECB, SNL and IMF staff calculations. Note: 1/ assumes unchanged capital adequacy ratio (CAR) and overall credit quality of loan portfolio, subject to a capital buffer of 2pcp over the minimum of 12.7% (based on Pillar I (4.5%), capital conservation buffer (2.5%), and Pillar IIA and IIB requirements of 2.7% and 3.0%, respectively); for Italy, the data cut-off was end-Q3 2015 due to significant one-off items in Q4 2015.

⁸ See Italy 2016 Article IV Consultation, Selected Issues Paper on "Profitability and Balance Sheet Repair of Italian Banks."

⁹ The regulatory minimum is defined as the bank-specific capital requirement defined by the ECB's Supervisory Review and Evaluation Process (SREP). The capital buffer is calculated as the difference between CAR and a minimum capital requirement of 12.7 percent (based on Pillar I (4.5 percent), capital conservation buffer (2.5 percent), and Pillar IIA and IIB requirements of 2.7 percent and 3.0 percent, respectively), subject to a structural capital buffer of 2 percentage points.

Policies	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next Steps
Monetary Policies	<p>If inflation and inflation expectations fail to pick up as expected, the ECB should extend the ECB's asset purchase program.</p> <p>Expand flexibility in asset purchases and develop a (proactive) common securities lending framework within the Eurosystem to expand and facilitate market access to national central banks' sovereign bond holdings.</p>	<p>The ECB increased the issue share limited to 33% (from 25%) in September 2015; extended in December the asset purchase program (APP) to March 2017, or beyond, if necessary; included bonds issued by public sector agencies in the purchase program (and widened the eligibility of agency debt twice since their inclusion in the APP); decided to reinvest the principal payments on maturing securities for as long as necessary. In March 2016, a corporate sector purchase program (CSPP) and a new series of four targeted longer-term refinancing operations (TLTRO II) were launched (and started in June), and the monthly purchase was expanded to €80 billion (up from €60 billion).</p> <p>More NCBs have moved from bilateral securities lending to a principal-based securities lending framework via a designated international central securities depository (ICSD).</p>	<p>Maintain monetary easing and if inflation remains below its anticipated adjustment path, stand ready to ease further. Priority should be on credit easing measures over further interest rate cuts.</p> <p>To facilitate access to high-quality collateral, develop a common securities lending framework for NCBs, similar to the ECB's own lending framework. The ECB should also encourage NCBs to lend securities via multiple central counterparties to better distribute collateral through the system.</p>
Fiscal Policies	Use fiscal space and flexibility within the SGP to support investment and structural reforms.	Countries with fiscal space have used it partially to expand refugee-related spending and public investment.	To rebuild buffers and stimulate investment, countries should pursue more growth-friendly fiscal reforms. At the regional level, expand centrally-financed investment schemes to lift near-term and potential growth.
	Focus the fiscal framework on a single fiscal anchor (public debt-to-GDP) and a single operational target (an expenditure growth rule, possibly with a debt correction mechanism) linked to the anchor.	Discussions are ongoing.	To restore credibility and rebuild trust, enhance the fiscal framework through simpler rules with more automatic enforcement and an independent fiscal board.
	Rapid implementation of the EFSI to boost investment.	The European Fund for Strategic Investment (EFSI) has approved over €100 billion in projects so far, mainly in energy.	Accelerate project approvals and disbursement.

Policies	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next Steps
Financial Policies	Complete the banking union by ratifying SRF and accelerating its funding; establishing a pan-European deposit guarantee scheme (DGS); and putting in place a common fiscal backstop for the banking union. Additionally, a relaxation of ESM direct recap preconditions could be considered.	SRF was ratified in November 2015, but a faster timeline for mutualization was not agreed. A proposal for a European deposit insurance scheme (EDIS) was put forward by the EC in October 2015 but is stalled due to objections by some member states. There have been no changes to ESM direct recap preconditions.	The EDIS and a common fiscal backstop are essential to the long-term viability of the banking union. ESM direct recap conditions may need to be relaxed in a systemic crisis.
	Harmonize bank supervisory treatment and the definition of bank capital across the banking union.	An ECB regulation on harmonizing options and national discretions (ONDs) was published in March 2016.	Remaining areas of national discretion in banking supervision should be harmonized, including those related to the use of macroprudential instruments such as loan-to-value ratios.
	Develop a comprehensive strategy for NPL resolution, combining more assertive supervision, structural reforms to enforcement and insolvency regimes, and measures to develop a market for distressed debt.	Write-off rates of NPLs increased in 2015, and the stock of NPLs declined for the first time since the global financial crisis. The ECB's NPL Task Force completed its data collection on countries' and banks' NPL management practices. There are plans to issue NPL reduction targets for identified banks.	Continue to incentivize NPL resolution through stricter supervision, faster insolvency regimes, and deeper markets for distressed assets. In systemic cases, apply EU State Aid rules for public support flexibly.
	Push forward with a capital markets union (CMU), including promoting high quality securitization and removing national differences in capital market infrastructure and regulations.	The EC's legislative proposal for simple, transparent, and standards securitization (STS) from December 2015 is now awaiting approval by the European Parliament. As part of the CMU Action plan issued in September 2015, the EC put out a "call for evidence" on the EU regulatory framework for financial services with a view to assessing overlaps and gaps in the interaction of the individual rules and cumulative impact of the legislation on cross-border transactions.	A more ambitious timeline for capital markets union, including a faster harmonization of insolvency regimes and other deeper institutional changes to create a more integrated capital market.

Policies	2015 Article IV Policy Advice	Actions since 2015 Article IV	Next Steps
Structural Policies	Structural reform priorities at the national level should include labor market reforms to reduce duality and increase employment opportunities, as well as product and service sector reforms to improve the business climate.	Ongoing. Overall, significant progress on financial services and ALMPs, while regulatory reforms to strengthen the business environment and employment, increase female labor market participation, and reduce barriers to competition in the services sector have been slow. See Table 4 for country-specific progress.	Reform priorities include: reducing entry barriers in the professional and retail sectors; improving the efficiency of public administration; and strengthening insolvency regimes; shrinking the labor tax wedge; expanding cost-effective active labor market policies (ALMPs); credible commitment to reducing protections for regular workers and scaling back excessive unemployment benefits. See Table 4 listing country specific recommendations and progress.
	At the regional level, faster implementation of the Services Directive, further improvements to insolvency regimes, and a greater push toward a single market in capital, transport, energy, and the digital economy would help further integration.	In response to the slow implementation of the Services Directive, a new single market strategy for the services sector has been developed since late 2015. There has been progress in implementing the necessary measures to complete the single market in capital, energy, transport, and digital commerce. The negotiations for TTIP are ongoing.	Faster progress in completing the single market in services, energy, digital commerce, and transport and an ambitious TTIP is needed.
	A more effective governance framework would help advance structural reforms, including via using outcome-based structural reform benchmarks.	In December 2015, the Eurogroup agreed to benchmark euro area member states' tax wedge on labor for a single worker at average wage and a single worker at low wage against the GDP-weighted EU average. Benchmarks on service sector regulation and insolvency are being developed. Compliance with the 2015 Country Specific Recommendations (SCR) under the European Semester has worsened relative to that for 2013-14 CSRs. The Excessive Imbalance Procedure was not recommended once again even though several member states have been found to have excessive imbalances for two consecutive years.	To improve enforcement, the 2016 European Semester and MIP should link CSRs to ambitious outcome-based structural reform benchmarks. The following measures could be benchmarked: OECD indices on regulatory barriers in professional services, the number of licenses needed to engage in retail trade, employment protection in work contracts; the World Bank measure of the number of days to enforce a contract, and public sector value added per employee. To better incentivize structural reforms, the economic governance framework needs to be strengthened significantly. The EIP should be opened for repeat offenders.

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

1. **Transition to the new international statistical standards³ is largely complete.** All member states now compile national accounts according to the new European System of National and Regional Accounts (ESA 2010) and many took the opportunity to implement benchmark revisions and introduce other statistical improvements, including to data sources and compilation methods to improve the consistency and completeness of data. Most countries requested derogations in some areas up to 2020. The transition to the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6) is also complete. The ECB's new data reporting requirements on external statistics under BPM6 are more detailed, particularly as regards the instrument breakdown within the various functional categories, and have full stock-flow reconciliation. Eurostat and the ECB continue to work closely with all stakeholders on resolving outstanding issues regarding extending the availability of historical series. The methodology of monetary and financial statistics (e.g., interest rates, investment funds, financial vehicle corporations, securities issues) has also been adapted and new statistics (with more detailed breakdowns) have become available since July 2015.
2. **Flash quarterly GDP estimates are now published at T+30 days.** On April 29, 2016, [Eurostat](#) began publishing preliminary flash estimates of quarterly [GDP](#) for the [euro area \(EA\)](#) and for the [European Union \(EU\)](#) about 30 days after the end of the quarter (t+30). This earlier publication is an achievement of the [European Statistical System](#), as member states contribute by providing their national estimates to Eurostat two weeks earlier than before. The methodology mainly follows the current methodology for the GDP flash estimates published 45 days after the end of the quarter (t+45). The main difference is the use of more preliminary country estimates. Because

¹ Prepared by the European Department.

² The ESS is defined by Article 4 of Regulation (EC) No. 223/2009 of the European Parliament and of the Council on European statistics. The ESCB performs its statistical function on the basis of Article 5 of the Statute of the ESCB and of the ECB.

³ The transition to ESA 2010 is regulated by EU Regulation No. 549/2013 and the transition to BPM6 is regulated by EU Regulation No. 555/2012 and ECB Guideline ECB/2011/23, as amended. Changes to monetary and financial statistics are regulated by the ECB.

of the earlier timing, data for the third month of the quarter often have to be (at least partially) estimated by member states.

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

- A new basic legal act on the *Harmonised Indices of Consumer Prices (HICP) and the House Price Index* entered into force. It provides, amongst others, HICP flash estimates for all euro area member states by the end of each reference month, and indices at the sub-class level of the classification of individual consumption by purpose (level 5). In May 2016, the owner-occupied housing price index was released for the first time. It is a quarterly index based on the 'net acquisition' approach.
- *DG ECFIN is funding two revised and updated versions of the EU KLEMS Productivity and Growth Accounts at the industry level.* The project will cover 34 industries, all EU 28 economies, several EU-aggregates, Japan, and the United States. Sectoral data will be consistent with the European System of National Accounts (ESA 2010) in accordance with the latest industry classification (ISIC Rev. 4/NACE Rev 2). Phase I of the project, from December 2015 to July 2016, will lead to publication of the updated EU KLEMS database starting with 12 countries and covering 1995–2014.
- *European level supply and use tables.* The FIGARO⁴ project, a cooperative effort by Eurostat and the Joint Research Centre of the European Commission, 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 competitiveness, growth, productivity, employment and international trade, and assessment of the position of the European Union and the euro area 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 in summer 2017.
- Significant progress has been made in the drafting of the *Framework Regulation Integrating Business Statistics (FRIBS)* which will expand the coverage of the services sectors and global value chains and improve the timeliness and quality of business and trade statistics. The FRIBS will bring a further integration of international trade statistics, both on goods and services, with business statistics. This improvement of consistency of trade and business primary statistics will better serve accounting systems such as National Accounts and Balance of Payments in the area of international trade in services.
- The *EuroGroup Register (EGR)*—the central European register for multinational enterprise groups—is constantly improving in coverage and quality. Based on the microdata sent by National Statistical Offices, more than 60,000 enterprise groups are now part of this register.

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

The EGR is increasingly used for the production of European business statistics (such as the Foreign Affiliates Statistics—FATS).

- *Further harmonization of data on trade of goods and services.* This will benefit from the ongoing study of discrepancies between national accounts, balance of payments statistics, and international trade in goods and services statistics. The largest gaps are observed in data on imports and exports of goods reported in the international trade statistics compared with the national accounts and balance of payments. Eurostat and the ECB are working on resolving discrepancies.
- The *European Wheel of Competitiveness (EWoC)* is a collaborative project between Eurostat and the DG Joint Research Centre which aims at building a statistical reference framework for competitiveness analyses. It will encompass dimensions which are relevant for competitiveness studies at the European level: macro-economic, micro-economic, globalization, environmental and socio-institutional. Each dimension of the EU Wheel of Competitiveness is described by facets and a set of indicators assessed in the literature and defined in collaboration with experts from various Directorate Generals of the European Commission. The EWoC provides a set of indicators based on comparable and harmonized statistical information and with a large country and time coverage which allows for comparative studies at EU country and industry level and over time. The data are to be disseminated in the second half of 2016.
- Eurostat in collaboration with DG Joint Research Centre has developed new indicators for analyzing the labor and capital productivity components of economic growth: a *Quality-Adjusted Labour Input (QALI) index and a set of capital indicators*. The QALI measures labour input to economic production taking into account the different compositions of the workforce as well as the volume of hours worked. Such an approach provides a more complete picture of labor inputs to the production process as opposed to traditional measures, which focus only on the quantity of labor input (e.g. employment). A time series for the net fixed capital stock, gross fixed capital formation and the average service life of assets has been estimated to provide researchers and policymakers with a set of comparable indicators at country and industry level.

4. **Modernization of intra-EU trade in goods statistics.** Following the demands 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. Two complementary projects SIMSTAT and REDESIGN were recently successfully completed and final reports presented. SIMSTAT was able to prove the technical and statistical feasibility of the micro-data exchange on intra EU exports between the member states as well as the usability of the exchanged data for the compilation of intra-EU imports statistics, REDESIGN allowed the identification of the costs, the benefits and the risks of the main options for the modernization of intra-EU trade in goods statistics. Work is now under way to elaborate a proposal according to the strategic orientation provided by EU member states in May

2016, putting in place the key elements of such a modernized intra-EU trade in goods statistics, and preparing its concrete implementation, including the exchange of micro-data.

5. **Further progress has been made in government finance statistics (GFS) to enhance economic and fiscal governance.** Annual and quarterly ESA 2010-based GFS time series are available for all countries. The revisions to government deficit and debt levels due to the introduction of the ESA 2010 standard occurred in October 2014, and were largely due to reclassification of units in the general government sector. Quarterly non-financial accounts data by subsector of general government are now being collected under the ESA framework. All countries supply detailed COFOG (Classification of the Functions of Government) 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”). Further, in February 2015 and in the context of “Six-Pack”, Eurostat began 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). Work is underway to encourage member states to improve comparability of data across countries. Technical work is also ongoing to harmonize and modernize public sector accounting standards by moving to accruals based accounting in the context of the EPSAS (European Public Sector Accounting Standards) project. An interim technical report is scheduled for the first half of 2016.

6. **Technical work is also ongoing towards modernizing and harmonizing public sector accounting standards in the context of the EPSAS (European Public Sector Accounting Standards) project.** The first EPSAS Working Group meeting took place in Malta in September 2015. The EPSAS Working Group is intended to establish a more permanent forum for public sector accounting standard-setters in Europe and technical experts, at all levels of government. Discussions concern the development, introduction and operation of EPSAS in the mid-to-longer term with a view to informing the Commission’s work regarding EPSAS. The Commission/Eurostat are providing support for accruals implementation of the International Public Sector Accounting Standards (IPSAS) to member states. Ongoing technical work is on first time implementation guidance for accruals accounting, accounting definitions, governance and accounting principles related to standards and public sector specific accounting issues such as tax revenue, relief for small and less risky entities, heritage, or pensions.

7. **The effect of the European Fund for Strategic Investments (EFSI) on GFS remains uncertain.** The EFSI regulation includes a declaration by the Commission regarding the treatment under the Stability and Growth Pact of Member State contributions. The declaration does not change the reporting rules but simply recalls the application of the existing rules. It is expected that the Commission will undertake case-by-case assessments. It is possible that EFSI transactions will be included in government deficits, although this impact would be excluded by the European Commission for the purposes of the Excessive Deficit Procedure, in line with its communication on

flexibility in early 2015. The investments undertaken in the context of EFSI, including Public-Private Partnerships, will be analyzed under the statistical rules in force (ESA 2010 Regulation).

8. **Ongoing efforts aim to enhance statistics for the Macroeconomic Imbalances**

Procedure (MIP). In November 2015, Eurostat published the indicators for the Macroeconomic Imbalances Procedure (MIP) Scoreboard. The MIP Scoreboard provides the statistical basis for the annual Alert Mechanism Report released by the European Commission at the start of the European Semester. The main challenge is the availability of historical time series of sufficient length based on the new statistical standards, although the majority of countries, together with the ECB and Eurostat, are working to calculate the main historical balance of payments series according to the new standards. As a result, data coverage for the ten-year timespan needed for the 2016 Statistical Annex was improved substantially, even if some gaps still remain. Besides the time coverage, the domain coverage also increased from the 2015 release: the list of headline indicators now has three new indicators in the labor market domain: the activity rate, the youth unemployment and the long term unemployment. The new indicators are based on Labor Force Survey results and already cover the needed 10-year span time. The ESS and the ESCB continue to work closely to ensure the quality of MIP-relevant statistics and have developed a quality assurance framework. As outlined in the ESS-ESCB work program on quality assurance of the statistics underlying the MIP, practical arrangements for operationalizing cooperation between the two statistical systems have been put in place. These consist of three elements: (i) an annual high-level ESS-ESCB quality assessment report on statistics underlying the MIP indicators (“level 1”) has been prepared by Eurostat and the ECB (the first report was prepared in 2015); (ii) progressive alignment and harmonization of Quality Reports produced across domains by the ESS and the ESCB in their respective fields of competence (“level 2”) (this action is ongoing); and (iii) publication of condensed country specific reports on the quality and statistical processes of statistics underlying the MIP indicators (“level 3”) (these reports have already been published for the balance of payments and international investment position).

9. **The ECB is working on several projects to enhance the availability and quality of statistics based on new granular databases.**

- *Money Market Statistical Reporting (MMSR).* The ECB Regulation (ECB/2014/48), adopted in November 2014, was implemented in spring 2016. The 52 biggest credit institutions in terms of balance sheets are reporting daily on their individual transactions relating to various segments of the money market. In particular, the transaction-by-transaction data are covering: (i) daily unsecured borrowing transactions with maturity up to and including one year as well as interbank lending; (ii) daily secured lending and borrowing transactions data; and (iii) daily foreign exchange swaps (FX swaps) transactions and overnight index swaps transactions denominated in euro (volume and rates). To ensure standardization, the ECB has developed a common set of reporting instructions, which are fully compliant with the ISO 20022 standard. Some aggregated indicators will be released to the public in early 2017.
- *Securities holdings statistics.* Securities holdings statistics have been collected since end-2013. The data contain quarterly information on holdings of individual securities by institutional sectors, collected after 70 days from euro area (and some other EU) national

central banks, and include reference issuer and securities information from the ECB Centralized Securities Database (CSDB). Additionally, a second module comprises security-by-security information on the holdings by 26 individual euro area banking groups identified as important for the stability and functioning of the financial system in the euro area. The granularity of the data provides a range of breakdowns on both the issuer and holder sides, which are not available in other statistics. Starting in 2016, the timeliness of the data collection on individual banking groups has been reduced to 55 days. It is envisaged to increase, as of 2018, the reporting population to all institutions directly supervised by the ECB.

- *Insurance corporations' statistics.* An ECB regulation (ECB/2014/50) adopted in November 2014 requires insurance corporations to report quarterly their balance sheets beginning in May 2016, and covering data starting with the first quarter of 2016. The granularity and the expected quality of these data will be comparable to balance sheet statistics of other types of financial institutions collected under ECB regulations, such as monetary financial institutions and investment funds. In addition, annual data on premiums, claims, and commissions will be reported. To limit the reporting burden, national central banks may use harmonized European supervisory reports ("Solvency II") to compile the statistics. The first release of the statistics is planned for January 2017. They will replace the current, non-harmonized ECB insurance corporations statistics, which will continue to be compiled until the second quarter of 2016.
- *Harmonized granular credit data (AnaCredit Project).* This initiative aims to establish a long-term framework governing the collection of harmonized granular credit and credit risk data to support many tasks of the ESCB, in particular monetary policy analysis and operations, risk management, financial stability surveillance, and macro-prudential policy. Information will be provided by the Central Credit Registers, maintained by the NCBs or similar granular statistical databases. In December 2015, the ECB published the AnaCredit draft regulation, giving to the public the opportunity to comment until end January 2016. As a result, an amended version of the draft regulation was approved by the Governing Council in May 2016 (ECB/2016/13). First reporting is expected to take place in mid-November 2018 based on data as of September 2018 and will focus on credit granted to legal entities (non-financial and financial corporations, and governments).

10. **In 2015 the ECB enhanced processes for collecting data relating to supervisory tasks.** .

The work of the Supervisory Statistics Division within the ECB's Directorate General Statistics covers the governance framework for the management of data from all supervised groups and individual institutions, including the coordination, receipt, quality management, and reconciliation of supervisory data. The entry into force in 2014 of the EBA's Implementing Technical Standards (ITS) on supervisory reporting significantly increased the amount of comparable information on capital adequacy and financial positions. This framework now includes additional data on forbearance and non-performing loans (with uniform definitions), asset encumbrance, liquidity and leverage. In addition, in March 2015, the ECB published Regulation (ECB/2015/13) on supervisory financial

information, which gradually extends reporting requirements to all supervised entities not yet reporting on the basis of ITS supervisory financial reports (FINREP), with the rollout starting at end-2015. Data collection follows a “sequential approach” whereby banks submit their data to national supervisors, who then report to the ECB, which in turn disseminates selected data to stakeholders.

11. **The latest results of Survey on Access to Finance of Enterprises (SAFE) were published on 1 June 2016.** The report provides evidence on changes in the financial situation, financing needs and access to financing of small and medium-sized enterprises (SMEs) in the euro area in the six months from October 2015 to March 2016, as well as comparing the situation of SMEs with that of large enterprises. In this round, an ad hoc set of questions on the level of liquid assets was included in the questionnaire. SMEs reported increased willingness of banks to provide credit at lower interest rates and signaled a further improvement in the availability of external sources of finance. Finding customers remains their main concern, while access to finance was the least important problem that SMEs faced, although results differ across countries. The results of the next larger survey round, conducted in cooperation with the European Commission and covering all countries in the European Union as well as neighboring countries, will be published on 30 November 2016.

12. **The ECB and Eurostat supported the launch in November 2014 of the Special Data Dissemination Standard plus, the third and highest tier of the IMF’s Data Standards Initiatives.** Six euro area countries (and nine EU member states) adhere to the SDDS Plus.



EURO AREA POLICIES

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

July 1, 2016

Prepared By

The European Department

- This supplement provides information that has become available since the issuance of the staff report.** The information does not alter the thrust of the staff appraisal.
- On June 23, the people of the United Kingdom voted to exit the European Union.** With the announcement by Prime Minister Cameron that he will resign, a new U.K. government is expected to decide when to trigger Article 50 to start the formal and legal process of leaving the EU, and discuss possible new trade arrangements.
- The referendum result surprised financial markets and triggered widespread risk aversion, including in the euro area.** The euro depreciated against the US dollar by 2.2 percent as of July 1 but was broadly unchanged in nominal effective terms. Sovereign yields initially rose in some countries but have significantly declined during the week following the referendum (with the exception of Greece and Portugal) as German Bund yields reached record lows. Equity markets in the euro area initially fell but have since recovered to around 5 percent below their pre-referendum level. Equity declines were led by bank share prices which have fallen by 17 percent, with sharper drops in Greece, Ireland, and Italy. Despite the financial turbulence, there is little evidence to date of market dysfunction: liquidity has not dried up, and most financial prices have recovered partially from their post-vote troughs. This partly reflects the actions and willingness of the Bank of England, the ECB, and other central banks to backstop liquidity in euros and other currencies.
- The U.K. is an important trading partner for the euro area, as the destination for about 13 percent of euro area exports, and also has close financial links with the region.** Its exit from the EU is expected to negatively affect euro area economies through trade, financial and confidence channels. On this basis, staff now project euro area real GDP to grow by 1.6 percent this year and 1.4 percent next year, somewhat lower than the staff report projections (see table). Inflation has also been revised downward slightly in light of the slower pace of growth.

5. **The revised forecast for the euro area is broadly consistent with the “limited scenario” outlined in the 2016 U.K. Article IV report and accompanying Selected Issues paper, in which output in the U.K. is assumed to be 1½ percent below the baseline by 2019.** The mark-downs for the euro area reflect likely weaker investor confidence on account of heightened uncertainty, greater financial market volatility, and lower import demand from the U.K. Given the euro area’s substantial weight in world trade, this slowdown would have spillovers to many other economies, including emerging markets but the impact is expected to be limited.
6. **Looking ahead, the risks to the outlook remain firmly on the downside and are mainly political.** Uncertainty will persist as long as the U.K.’s new status vis-à-vis the EU is not clear. The recommendation in the staff report that collective actions should be taken to improve the governance of the economic union and make it more cohesive remains valid, and has now taken on greater urgency.
7. **Reflecting the U.K. referendum result, staff also updated the euro area page for the External Sector Report** (attached). Specifically, the revised page now notes that the U.K.’s decision to exit the EU does not affect staff’s external assessment for 2015, but may have implications for the assessment going forward, which will be assessed in the context of future ESR and euro area reports. In addition, EBA results and the latest euro real exchange rate movements are updated, reflecting new information after the issuance of the staff report, neither of which affects staff’s assessment of the euro area external position in 2015.

Table 1. Euro Area: Main Economic Indicators, 2016–2018

	2016	2017	2018
Staff report			
Real GDP (percent)	1.7	1.7	1.7
Inflation (percent)	0.3	1.2	1.4
Preliminary forecast update			
Real GDP (percent)	1.6	1.4	1.6
Inflation (percent)	0.2	1.1	1.2

Source: IMF staff estimates.

Table 2. 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 deteriorated to -17 percent of GDP in 2009, but has since recovered to around -4 percent in 2015. The improvement was driven by stronger current account balances and modest nominal GDP growth. On a gross basis, the steady rise in both asset and liability positions in the pre-crisis period reversed sharply in 2008, due to a sudden stop of financial flows. Since 2009, gross positions have rebounded, reaching 225 percent of GDP for assets and 229 percent of GDP for liabilities in 2015.</p> <p>Assessment. Projections of continued current account surpluses suggest that the NIIP-to-GDP ratio will continue to improve at a moderate pace, while gross positions will likely remain sensitive to swings in asset prices. Despite recent improvements, some countries with sizable net foreign liabilities still remain vulnerable to a sudden stop in capital flows.</p>	<p>Overall Assessment: <i>The external position of the euro area in 2015 was broadly consistent with the level implied by medium-term fundamentals and desirable policies. In 2016, the current account is projected to remain broadly unchanged.</i></p> <p>Given still sizeable imbalances at the national level, further adjustment is needed by net external creditors to strengthen domestic demand (reducing surpluses) and net external debtors to raise productivity and competitiveness (raising surpluses or lowering deficits). The U.K.'s decision to exit the EU may affect euro area's external position through trade, financial and confidence channels, which will be assessed in the context of future ESR reports.</p> <p>Potential policy responses: Continued monetary accommodation is appropriate to lift inflation closer to the ECB's medium-term price stability objective, which should also help increase demand and facilitate relative price adjustments at the national level. Monetary easing should be complemented with policies to strengthen private sector balance sheets, structural reforms to enhance productivity and improve competitiveness, and more growth-friendly fiscal policy. Countries should fully use fiscal space where available to expand investment and promote structural reforms, while those without fiscal space should continue consolidating. At the regional level, centralized investment schemes should be explored to support growth. A more balanced policy mix would better boost domestic demand, lift inflation, and rebuild policy buffers, helping to reduce external imbalances, including within the euro area.</p>
Current account	<p>Background. The current account (CA) balance for the euro area strengthened in 2015 to 3.2 percent of GDP (cyclically adjusted 2.7 percent), up from 2.5 percent of GDP in 2014, with two-thirds of the improvement reflecting a higher energy balance from lower oil prices. The CA increase was broad based but reflects different drivers at the national level. The current account of debtor countries, such as Spain and Portugal, improved during the crisis but mainly through import compression. More recently, external competitiveness gains from price and wage adjustments have strengthened these current accounts. On the other hand, the surpluses of some large creditor countries, such as Germany, continue to grow, reflecting still-weak investment and stronger fiscal positions.</p> <p>Assessment. The EBA model estimates a CA gap of -0.2 percent of GDP for 2015, with a CA norm of 2.9 percent of GDP. This calculation of the CA norm, however, does not fully account for factors such as the recent improvements in Germany's demographic outlook reflecting in part the recent refugee wave or the still-large need in Spain to improve the NIIP. Taking into account these factors and the uncertainties in model-based estimates, staff assesses the CA gap to be in the range of -0.5 to 1.5 percent of GDP for 2015, leaving the underlying CA broadly consistent with the level implied by medium-term fundamentals and desirable policies. 1/ 2/</p>	
Real exchange rate	<p>Background. The CPI-based real effective exchange rate depreciated by 8.6 percent from 2014 to 2015, reflecting the euro area's weak cyclical position, lower inflation, and the accommodative monetary policy. Compared to the 2015 average, the REER has appreciated by 1 percent as of June 2016, as the modest nominal effective appreciation has been offset only partly by weaker inflation in the euro area relative to its trading partners. The euro depreciated in the days after the U.K. decided to exit the EU. This decision does not affect staff's external assessment for 2015, but may have implications for the assessment going forward, which will be assessed in the context of future ESR and euro area reports.</p> <p>Assessment. The EBA index REER model points to an overvaluation of 1.2 percent, while the level REER model suggests an undervaluation of around 6 percent; the CA regression model using standard trade elasticities indicates a 1 percent overvaluation. On balance, staff assesses the euro area average real exchange rate in 2015 to be undervalued by 0-10 percent. The REER gaps are large in many member countries, ranging from an undervaluation of 10-20 percent in Germany to an overvaluation of 5-10 percent in Spain. The large differences in REER gaps within the euro area highlight the continuing need for debtor countries to improve their external competitiveness and for creditor countries to boost domestic demand.</p>	
Capital and financial accounts: flows and policy measures	<p>Background. The rise of the CA surplus in 2015 was mirrored by financial outflows on a net basis. In particular, the financial account deficit was driven predominantly by portfolio debt outflows, which were partly offset by increases in portfolio equity inflows.</p> <p>Assessment. The trend of financial flows has followed closely developments in the current account. Capital outflows arise in the context of easing financial conditions due primarily to the ECB's monetary accommodation. Looking ahead, reducing capital outflows would depend crucially on improving domestic growth prospects and institutional and structural reforms that strengthen the resilience of the EMU and raise potential growth.</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, as well as from estimates for the euro area as a whole.</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 (for which no such correction is available).</p>	

Statement by Mr. de Villeroché, Executive Director for France

July 6, 2016

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

The authorities of the euro-area Member States and EU institutions are grateful for open and fruitful consultations with staff and for their constructive policy advice.

The authorities are in broad agreement with staff findings and recommendations. A reinforced policy response to address the underwhelming growth performance is essential. Such a policy response needs to address in a comprehensive way both demand and supply side factors and should focus on responsible and growth-friendly fiscal policy in line with European fiscal rules, building conditions for stronger investment and implementation of structural reforms.

After the publication of the staff concluding statement on 16 June, an important political risk has materialized with the outcome of the UK referendum and makes a convincing policy response to the challenges outlined by the staff more urgent.

Euro area recovery and risks

The authorities broadly share staff's view that in the central scenario the recovery, which has been more robust than expected, is set to continue with the near-term outlook depending crucially on the strength of domestic demand. In 2016, the economic recovery has entered its fourth year and by now economic activity exceeds the pre-crisis peak. Supportive factors in 2016 include still relatively low levels of oil prices and the euro, strong support from a very accommodative monetary policy, and slightly expansionary fiscal policy in the euro area as a whole. However, the growth dynamics are hampered by several factors. Among them are the remaining legacies of the crisis, low potential growth, slowing economic growth in several emerging market economies (including China), but also weak performances in several advanced economies outside Europe. Moreover, the relatively slow expansion of global trade and elevated geopolitical and policy-related uncertainty are weighing on the economic activity in Europe. Regarding the external position, according to Commission's 2016 Alert Mechanism Report, the euro area surplus is considered to be above what could be explained by fundamentals.

The staff's assessment highlights that uncertainty and downside risks to the growth outlook have recently increased. The authorities agree on this assessment. On the external side, risks relate to the expected rebound in emerging markets and the smoothness of Chinese transition, to moves in oil prices and geopolitical tensions. On the domestic side, risks mainly relate to overall policy uncertainty and the capacity to implement common solutions to common challenges. Moreover, one of the risks identified in 2016 Commission Spring Forecast has materialized, with the outcome of the UK referendum, which not in the central scenario of the IMF's forecast. This will affect not only the economy of the UK but also the economy of euro area. The size of the impact will however depend on the forthcoming negotiations. In the near term, political and economic uncertainty during the exit negotiations can lead to financial market tensions and higher risk premia, as well as confidence effects. The medium-term

impact will depend very much on the future bilateral regime between the EU and the UK and the policy response by the EU. In that regard, any assessment of the implications of the exit remains preliminary.

The authorities agree with the medium term outlook presented in the report for the central scenario. We also broadly share the view that the factors responsible for low medium term growth are related to weak investment, population aging and a slowdown of TFP growth. Our own work also supports the view presented in the report that financial legacy issues (over-borrowing and non-performing loans) are important for explaining weak investment. More work is needed to fully understand the slowdown in TFP growth in the euro area. Here the picture differs across euro area economies. More progress needs to be made in disentangling the various factors such as ageing effects, entry barriers, skill mismatch, sectoral change, mis-measurement of value added of services and new consumer products. An important question is also to what extent the crisis has accelerated the productivity decline due to financial constraints on innovators and adopters.

Complete the banking union and accelerate bank balance sheet repair

As a result of supportive monetary policy and the progress achieved towards the Banking Union, financial conditions continue to improve and banks have strengthened their capital and liquidity buffers. Lending rates have declined in the euro area and credit growth has turned positive. According to the latest surveys, companies (including SMEs) do not see availability of bank funding as their main constraint. The authorities expect that, as the recovery firms up, these trends will continue.

Nevertheless, more needs to be done to accelerate and advance bank balance sheet repair across the euro area. Despite some recent decline, non-performing loans (NPLs) ratios remain elevated, especially in some Member States. The authorities agree that addressing this challenge requires a comprehensive strategy combining efforts by bank supervisors, national and, potentially, European policy makers. The legal and institutional framework could also usefully be revisited in many Member States. This includes foreclosure and bankruptcy laws and procedures, the supervisory treatment of provisioning requirements and non-performing and forbore loans, as well as market rules for distressed loan sales and tax rules. Progress on these fronts is currently being made in several Member States. The authorities would have to further explore how the incentives framework can be strong enough for banks to address their NPLs while respecting the applicable EU rules on state aids and on bank resolution (BRRD).

At the same time, banks will need to do their part to restore sufficient levels of profitability – while at the same time recognizing that pre-crisis profitability will not return – e.g. by growing their non-interest income, reducing costs, and adapting their business models to the evolving economic context and technological progress. The authorities agree that further consolidation of the banking system is needed in several countries.

The authorities broadly share staff's views concerning the completion of the Banking Union. Further steps will have to be taken in terms of reducing and sharing risks in the financial sector, in the appropriate sequence, in order to address a number of remaining challenges. The next steps are outlined in the roadmap endorsed by the June Ecofin Council.

Progress is continuing towards the objective of establishing a Capital Market Union in the EU. New rules have already been enacted to support investment by insurers and reinsurers in

infrastructure projects. A legislative proposal to restart securitization markets in Europe was agreed in record time by Member States in December 2015, and is currently being considered by the European Parliament. A proposal was also presented to simplify prospectus requirements and reduce burdens for companies issuing shares and bonds. The authorities are also assessing the submissions received in the context of the so-called "Call for Evidence" with a view to determine whether the EU's legislative framework is working to support growth across the EU.

Strengthen the fiscal framework while assessing centralized support

On the fiscal policy side, the authorities broadly agree with the Fund's assessment that, in line with European fiscal rules, fiscal policies should reflect the economic conditions and sustainability risks at Member State level, while ensuring an effective co-ordination of economic policies. Fiscal adjustment in structural terms came to a halt in 2015 at the euro area level. For 2016 a slightly expansionary fiscal stance is expected for the euro area, before turning broadly neutral in 2017. This is deemed appropriate given the combined need to reduce high debt levels and to support the closure of the output gap. The fiscal effort should be differentiated by individual Member States in compliance with the requirements under the Stability and Growth Pact (SGP), while considering stabilization needs, as well as taking into account possible spillovers across the Member States, including for the euro area as a whole. The authorities fully agree that there is further scope for improving the efficiency of tax systems and reducing the tax wedge on labor. Insufficiently productive expenditure should be further reduced.

Authorities emphasize that a predictable, transparent and consistent application of the SGP is key to fully enforce commitments, to ensure that all Member States are treated equally and to preserve the credibility of the Stability and Growth Pact (SGP) in a protracted phase of low inflation and slow growth. The Commission and Member States are currently discussing ways to improve transparency and predictability and reduce the complexity of the fiscal rules. Options to increase reliance on a single operational target are being explored, while the medium-term budgetary objectives are already in place to anchor fiscal policy. However, a pro-cyclical bias needs to be avoided. Further strengthening of national fiscal frameworks should focus on ensuring their effective functioning to support the conduct of responsible fiscal policies, in compliance with the SGP.

On the windfall from lower interest payments, the authorities agree that countries with high debt should preferably use windfall gains, where available, to make further progress in improving debt positions.

The European Fund for Strategic Investments (EFSI) was successfully launched last year and is expected to have already mobilized investments of over EUR 106 billion in 26 Member States. Work is ongoing to provide public and private project promoters with valuable technical assistance including facilitating access to the EFSI. The European Investment Project Portal launched on 1 June 2016 increases the visibility of investment opportunities across Europe for investors worldwide. The European Commission will propose an extension of EFSI beyond the initially planned time horizon of 3 years, subject to a thorough assessment of its efficacy and impact. While, in the current circumstances, it is important to strengthen short-term and medium-term growth prospects, any additional "centralized investment schemes", as proposed in the report, would need to be carefully assessed. An experts group set

up by the Commission will consider these issues in relation to the second stage under the Five Presidents' Report.

Monetary policy and the outlook for price stability

The ECB's monetary policy remains supportive to the economic recovery. It has decisively contributed to the easing of financing conditions and to supporting the recovery in credit creation to firms and households. Moreover, additional monetary stimulus is expected from the measures that are still at an early stage of implementation, notably from the corporate sector purchase programme (CSPP) and the second wave of targeted longer-term refinancing operations. This will contribute to further rebalancing the risks to the outlook for growth and inflation.

The ECB closely monitors the evolution of the outlook for price stability and, if warranted to achieve its objective, will act by using all the instruments available within its mandate. Obviously, monetary policy does not act in isolation. Solid public finances and structural reforms are crucially important for higher sustainable economic growth in the euro area.

Prioritize structural reforms and their governance

The authorities agree that well-designed and sequenced structural reforms can have a sizeable positive medium-term impact on potential growth and contribute to enhance the adjustment capacity of the euro area. Moreover, the short-term impact of structural reforms in product and labor markets on growth can be maximized if determined implementation boosts confidence. A coordinated implementation of reforms by the Member States can produce higher gains, while synergies with fiscal and monetary policy can generate additional positive spillovers.

Member States have advanced reforms over the last year but the pace of reforms was slower than in the previous year and uneven across countries. There was more progress in addressing country-specific recommendations (CSRs) in Member States experiencing imbalances than in the others, reflecting a larger need for reform, enhanced monitoring including a more regular policy dialogue with the EU institutions and, in some cases, stronger market pressure. While significant progress was observed with regard to CSRs in the areas of financial services and active labor market policies, much remains to be done in other important areas such as addressing weaknesses in the business environment, improving the functioning of labor markets and reducing barriers in the services sector.

The authorities agree on the reform priorities highlighted by the staff. The 2016 European Semester has put particular emphasis on removing barriers to investment, improving the business environment and productivity, making public expenditure more supportive to growth, and improving employment, human capital, social inclusion and protection.

Many efforts have been made to streamline the European Semester in order to increase political ownership and accountability, strengthen its credibility and improve the implementation of the CSRs. A greater focus has been on euro area challenges and on the interdependence between economies. The Commission is progressively putting in place benchmarking and cross-examination exercises across policy or thematic areas, to foster a common understanding of challenges and policy responses and to increase reform implementation. Cross-country analyses and benchmarking exercises have become important tools to support policy advice given in the country-specific recommendations, facilitating a

transparent discussion of best practices and fostering reform implementation in various policy areas.

Reinforcing the Single Market is essential to enhance firms' capacity to innovate, invest, become more productive and create jobs. Complementing the necessary reform efforts of the Member States, the Commission has launched initiatives to reinforce the Single Market and create a business-friendly environment, notably through initiatives to develop a Capital Markets Union; to further deepen the Single Market for goods and services; to create a Digital Single Market; and improve the Single Market in transport and energy.