INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/219

# EURO AREA POLICIES

July 2019

## 2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 Article IV consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 8, 2019 consideration of the staff report that concluded the Article IV consultation with member countries.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 8, 2019, following discussions that ended on May 24, 2019, with the officials at EU institutions on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 20, 2019.
- A **Statement by the Executive Director** for the Dutch-Belgian Constituency, on behalf of the euro area Member States and the European community.

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July 11, 2019

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**IMF Executive Board Concludes 2019 Article IV Consultation on Euro Area Policies**

On July 8, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] on euro area policies with member countries.

Euro area growth slowed in 2018 but is expected to firm up over the course of 2019. Domestic demand is expected to remain resilient on the back of tight labor markets and external demand is projected to improve in the second half of the year. Growth is forecast to pick up from 1.3 percent in 2019 to 1.6 percent in 2020, before moderating to slightly below 1½ over the medium term. Headline inflation continues to exhibit some volatility, mainly due to energy price fluctuations, but core inflation remains subdued. Inflation is projected to take several years to durably converge to the European Central Bank's objective of below, but close to 2 percent.

There are significant downside risks to the outlook. Prolonged or elevated trade tensions could undermine exports and investment. The risk of a no-deal Brexit remains high. If realized, this could cause short-term disruptions for the euro area, as well as longer-term output losses. Countries with high public debt have not consolidated sufficiently leaving them vulnerable to shocks. Even in the absence of a major shock, there is a risk the euro area could experience a prolonged period of anemic growth and inflation.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. Staff hold separate annual discussions with the regional institutions responsible for common policies for the countries in four currency unions—the Euro Area, the Eastern Caribbean Currency Union, the Central African Economic and Monetary Union, and the West African Economic and Monetary Union. For each of the currency unions, staff teams visit the regional institutions responsible for common policies in the currency union, collect economic and financial information, and discuss with officials the currency union's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis of discussion by the IMF Executive Board. Both staff's discussions with the regional institutions and the Board discussion of the annual staff report subsequently are considered an integral part of the Article IV consultation with each member.

(continued…)

**Executive Board Assessment**[2]

Directors welcomed the projected growth recovery, while noting that inflation remained subdued despite stronger wage growth. However, they expressed concerns about risks from rising trade tensions, a possible no-deal Brexit, and vulnerabilities in high-debt countries, and called for appropriately tailored monetary and fiscal policies supported by acceleration of structural and architectural reforms.

Directors agreed that monetary policy should remain accommodative until inflation is sustainably converging to the ECB's objective. They welcomed the recent extension of forward guidance to help achieve a sustained pickup in inflation. Targeted macroprudential policies could be used to address any financial stability risks.

Directors called for fiscal policy to be tailored to country circumstances. While high-debt countries should rebuild lost fiscal space, countries with ample fiscal space should use it to invest in potential growth enhancing areas, such as infrastructure, innovation, and education. Directors encouraged better compliance with the fiscal rules and looked forward to the planned review of the current rules. Directors advised that, in the event of a severe downturn, fiscal policy should more actively support growth, with the fiscal response appropriately differentiated across countries, depending on the severity of the shock, fiscal space, and financing conditions.

Directors called for the acceleration of national structural reforms to address deep-seated productivity and competitiveness gaps and improve economic resilience. They urged deepening the EU Single Market for services and implementing proposals for EU financial support for reforms.

Directors supported the policy efforts to reduce external imbalances. They called on net external creditor countries to implement policies to incentivize domestic investment, which would contribute to reducing external surpluses. They welcomed the EU's efforts to modernize the rules-based global trading system.

Directors welcomed the further increase in the banking sector's capital buffers and the reduction of nonperforming loans, but were concerned about the sector's structurally low profitability. They welcomed progress in implementing the FSAP recommendations, but noted that the overhaul of bank supervision and the review of the bank resolution framework have been delayed. Directors saw merit in consolidating the anti-money laundering oversight at the EU level over the medium term.

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

Directors urged EU policymakers to find a consensus on completing the architecture of the monetary union. They welcomed the agreement on a backstop for the Single Resolution Fund from the European Stability Mechanism and encouraged EU leaders to agree on a common deposit insurance scheme in conjunction with further risk reduction. Directors supported efforts in improving capital markets by enhanced transparency, better regulatory oversight, and more efficient insolvency regimes. Directors welcomed the proposed euro area budget for convergence and competitiveness but saw merit in a central instrument for macroeconomic stabilization.

## Euro Area: Main Economic Indicators, 2016–24

| | 2016 | 2017 | 2018 | Projections 1/ 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|---|---|---|---|
| Demand and Supply | | | | | | | | | |
| Real GDP | 1.9 | 2.4 | 1.9 | 1.3 | 1.6 | 1.5 | 1.4 | 1.4 | 1.3 |
| Private consumption | 1.9 | 1.7 | 1.3 | 1.4 | 1.5 | 1.5 | 1.4 | 1.4 | 1.3 |
| Public consumption | 1.8 | 1.2 | 1.0 | 1.0 | 1.1 | 0.9 | 0.8 | 0.9 | 1.0 |
| Gross fixed investment | 3.9 | 2.7 | 3.4 | 2.8 | 2.7 | 2.5 | 2.3 | 2.1 | 1.9 |
| Final domestic demand | 2.3 | 1.8 | 1.7 | 1.6 | 1.7 | 1.6 | 1.5 | 1.4 | 1.4 |
| Stockbuilding 2/ | 0.1 | 0.0 | 0.1 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Domestic demand | 2.4 | 1.8 | 1.8 | 1.4 | 1.7 | 1.5 | 1.5 | 1.4 | 1.4 |
| Foreign balance 2/ | -0.3 | 0.7 | 0.2 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Exports 3/ | 3.0 | 5.1 | 3.2 | 2.6 | 3.4 | 3.4 | 3.4 | 3.3 | 3.2 |
| Imports 3/ | 4.2 | 3.9 | 3.2 | 3.0 | 3.8 | 3.7 | 3.6 | 3.5 | 3.5 |
| Resource Utilization | | | | | | | | | |
| Potential GDP | 1.2 | 1.4 | 1.3 | 1.3 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| Output gap | -1.2 | -0.3 | 0.3 | 0.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 |
| Employment | 1.4 | 1.6 | 1.5 | 0.9 | 0.6 | 0.4 | 0.3 | 0.2 | 0.2 |
| Unemployment rate 4/ | 10.0 | 9.1 | 8.2 | 7.7 | 7.5 | 7.3 | 7.2 | 7.1 | 7.1 |
| Prices | | | | | | | | | |
| GDP deflator | 0.9 | 1.1 | 1.4 | 1.5 | 1.6 | 1.7 | 1.8 | 1.9 | 2.0 |
| Consumer prices | 0.2 | 1.5 | 1.8 | 1.3 | 1.6 | 1.6 | 1.8 | 1.9 | 1.9 |
| Public Finance 5/ | | | | | | | | | |
| General government balance | -1.6 | -1.0 | -0.5 | -0.9 | -0.8 | -1.0 | -1.0 | -1.0 | -1.0 |
| General government structural balance | -0.8 | -0.7 | -0.6 | -0.8 | -1.0 | -1.1 | -1.2 | -1.1 | -1.1 |
| General government gross debt | 89.2 | 87.1 | 85.1 | 83.7 | 81.9 | 80.3 | 78.7 | 77.1 | 75.6 |
| External Sector 5/, 6/ | | | | | | | | | |
| Current account balance | 3.1 | 3.2 | 2.9 | 2.8 | 2.6 | 2.5 | 2.4 | 2.3 | 2.2 |
| Interest Rates (end of period) 4/, 7/ | | | | | | | | | |
| EURIBOR 3-month offered rate | -0.3 | -0.3 | -0.3 | -0.3 | ... | ... | ... | ... | ... |
| 10-year government benchmark bond yield | 1.3 | 0.9 | 1.2 | 0.9 | ... | ... | ... | ... | ... |
| Exchange Rates (end of period) 7/ | | | | | | | | | |
| U.S. dollar per euro | 1.05 | 1.18 | 1.14 | 1.12 | ... | ... | ... | ... | ... |
| Nominal effective rate (2005=100) | 98.9 | 106.1 | 107.7 | 107.0 | ... | ... | ... | ... | ... |
| Real effective rate (2005=100, ULC based) | 81.2 | 86.7 | 86.2 | 85.6 | ... | ... | ... | ... | ... |

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

1/ Projections are based on aggregation of *WEO* July 2019 projections submitted by IMF country teams.

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ In percent.

5/ In percent of GDP.

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

7/ Latest monthly available data for 2019.

INTERNATIONAL MONETARY FUND

# EURO AREA POLICIES

## STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

June 20, 2019

## KEY ISSUES

After a sharp slowdown starting in 2018, euro area growth is expected to recover over the course of 2019. However, mounting downside risks from global trade tensions, a no-deal Brexit, and market concerns about countries with high public debt emphasize the precarious nature of the forecast. Even in the absence of a major shock, there is a danger that the area could enter a prolonged period of anemic growth and inflation.

Policies should focus on supporting growth while also reducing vulnerabilities.

- The undershooting of the inflation objective calls for prolonged monetary accommodation. This course is not devoid of risks, especially in view of large cyclical differences among countries. Macro-prudential tools should be used as necessary to manage specific financial stability risks.

- Countries with high public debt should pursue a prudent path of gradual fiscal adjustment, even if growth has slowed, to strengthen public finances in case a more severe downturn materializes. Stronger enforcement of fiscal rules would support this. Those with fiscal space should take advantage of low borrowing costs to invest in growth-enhancing spending, which will also help reduce large external surpluses.

- Deep-rooted productivity gaps in some countries call for stronger reform efforts. Further integration in the EU services sector could also boost productivity. At a time when risks loom, reforms would strengthen the resilience to shocks.

- Progress on euro area architectural reforms is essential but has been too slow. Political agreement is needed on a timetable for risk reduction and risk sharing to move forward together.

Central and national authorities need to be ready to respond with additional measures if downside risks materialize. If the inflation outlook deteriorates further the European Central Bank (ECB) should consider further accommodative measures, while keeping a vigilant eye on potential financial stability risks. In a severe economic downturn, euro area countries with available fiscal space should stand ready to implement stimulus. Countries where fiscal space is at risk could temporarily slow down fiscal consolidation relative to the baseline recommendation, provided that their financing conditions remain amenable and debt sustainability is not put at risk.

Approved By
**Poul M. Thomsen (EUR) and Petya Koeva Brooks (SPR)**

Discussions took place during May 13–24. Mission members included M. Pradhan (head), S. Aiyar, B. Barkbu, A. Bhatia, S. Mitra, A. Weber, N. Arnold, L. Lin, D. Garcia-Macia (all EUR), and E. Ture (FAD), joined by C. Ebeke, J. Frie, and L. Rabier (all EUO), and with H. de Villeroché and B. Parkanyi (both EURIMF) as observers. H. Qu, D. Malacrino, X. Shao, J. Siminitz, and C. Rubio supported the mission from headquarters.

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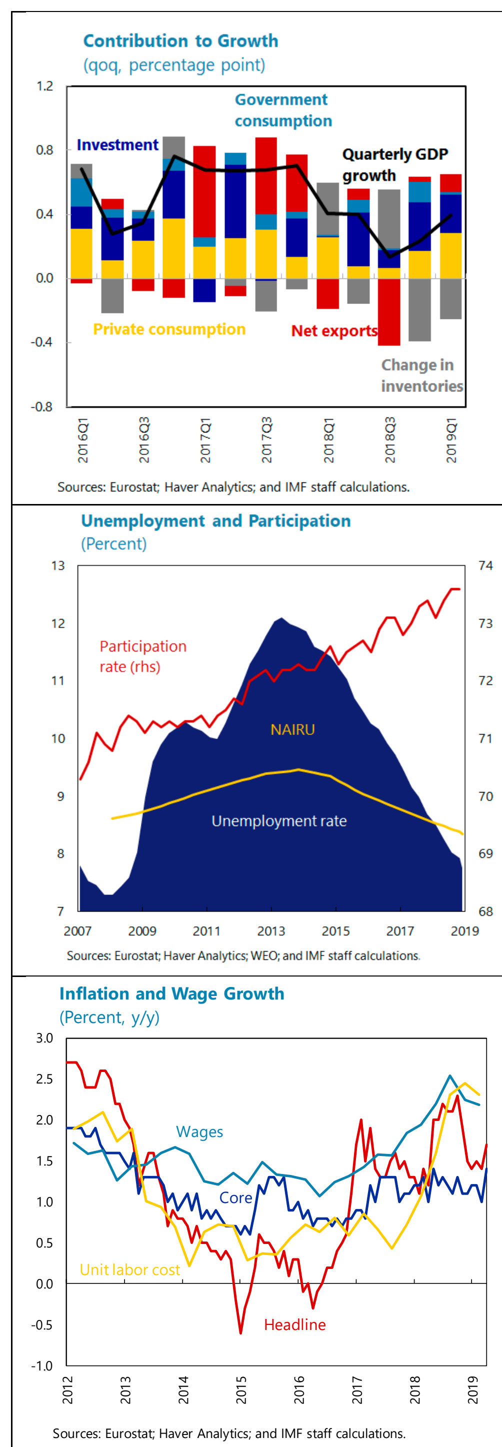
# CONJUNCTURE

## A. Recent Developments

**1. After a long expansion, euro area growth slowed sharply in 2018**. Growth reached a cyclical peak of 2.4 percent in 2017, before moderating to 1.9 percent in 2018. The main source of the slowdown has been weaker external demand, including from Asia, especially China, and also non-euro area European countries. Global trade tensions weakened business confidence in the euro area, holding back investment. And a combination of domestic factors, including disruptions to the German car industry, social unrest in France and policy uncertainties in Italy, further weighed on domestic activity, in particular consumption. As a result, domestic demand also softened, while remaining the key engine of growth.




**2. Despite the slowdown, capacity utilization is high and labor markets tight**. Survey data indicate that capacity utilization, as well as the share of firms experiencing a shortage of labor, reached record levels in 2018. The unemployment rate has steadily declined, reaching 7.6 percent in April 2019—close to the pre-crisis trough. With rising labor force participation, the number of employed persons also reached an all-time high. Consistent with high capacity utilization and tight labor markets, the output gap is estimated to have turned slightly positive in 2018. In the context of the growth slowdown, however, rising employment led to a decline in labor productivity growth in 2018.

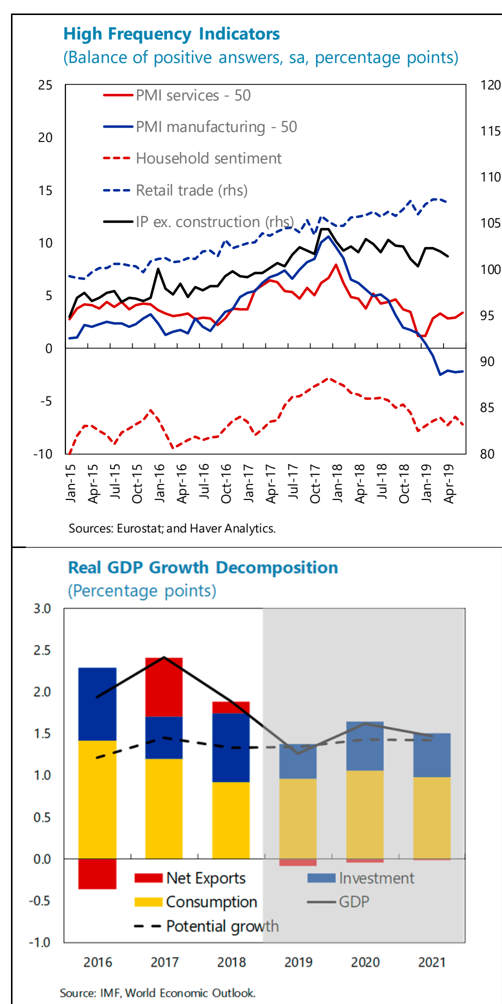
**3. Wage growth has picked up, while core inflation remains subdued**. Spurred by strong labor markets and public sector wage increases in some countries, wages rose by 2.2 percent in 2018, up from 1.6 percent in 2017. Headline inflation reached 1.8 percent in 2018, but has come down in early 2019, reflecting lower energy price inflation. Core inflation inched up by only 0.1 percentage points to 1.2 percent in 2018, despite wage growth picking up and prolonged monetary accommodation.

**4. Economic conditions vary considerably across euro area countries**. While growth slowed substantially in Germany, its output gap—at 1 percent in 2018—is large and positive. Other countries such as France and Spain had small positive output gaps, whereas Italy's output gap was negative at -1 percent. Germany is also experiencing a tight labor market, with an unemployment rate below 4 percent, while Italy, Spain, and Greece still have rates in double digits. Divergence in cyclical conditions has led to inflation differentials, with core inflation rates at 1.3 percent in Germany in 2018, and below 1 percent in France, Italy, and Spain.

**5. Private sector credit is growing at healthy rates, and financial conditions are supportive overall**. Bank lending rates and credit standards were broadly unchanged for both households and firms in the first quarter of 2019, with margins increasing only for riskier loans. As of April 2019, private sector loan growth was 3.6 percent. Short-term money market rates remain below zero, and long-term sovereign bond yields and credit spreads for high-yield corporates have come down in 2019, despite the end of net asset purchases in December 2018. Bank stock prices, which suffered considerable losses in 2018, have recovered partly in 2019, and market volatility has subsided.

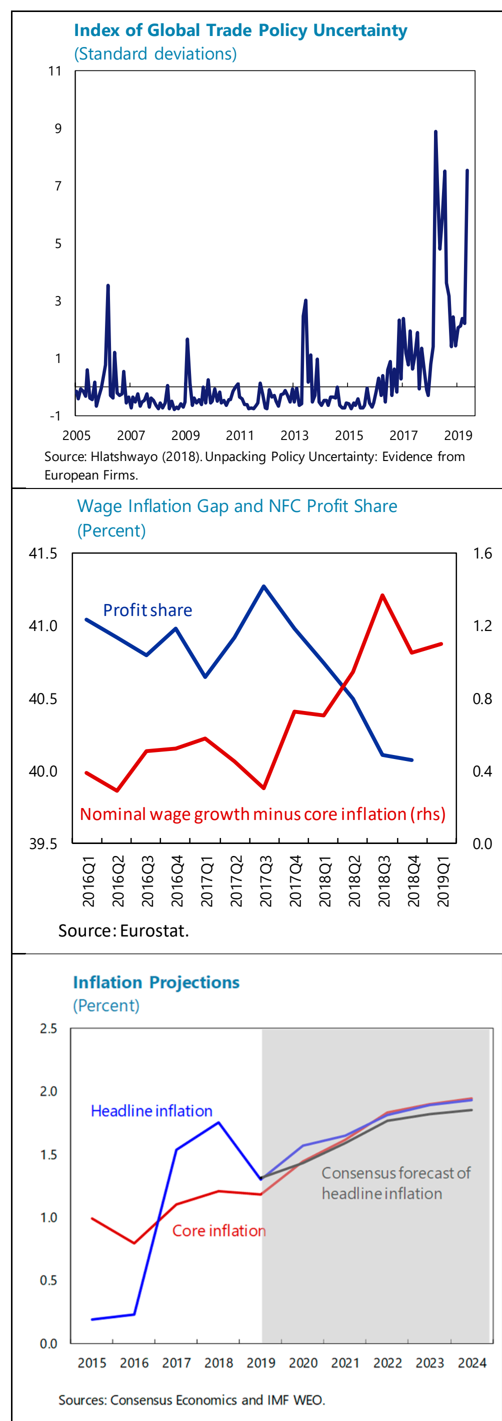
## B. Outlook

**6. High-frequency indicators point to resilience in domestic demand, while external demand remains weak so far**. Domestically driven indicators such as retail trade and construction have been relatively resilient, and the services PMI and household confidence have overall improved since the beginning of the year. However, industrial production remained weak in April. Moreover, the manufacturing PMI and indicators for new orders stayed in contractionary territory through May, corroborated by the sluggish global trade momentum in early 2019.




**7. Growth is expected to pick up modestly in the second half of the year, as external demand recovers and temporary factors wane**. Two key trade partners exceeded expectations in the first quarter, with U.S. growth accelerating and growth in China holding steady. The easing of fiscal policies in a number of Asian countries (including China), as well as the more accommodative monetary stance in major economies, are likely to support global growth. On the domestic front, German car registrations have recovered after the collapse in the second half of 2018, while yellow-vest protests in France are fading. Moreover, the recent employment PMI suggests that strong labor markets will continue to support household demand.

**8. But heightened uncertainty could weigh on growth**. Lack of clarity about Brexit will continue to act as a drag on growth until an agreement is reached. Policy uncertainties in Italy are unlikely to dissipate soon. And despite rapid first quarter growth in the U.S. and China, high-frequency indicators suggest a weak growth momentum in the near term, and increasing trade tensions could further weaken global growth prospects. Overall, real GDP growth is projected at 1.3 and 1.6 percent in 2019 and 2020. The output gap is expected to stay modestly positive over the forecast horizon.




**9. Weaker growth forecasts and lower energy prices have dampened inflation prospects**. Inflation is projected to decline to 1.3 percent in 2019, about 0.4 percentage points lower than in the October 2018 *World Economic Outlook* forecast. Tight labor markets and the forecast pickup in activity are expected to put upward pressure on inflation. There is evidence that firms have compressed profits as labor costs have risen over the past years, thereby holding down inflation, but given the projected strengthening in growth, firms are expected to adjust prices upwards. But the adjustment is likely to be gradual, in line with the high degree of persistence of euro area inflation and the still modest size of the positive output gap.[1] On this basis, inflation is now expected to converge to the ECB's objective only in 2022.

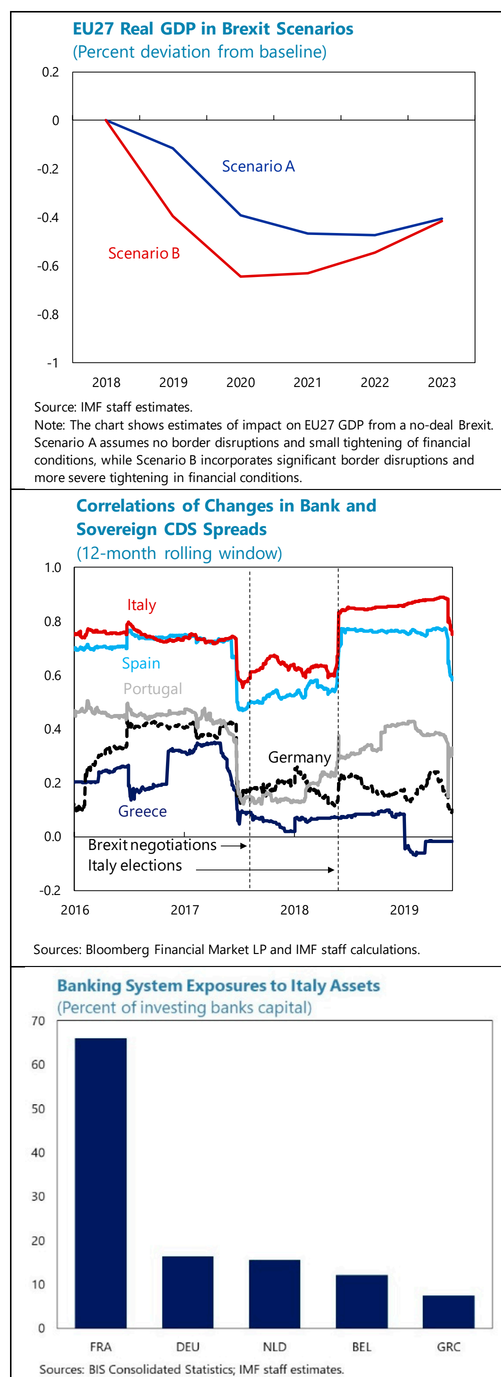
**10. Sluggish productivity growth and demographic headwinds will hold back growth in the medium term and perpetuate divergence in per capita incomes**. Medium-term growth of around 1½ percent on average for the euro area is predicated on persistently muted productivity growth, consistent with limited progress on structural reforms; low investment levels and subsequent sluggish growth of capital stocks in the aftermath of the crisis; and demographic changes, including the aging of the population. Moreover, potential growth rates tend to be lower in lagging

[1] See Abdih, Lin, and Paret, 2018, "Understanding Euro Area Inflation Dynamics: Why So Low for So Long?" IMF Working Paper No. 18/188.

countries such as Italy and Greece—currently projected at about ½ percent—raising the prospect of further income divergence in the medium term absent substantial structural reforms in these countries.[2]

## C. Risks

**11. Downside risks—including those in the near term—have increased**. While each of the risks below could have a substantial impact, they would tend to amplify each other if they materialized synchronously, possibly tipping the euro area into a hard landing.




- **Prolonged—or elevated—trade tensions could dent exports and investment**. An escalation of the U.S.-China trade dispute could result in some trade diversion to the euro area, but any positive growth impact would likely be outweighed by the effect of a deterioration in confidence and weaker global growth. If the U.S. implements tariffs on EU cars exports, based on the investigations into a potential national security threat posed by such imports, ongoing EU-U.S. trade talks could be severely challenged. Such tariffs would likely dent euro area growth, by lowering exports, disrupting supply chains, and through weaker confidence weighing on investment.

- **A no-deal Brexit could bring significant short-run disruptions and long-term losses**. Uncertainty about the shape that Brexit will take remains high. In case of a no-deal Brexit, measures have been put in place to address most cliff-edge risks in the financial sector, although there are some residual concerns (see *financial sector policy section*). However, nonfinancial firms are bracing for significant disruptions, including border delays, a sudden increase in tariffs and nontariff costs, and disruptions to just-in-time supply chains. While the impact is expected to wane over time, higher barriers to trade with the U.K. will inevitably imply some loss in output for the EU even in the long term.

[2] See IMF, 2017, "Euro Area Policies: Selected Issues," IMF Country Report No. 17/236.

- **Some euro area countries that have both high sovereign debt and strong sovereign-bank linkages could come under market pressure**. For example, Italy remains vulnerable to a shift in market sentiment. The agreement with the European Commission (EC) in December 2018 on the 2019 deficit target reduced market pressure on Italian sovereign debt. However, with weak growth outturns, policy tensions could rise, and the risk of policy slippages remains. A change in market sentiment could send both sovereign and bank spreads higher, given the significant sovereign-bank linkages. This could necessitate a sharp procyclical fiscal tightening, further weighing on growth at a time when the economy is weakening. Spillovers to other countries have been contained so far, but some euro area banking systems have considerable exposures to Italian assets. Moreover, other euro area countries with high sovereign debt and strong sovereign-bank linkages could also come under pressure from investors if there were broader shifts in market sentiment.

**12. Even in the absence of a large shock there is the risk that the euro area fails to rebound, instead entering a prolonged period of anemic growth and low inflation**. The forecast uptick in global demand may not materialize in the near term and domestic demand could be less resilient than anticipated. Against a backdrop of weak growth and uncertainty about output gap estimates, inflation could drift lower instead of picking up. And these developments could be compounded by reform fatigue, or even a reversal of structural reforms, holding back productivity growth.

***Authorities' Views*[3]**

**13. The authorities also expect growth to firm up over the coming quarters**. The main impulse would come from domestic demand, following the resolution of temporary factors and supported by higher real income and accommodative policies. Net exports would contribute little to growth in 2019, as global trade is projected to bottom out this year but remain weak amid continued trade policy uncertainty. Over the medium term, the EC expects potential growth to slow down to about 1 percent, driven mainly by the drag on labor supply from population aging, which cannot be fully offset by lower structural unemployment, higher labor force participation, and inward migration.

**14. The ECB expects inflation to remain subdued in the near term, then gradually converge toward its medium-term objective**. Headline inflation will moderate further in the next months, reflecting negative base effects from oil price developments. Core inflation, however, is expected to rise slightly this year and adjust upwards gradually over the forecast horizon. This is in line with a closed output gap, and rising wage growth, which will eventually pass through to inflation.

**15. The authorities also see risks tilted firmly to the downside**. An escalation of trade disputes, Brexit and renewed concerns about Italy represent the main risks. On trade, they worried

[3] The term 'authorities' refers to regional institutions responsible for common policies in the currency union and not to the respective member states' authorities, unless specifically identified by the country's name.

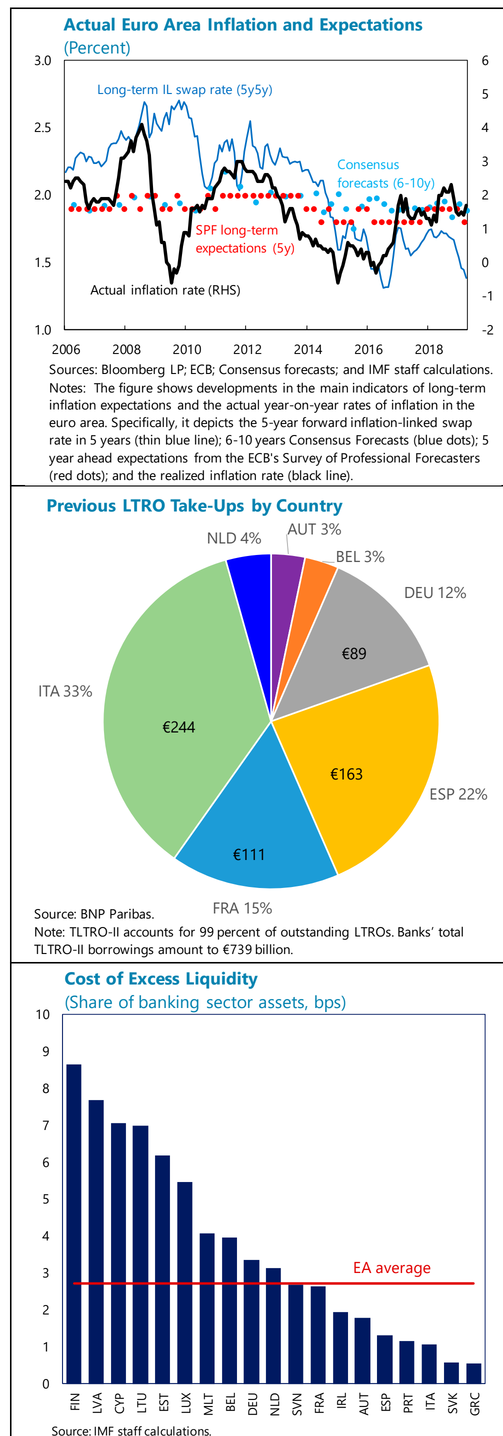
that disputes elsewhere could negatively impact the euro area through global supply chains. If risks were to materialize simultaneously, the situation would be challenging. They highlighted that, even without major shocks, the expected rebound could fail to materialize, with the euro area becoming a "1 percent economy" characterized by low growth and inflation.

# POLICIES

*With the economic slowdown and mounting downside risks, stronger policy efforts will be necessary to support growth and reduce vulnerabilities. This will not be easy, given substantial differences among countries along several dimensions, including cyclical position, fiscal space, and competitiveness. Policymakers at national and central levels need to be ready to respond with more aggressive measures if risks materialize.*

## A. Monetary Policy to Remain Accommodative

*The undershooting of the inflation objective calls for prolonged monetary accommodation, although this is not without risks. Macroprudential instruments should be used proactively to address any potential financial stability concerns. While the baseline forecast still sees a gradual pickup in inflation, the ECB has room for maneuver if the outlook were to deteriorate further.*




Sources: Bloomberg LP; ECB; Consensus forecasts; and IMF staff calculations.
Notes: The figure shows developments in the main indicators of long-term inflation expectations and the actual year-on-year rates of inflation in the euro area. Specifically, it depicts the 5-year forward inflation-linked swap rate in 5 years (thin blue line); 6-10 years Consensus Forecasts (blue dots); 5 year ahead expectations from the ECB's Survey of Professional Forecasters (red dots); and the realized inflation rate (black line).

Source: BNP Paribas.
Note: TLTRO-II accounts for 99 percent of outstanding LTROs. Banks' total TLTRO-II borrowings amount to €739 billion.

Source: IMF staff calculations.

**16. Monetary policy is expected to remain strongly accommodative at least through the first half of 2020**. The ECB intends to fully reinvest maturing securities under the asset purchases program until well beyond the first rate hike, implying a repurchase of about €20 billion per month in a context of falling debt-to-GDP ratios in most euro area countries. Reflecting the global headwinds that continue to weigh on the outlook for growth and inflation, the ECB Governing Council in June 2019 postponed the first rate hike to after mid-2020 at the earliest, and announced the pricing details of the new quarterly series of targeted longer-term refinancing operations (TLTRO III) to be offered between September 2019 and March 2021. The new round of refinancing operations will avoid the cliff-edge contractions of the ECB's balance sheet, as more than

€700 billion of the previous TLTRO program will mature between June 2020 and March 2021. The new funding—for two years instead of the previous four-year facility—addresses liquidity needs for banks, especially in countries with high reliance on TLTROs.

**17. The ECB's intention to maintain ample accommodation for longer is vital**. Given the downward adjustment to the expected inflation path, the ECB's recent postponement of normalization is essential to support the sustained convergence of inflation to the objective. The six-month extension of the calendar-based leg of the forward guidance on interest rates has helped further push out the expected lift-off date; in fact, market expectations of a small rate cut by mid-2020 are rising.

**18. Targeted funding should guard against banks increasing sovereign exposure**. The ECB should ensure that the new funding under the TLTRO III will be channeled to the private sector and does not increase banks' sovereign exposures. The pricing of the new TLTROs should help in this regard. Applicable interest rates will range from a maximum of 10 basis points above the main refinancing operation rate to a minimum of 10 basis points above the deposit facility rate, depending on the volume of eligible net lending. It is appropriate for the ECB to shorten the maturity of the new TLTROs and to offer less generous pricing terms than on TLTRO II to limit banks' dependency and provide incentives for banks to seek alternative funding solutions over time.

**19. Prolonged monetary accommodation is not without risks**. As noted earlier, there is considerable heterogeneity among euro area countries in terms of cyclical position, implying that prolonged accommodation could lead to different outcomes in different economies. For instance, in economies with a positive output gap, financial stability risks could emerge earlier than in other economies. These risks would have to be closely monitored, as would the effectiveness of prudential measures at the national level.

**20. Staff analysis suggests limited benefits of potential measures to mitigate the effects of negative interest rates on bank profits**. The direct costs to euro area banks from excess liquidity amount to only about €7.5 billion (about 0.03 percent of total banking system assets), although effects vary by bank and across countries. A regime of "tiering" that would exempt some portion of reserves from the ECB's negative deposit rate would therefore have a very small impact on aggregate bank profitability and a questionable impact on credit conditions, since it may lead banks to further build up excess reserves rather than lending. Overall, the direct costs of negative rates are likely outweighed by their positive indirect effects on aggregate demand and bank profitability.[4]

**21. If the inflation outlook were to be substantially downgraded or inflation expectations continued to decline, further and stronger accommodation may be necessary**. The ECB's monetary policy toolkit includes a broad set of instruments, including forward guidance, negative policy rates, asset purchases, and bank liquidity facilities. The exact instruments and sequencing

[4] See Jobst and Lin, 2016, "Negative Interest Rate Policy: Implications for Monetary Transmission and Bank Profitability in the Euro Area," IMF Working Paper No. 16/172.

used to achieve a further expansion should be guided by the specific circumstances. For instance, there may be only limited room to cut rates further as diminishing returns set in. The asset purchase program could be resuscitated, while remaining anchored by the capital key, and possibly broadened to include a larger set of eligible assets.[5] Further credit easing measures—such as new, cheaper liquidity facilities for banks—could also be considered, although their effectiveness could be constrained by lingering weakness in bank balance sheets.

**22. Resuming balance sheet expansion in a downside scenario creates risks, but these are likely outweighed by the risks of doing too little**. A larger ECB balance sheet, other things equal, would be more difficult and complex to unwind, especially if the asset purchase program expands to cover new asset classes. Moreover, as noted earlier, there is considerable heterogeneity among euro area countries in terms of cyclical position, implying that further accommodation could lead to different outcomes in different economies. For instance, in those economies with a positive output gap, more generalized financial stability risks could emerge earlier than in other economies even if they are not in evidence at the current juncture. These considerations must be set against the larger risk of a prolonged period of below-target inflation and anemic growth, damaging ECB credibility.

**23. Looking much further ahead, when the time comes for normalization, the path of the ECB's balance sheet should be flexibly calibrated while remaining anchored by the capital key**. In the near term, ECB policies aimed at maintaining low long-term yields are helped by Bund scarcity. Staff research finds that the relative scarcity of German bonds has increased their premium over other sovereign assets (Box 1). This, combined with the projected decrease in the German government debt stock, will exert further downward pressure on the long end of the yield curve, potentially complicating the process of monetary policy normalization over the longer run. Moreover, with safe asset supply being a key determinant of government bond yields, changes in government debt issuance can lead to rapid changes in financial conditions outside of the ECB's control, underscoring the need for flexibility on the reinvestment strategy.

***Authorities' Views***

**24. The ECB considers that strong monetary accommodation remains necessary to ensure sustained convergence of inflation to its objective**. It noted that it had managed the end of net asset purchases by enhancing its reliance on forward guidance on the path of policy rates, thereby maintaining a very accommodative policy stance. A new series of TLTROs was announced to preserve favorable lending conditions. Factors that are holding back inflation, such as firms compressing profit margins, are expected to unwind over the medium term. While 5y/5y measures of inflation expectations have come down, this is seen as mainly reflecting increased risk premia, with survey-based measures remaining more robust.

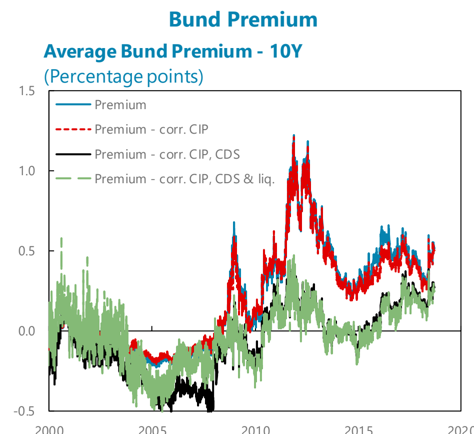
[5] The capital key refers to the share of ECB capital provided by each euro area member, and is used to determine the distribution of sovereign asset purchases.

## Box 1. Is There A Bund Premium?[1/]

**Are Bunds special?** Staff has estimated the "Bund premium" as the difference in convenience yields between German government bonds and other sovereign safe assets (the G10 currency countries and large euro area countries) adjusted for exchange rate and sovereign credit risk, liquidity as well as swap market frictions.[2/] A larger wedge suggests that there is a price premium, equivalent to an interest rate discount, and hence less substitutability of sovereign bonds.

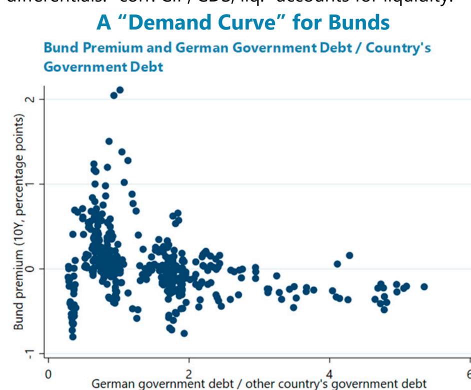
**There has been an increase in the Bund premium following the crisis**. Prior to and at the beginning of the global financial crisis, the German bond premium was negative, with U.S. treasuries being more attractive. This is in line with past research arguing that there is a "specialness" to U.S. treasuries since the U.S. dollar is the world's most significant reserve currency. However, more recently, the Bund premium has increased, both *vis-à-vis* other G10 currency countries overall and large euro area countries. The European debt crisis stands out, possibly reflecting periodic redenomination risk in the euro area.

**Bund Premium**




Source: Bloomberg, Markit, WEO, and IMF staff.
Notes: Average premium vs. G10 currency countries plus G7 euro area. "Corr. CIP" corrects for FX swap market mispricing, "corr. CIP, CDS" also accounts for credit risk differentials. "corr. CIP, CDS, liq." accounts for liquidity.

**A "Demand Curve" for Bunds**




Source: Bloomberg, Markit, WEO, and IMF staff.

**The rising premium reflects the extreme scarcity of German government bonds**. There is a negative relationship between the Bund premium and the supply of Bunds relative to other advanced economy debt. Panel analysis confirms that this relationship is robust and more pronounced for longer-dated German bonds and when uncertainty and volatility are high. These findings are in line with a model in which preferred habitat investors, prefering bonds from a specific sovereign and maturity, and arbitraguers coexist. The fact that German Bunds are now the most highly sought-after collateral, with financial institutions preferring them over cash for collateral purposes, suggests that preferred clienteles are significant.

**These findings have important monetary policy implications**. German bond yields are eurozone benchmark yields. German sovereign debt is projected to shrink over the coming years, further compressing Bund yields. While these scarcity effects are beneficial in helping the ECB maintain low long-term yields in the near term, they could complicate the process of monetary policy normalization over the longer run.

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1/ See Paret and Weber, 2019, "German Bond Yields and Debt Supply: Is There A 'Bund Premium'?" IMF Working Paper (forthcoming).

2/ Australia, Canada, Denmark, France, Italy, Japan, New Zealand, Norway, Spain, Sweden, Switzerland, U.K., and U.S.

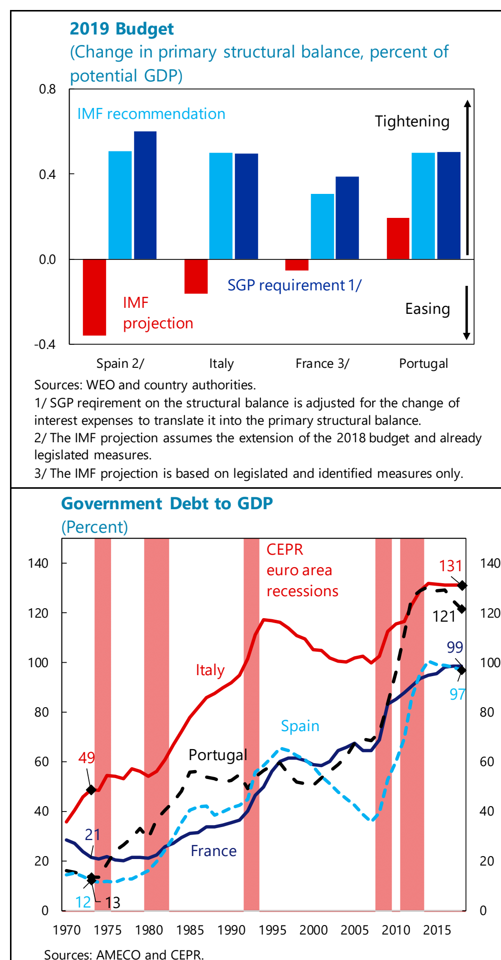
**25. The ECB is closely monitoring potential negative side effects on bank intermediation from its negative interest rate policy**. So far, the overall impact of negative interest rates has been positive. But the effects of compressed net interest margins on bank profitability may become more pronounced over time. The ECB regularly reviews the impact of its policies on bank-based intermediation, with a view to determining whether mitigating measures are needed.

**26. The ECB emphasized that its reaction function is well designed to respond to further delays in inflation convergence**. In particular, it views further adjustments to the calendar-based leg of its forward guidance on interest rates as an effective way to push the distribution of market expectations of the liftoff further into the future and preserve favorable financing conditions. The calibration of the parameters of the new series of TLTROs reflects an assessment of the bank-based transmission channel as well as evolving macroeconomic conditions. Should the medium-term outlook deteriorate significantly, the ECB stands ready to adapt all monetary policy actions necessary and proportionate to achieve its objective, using the variety of instruments it has at its disposal to deliver on its mandate.

## B. Fiscal Policies to Support Growth and Reduce Vulnerabilities

*Countries with fiscal space should invest in growth-enhancing spending. Those with high public debt should pursue a more prudent path of gradual fiscal adjustment, even if growth is slowing, to reduce vulnerabilities. Stronger enforcement of the EU fiscal rules would support debt reduction. In a severe economic downturn, greater fiscal stimulus would be needed, with the response differentiated in line with country-specific circumstances. Such fiscal easing would strengthen the impact of accommodative monetary policy.*

**27. The sum of national fiscal balances is expected to be modestly expansionary in 2019**. The fiscal impulse for the euro area as a whole (as measured by the change in the structural primary balance) is estimated at 0.3 percent of potential GDP in 2019. Germany is expected to ease by around 0.6 percent and the Netherlands by 0.4 percent. For Germany though, there is a risk that the fiscal outturn will be less expansionary than currently forecast, as it has strongly overperformed fiscal projections in recent years, especially on revenue. Staff projects a nearly 0.4 percent of GDP easing in Spain, a 0.2 percent of GDP loosening in Italy, and broadly neutral stances for France and Portugal.




Sources: WEO and country authorities.
1/ SGP reqirement on the structural balance is adjusted for the change of interest expenses to translate it into the primary structural balance.
2/ The IMF projection assumes the extension of the 2018 budget and already legislated measures.
3/ The IMF projection is based on legislated and identified measures only.

Sources: AMECO and CEPR.

**28. The distribution of fiscal stances across countries is far from optimal, with high-debt countries in particular failing to make needed fiscal adjustments**.

- The fiscal easing in Germany and the Netherlands in 2019, which have substantial space under the EU fiscal rules, is in line with staff's advice. For Germany, the composition of the easing measures is broadly

appropriate, but there is scope for greater investment, particularly in infrastructure. In the Netherlands, much of the easing reflects recommended increases in education and innovation spending. However, both countries are projected by staff to shift toward neutral stances in 2020. Staff's advice is for these countries to fully use their space for greater public investment in physical infrastructure (Germany) and human capital (both), as well as for lowering high labor tax wedges.

- Countries with high public debt levels should pursue gradual fiscal adjustment, even in the current weaker growth environment. The need for adjustment is particularly relevant where sovereign spreads are high and financing needs are large. Credibly committing to debt reduction over the medium term, and taking high-quality measures to do so, will be important to address any drag on growth from debt overhang and to rebuild fiscal space for future downturns. A growth-friendly fiscal consolidation that protects investment should be pursued.

**29. In a severe economic downturn, countries with fiscal space should stand ready to implement a stimulus**. If a combination of the downside risks described in the previous section materializes, the euro area could be tipped into a recession. In such a scenario, the escape clause in the fiscal framework should be activated to allow countries to respond appropriately. This would allow countries to use their fiscal space without violating the EU rules, including countries like Germany and the Netherlands which would have even more space available. A synchronized fiscal easing could amplify the area-wide impact. In the absence of a common fiscal capacity, however, the response will come from individual countries, taking into account the severity of the shock, fiscal space, and financing conditions in each country. Fiscal policy could turn expansionary through temporary high-quality measures in countries that have available fiscal space, while fiscal consolidation could be slowed down temporarily in countries where fiscal space is at risk, provided that their financing conditions remain amenable and debt sustainability is not jeopardized. Countries should work now to develop contingency plans in case downside risks materialize, including identifying growth-friendly stimulus measures that could be quickly deployed in countries with fiscal space.

**30. The Stability and Growth Pact (SGP) needs to be better enforced**.[6] The weak implementation and lax enforcement of the rules have undermined the credibility of the fiscal framework. This, in turn, has weakened countries' incentives to respect the rules, as well as the European institution's ability to enforce them. In June, the EC warned that a number of high-debt countries were at risk of significant deviations from the rules in 2019–20 (Belgium, France, Portugal, and Spain), without taking further steps. However, it did conclude that an Excessive Deficit Procedure is warranted for Italy, although launching such a procedure will require a formal EC recommendation and approval by the Council.

[6] Staff simulations illustrate that better compliance with the rules in the past would have led to limited cost in terms of lost output, but much lower debt levels by the time of the global financial crisis. For details, see Arnold and Garcia-Macia, 2019, "Compliance with the Stability and Growth Pact: Counterfactual Scenarios," IMF Working Paper (forthcoming).

**31. A simplification of the current set of complex rules would make it easier to monitor, communicate and enforce them**. Staff's recommendation remains to focus on a single anchor—a debt rule—and a single operational target—an expenditure growth rule. This would reduce the volatility of output, as it would help prevent procyclical fiscal policies.[7] Moreover, if it had been implemented in recent years, high-debt countries would have saved windfall gains from lower interest rates, helping to rebuild buffers.

**32. Negotiations are underway on the 2021–27 EU budget**. They center around the May 2018 EC proposals for the Multiannual Financial Framework (MFF) and own revenue resources. The proposals envisage both expenditure reallocation and revenue mobilization to increase spending on priority areas and to address the potential funding gap from the U.K.'s departure.

- The MFF proposal aims to rationalize expenditures on the common agricultural and cohesion policies. It would shift resources to areas such as research and innovation, young people, the digital economy, migration, and climate objectives. Budget negotiations on this expenditure reallocation should aim to maximize the growth dividend while being careful not to exacerbate regional inequality.
- On new revenue resources, the proposal to apply a rate of 3 percent to the new Common Consolidated Corporate Tax Base (CCCTB) is appealing, though the CCCTB has not yet been agreed upon. Collecting a share of the revenues from the Emissions Trading System is also appropriate, given the cross-border externalities from carbon emissions. Reducing the share that countries retain when collecting customs revenues for the EU budget would be appropriate, as long as their revenue collection costs are covered by the retained funds.

**33. Corporate taxation remains a challenge**. The CCCTB proposal has attractive features as a way forward for the EU as it reduces opportunities to shift profits within the EU through transfer mispricing and other schemes, but tax competition would remain a concern. Proposals for an EU "digital services tax" have been put off until 2020, though individual countries, such as Austria, France, Italy, and Spain, may go ahead with their own versions of such a tax. Implementing unilateral digital services taxes risks being distortive, and sustainable solutions to the challenges imposed by digitalization should preferably be coordinated internationally to limit complexity and spillovers.

***Authorities' Views***

**34. The EC largely agreed with staff's fiscal advice**. Countries with high debt should continue to consolidate gradually. Fiscal easing in surplus countries is helpful both to mitigate the growth slowdown and to address structural public investment needs. The EC concurred that fiscal policy should be eased further in a downturn scenario, but emphasized the challenges in achieving a countercyclical impact, given policy lags. They also agreed that such an easing would have to be country specific, but warned about the political challenges of advising such a differentiated fiscal response. The EC explained that the SGP escape clause could be activated in a severe downturn or if a severe downturn was forecast. This would allow countries to temporarily deviate from the SGP requirements, provided that fiscal sustainability is not endangered.

[7] See Andrle and others, 2015, "Reforming Fiscal Governance in the European Union," IMF Staff Discussion Note 15/09.

**35. There is broad agreement that the fiscal rules should be reformed, but not on the direction of the reforms**. Most member states agree that the rules should be simplified, but there are deep differences on details of the reform. The EC will conduct a review of the framework by the end of this year, which could inform a concrete discussion on the way forward.

**36. EU countries aim to complete the negotiations on the 2021–27 MFF by fall**. In parallel there are negotiations over the sources of financing, including the proposed new own resources. If no agreement is reached on the new revenue sources, the current own resource system would be preserved with the financing gap to be filled by additional member state contributions.

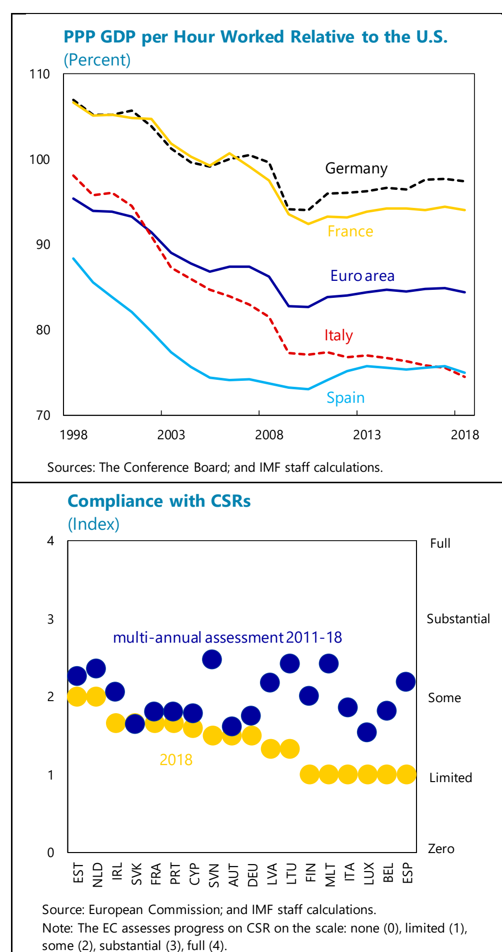
**37. The EC expects progress on harmonizing the rules for calculating the corporate tax base and implementing a narrow version of an EU-wide digital services tax**. An agreement across EU countries is expected by end-2019 on a single set of rules for the calculation of the corporate tax base. Thereafter, the allocation of firms' EU-wide profits will be discussed, most likely in 2021, depending on the new Commission's priorities. The EC noted that an agreement was likely by next year on an EU-wide digital services tax, albeit one restricted to online advertising rather than the broader scope of the March 2018 proposal. They saw the digital services tax as a reasonable interim step ahead of a more global solution.

## C. Structural Reforms to Boost Growth and Resilience

*Reform efforts both at the central and national level should be stepped up to address sluggish productivity growth, including in the services sector, and increase resilience to shocks.*

**38. Sluggish productivity growth at the aggregate level and persistent productivity gaps among member countries call for stepping up reform efforts**. Productivity in the euro area has failed to catch up with the U.S. over the past two decades, and productivity gaps across member countries remain significant. It is therefore imperative to advance labor and product market reforms to boost productivity and close the gaps among euro area countries, as reform efforts are likely to benefit more the countries where productivity is further away from the frontier.

**39. However, progress with structural reforms has been slow and uneven**. Reforms in France are advancing on several fronts including business environment, education and training, and labor markets. Efforts to



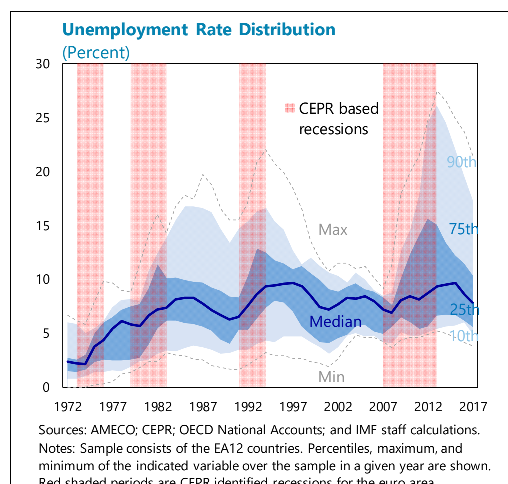
promote innovation and digitalization are underway in Austria, Estonia, and Ireland. But overall, progress has been weak, particularly in product market reforms, where the scope for productivity increases is large. Implementation of Country-Specific Recommendations (CSRs) continues to disappoint, with close to one-third of euro area countries achieving only limited progress in their 2018 CSR. While the multi-annual assessment shows better CSR compliance, almost half of euro area countries failed to make at least "some progress" on average when considering implementation of all CSRs since 2011.

**40. At the EU level, deepening the Single Market for services could substantially boost growth**. Despite several EU initiatives since the 2006 Service Directive, unduly restrictive regulations on services trade remain in key sectors such as professional services, including in larger euro area countries (see Box 2). Staff's recent analysis shows that slow progress on service sector reforms reflects the political cycle and vested interests. In fact, there is room to loosen excessive regulations without necessarily compromising service quality. At the EU level, continued focus on service sector reform in the CSRs could be combined with softer tools such as strengthening public communication and improving data availability on service sector performance across countries. Enforcement of the Services Directive should also be stepped up.

**41. EU-level instruments can also play a larger role in facilitating national structural reforms**. The newly proposed reform delivery tool and technical support instrument under the 2021–27 EU budget, while limited in size (0.2 percent of the EU-27 GDP), can incentivize national reform efforts. To be effective, financial support needs to be closely linked to reform implementation. Furthermore, based on Council recommendations, most euro area countries have established national productivity boards which help identify reform priorities and foster national ownership of reforms.

**42. Reform efforts at the national level can enhance resilience to adverse shocks**. The substantial heterogeneity in the severity of recessions among euro area economies points to the importance of country-specific factors. Staff analysis suggests that structural reforms that increase product and labor market flexibility (such as reducing barriers to firm entry and labor cost rigidities) and improve the functioning of corporate insolvency regimes strengthen an economy's ability to weather shocks and efficiently reallocate factors (see Box 3). Such reforms are even more essential for countries in a monetary union, where the exchange rates cannot provide an alternative adjustment mechanism.

**Unemployment Rate Distribution**
(Percent)

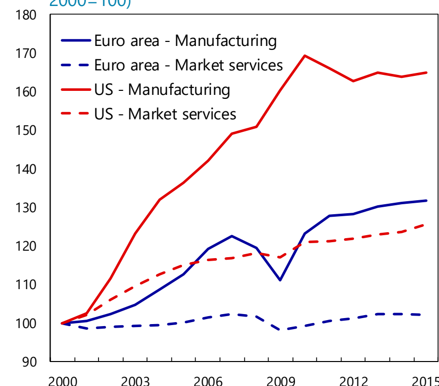



Sources: AMECO; CEPR; OECD National Accounts; and IMF staff calculations.
Notes: Sample consists of the EA12 countries. Percentiles, maximum, and minimum of the indicated variable over the sample in a given year are shown. Red shaded periods are CEPR identified recessions for the euro area.

**43. EU competition policy has been critical to the success of the Single Market, though there may be scope for reviewing how it operates in the context of global markets**. EU competition policy has served consumers well by ensuring sufficient competition and has been a cornerstone of the Single Market. Recently though, there have been calls for reforming the policy to

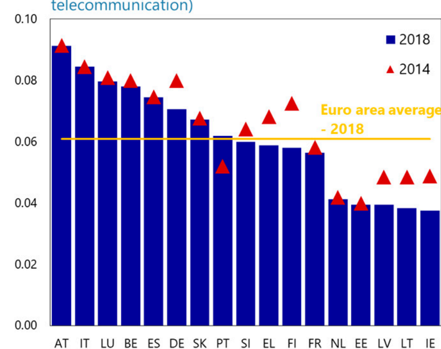
## Box 2. The Case for Strengthening the EU's Single Market for Services[1/]

**Productivity growth in the euro area services sector has been disappointing and the gap with the U.S. has widened**. Firms face challenges to growth, including because of limited adoption of innovative processes. Moreover, this low productivity weighs on the manufacturing sector, given its increased reliance on service sector inputs.



Sources: EU KLEMS, IMF staff estimates.

**Resistance to EU reform efforts has been strong**. Unduly restrictive regulations on services trade and cross-border investment have been linked in the literature to political economy factors and the influence of vested interests. Implementation of key EU initiatives to tackle the problem (e.g., the 2006 Services Directive) has been uneven and incomplete, resulting in substantial regulatory heterogeneity within the Single Market, as shown by the new OECD Services Trade Restrictions index measuring within-EU service sector restrictions.



Source: OECD.

**Staff analysis shows that the political cycle and vested interests are important determinants of the resistance to service sector reforms**. Service sector reforms tend to occur when governments have strong political capital (e.g., majority in parliament; beginning of legislature term). However, these reforms tend to be strongly resisted in sectors characterized by disproportionally high rents, confirming the key role of vested interests. Importantly, staff do not find evidence of a systematic relationship between services sector deregulation and consumer satisfaction, casting doubt on the argument often used against reforms, viz. that they systematically reduce service quality ex post.

**A two-pronged approach combining incentives with effective enforcement is needed to move forward**.

- **Incentives**: The continued focus on services sector reform in the Country-Specific Recommendations (CSRs) is important. The proposed Reform Delivery Tool could further incentivize countries, including by providing financial support to offset any costs associated with reforms. Recently created National Productivity Boards could also help by guaranteeing effective public communication of the reforms, including by showcasing examples of EU best practices. More EU-wide transparency and comparable data could help national competition authorities to play a larger role in evaluating whether a regulation is in line with public interest. Finally, harmonizing education and training requirements within the EU would also help facilitate the provision of services in a truly internal market.
- **Enforcement**: Formal infringement proceedings against member states to address gaps in implementing the Services Directive remains an important tool. The use of enforcement tools to date has been limited; the European Court of Auditors (2016) argues that it has been insufficient. The recent stepping up of infringement procedures with respect to both the Services Directive and the Professional Qualification Directive appears appropriate.

1/ See Ebeke, C., Frie, J.M., and Rabier, L., 2019, "Deepening the EU's Single Market for Services," IMF Working Paper (forthcoming).

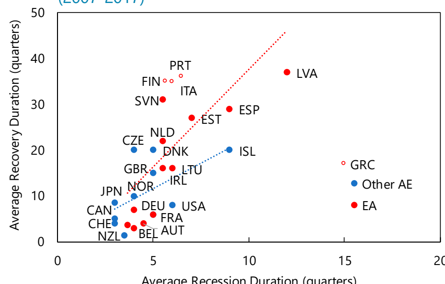
## Box 3. Structural Reforms and Economic Resilience[1/]

**Euro area countries have fared worse than other advanced economies in the aftermath of the global financial crisis**. Many euro area economies experienced double-dip recessions and slower and weaker recoveries. While there are many reasons for this, the marked heterogeneity among countries points to differences in economic resilience—an economy's ability to withstand and adjust to shocks—reflecting in part that the efficacy of adjustment mechanisms varies across countries. The lack of an independent nominal exchange rate makes the euro area economies more reliant on other mechanisms to buffer against shocks and facilitate adjustment.

**Structural reforms that increase price flexibility, ease of entry and exit, and the scope for labor market adjustment strengthen a country's ability to weather shocks**. Staff analysis shows that more stringent employment protection for regular workers and excessive product market regulation are generally associated with more severe recessions on average. Over the past four decades, output losses after financial crises or major recessions were smaller in those advanced economies that had reformed their labor and product markets. Furthermore, model simulation results also demonstrate that the benefits from flexible labor and product markets are even greater for countries that lack independent exchange rates, such as individual euro area countries.

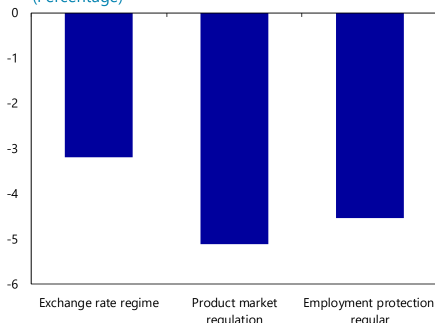
**Efficient and flexible corporate insolvency regimes improve resilience by facilitating the reallocation of resources towards more productive sectors and firms**. Cross-sectoral factor misallocation (as captured by the dispersion of sectoral productivity) tends to be greater in countries with lower-quality insolvency regimes. Moreover, regression analysis shows that capital reallocation towards more productive sectors and firms is larger in countries with higher-quality insolvency regimes.

**Recession Duration versus Recovery Duration**
(2007-2017)



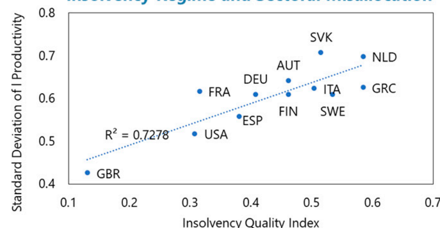

Sources: OECD; IMF Staff Calculations.
Notes: Recovery duration is defined as the time taken to recover the pre-recession real GDP peak. Statistics are calculated using completed and incomplete phases during 2007-2017, with incomplete phases being indicated by a hollow marker. Trendlines by sub-sample are indicated by color, excluding Greece's incomplete phase as a marked outlier. EA: euro area economy; other AE: other advanced economy.

**Impact on Recession Amplitude**
(Percentage)




Note: Impact on amplitude reflect estimates of average output loss during recession corresponding to the interquartile ranges (p75 - p25) of respective variables, except for exchange rate regime where estimates show moving from a flexible regime to a fixed one.

**Insolvency Regime and Sectoral Misallocation**




Sources: OECD Insolvency Indicators; EU KLEMS; and IMF staff calculations.
Notes: Higher insolvency quality index values indicates lower quality. Conceptually, there are two broad components in the index: flexibility in restructuring and efficiency of procedures. For example, Greece scores poorly on efficiency, while the Netherlands scores poorly on restructuring flexibility. These lead to overall index scores that are roughly similar. Productivity is measured by sectoral revenue total factor productivity as estimated by EU KLEMS. Under the assumptions of Hsieh and Klenow (2009), revenue total factor productivity dispersion captures the dispersion of marginal productivities in inputs, a fundamental measure of factor misallocation.

1/ See Aiyar and others, 2019, "Strengthening the Euro Area: The Role of National Structural Reforms in Enhancing Resilience," IMF Staff Discussion Note 19/05.

enable the creation of "European champions", which could better compete in global markets. A review of the rules to ensure they are fit for purpose is reasonable, while preserving the overarching goal of safeguarding competition. In particular, when assessing a merger, there could be scope to consider firms' ability to compete in global markets. Nevertheless, other policy instruments, such as securing greater market access in trade deals, would contribute to a more open trading environment that would enable European companies to become more competitive in foreign markets.

***Authorities' Views***

**44. Both the EC and ECB concurred with the recommendation to accelerate reforms at the national level and to continue deepening the Single Market**. The EC highlighted the progress with CSRs in the financial and fiscal areas as well as job creation on permanent contracts, but expressed concern about the loss of reform momentum in services, tax-base broadening, state-owned enterprises, and the competition and regulatory framework. Moreover, there have been cases of rollback of CSR implementation, including on pension reform. The EC views the European Semester as the central instrument to promote dialogue with EU countries on reforms, while it expects the newly created National Productivity Boards to raise awareness locally. Going forward, the EC plans to develop further its use of benchmarking. While the design of the Reform Delivery Tool is still under discussion—and connected to the proposed euro area budget for convergence and competitiveness—the EC believes it should include elements of reform conditionality and safeguards against rolling back reforms.

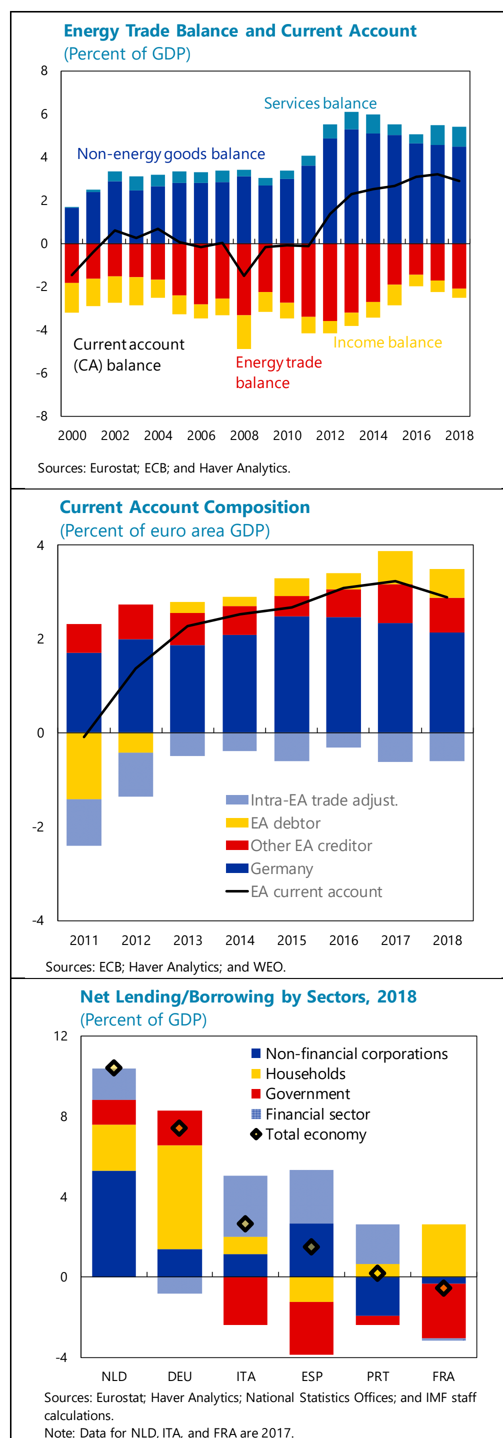
**45. The EC and the ECB agreed with staff on the importance of national structural reforms in strengthening resilience**. The EC views economic resilience as encompassing both a reduction in vulnerability to shocks and a greater capacity to absorb and recover from shocks. Beyond product and labor market regulations, the EC considers that reforms in the areas of business climate, public administration, and the digital economy would also improve resilience. Furthermore, the EC sees potential synergies for increasing resilience in the euro area from an EU-coordinated push for reforms, including legislative action at the EU level, particularly in network industries, and stresses the need to carefully sequence reform implementation over the business cycle.

## D. Addressing External Imbalances and Protecting the Rules-Based Global Trading System

*Ambitious action is needed to reduce external imbalances. Countries with large external surpluses should use fiscal policy and structural reforms to incentivize investment and lift potential growth. For net external debtor countries, reforms to boost productivity growth will help close competitiveness gaps. The EU should continue its proactive approach to safeguarding the rules-based global trading system.*

**46. The external current account surplus narrowed in 2018 but remains high**. The euro area surplus declined modestly to 2.9 percent in 2018 from 3.2 percent in 2017, mainly due to weaker external demand and higher oil prices. The CPI-based real effective exchange rate (REER)

appreciated by 3 percent on average in 2018. These changes are not large enough to materially alter the external sector assessment: the euro area's external position remains moderately stronger than implied by medium-term fundamentals and desirable policies, with a small REER undervaluation of about 3 percent.[8] Nevertheless, substantial imbalances persist at the country level.




**47. Countries with large external surpluses should use fiscal space and structural reforms to incentivize investment and lift potential growth**. Despite lower surpluses in 2018, the external positions of Germany and the Netherlands remain substantially stronger than the level consistent with fundamentals and desirable policies. These countries have not seen rapid wage growth in line with the tightness of labor markets, resulting in materially undervalued REERs. Excess saving net of investment by nonfinancial corporations and households explain the bulk of the surplus. Structural reforms to foster entrepreneurship, support SMEs, and advance digitalization would encourage domestic investment, helping to reduce corporate savings while improving potential growth. The recommended fiscal easing would also help reduce the external surplus. This could be combined with public communications geared toward encouraging faster wage growth, which would facilitate a relative price adjustment that would help with internal rebalancing within the euro area.

**48. Reforms that boost productivity will improve competitiveness and strengthen the external position of net debtor countries**. The external positions of debtor countries (e.g., Spain and Portugal) remain weaker than warranted, considering the large stocks of external liabilities. In these countries, post-crisis wage moderation has improved competitiveness, but productivity gaps remain. Additional policy efforts should focus on faster implementation of product and service market reforms (Italy and Spain), making the wage bargaining mechanism more effective by aligning wages with productivity at the firm level (Italy), actions to enhance education outcomes, training of

[8] The REER undervaluation of 3 percent is within the [-5 percent, +5 percent] interval described as broadly in line with fundamentals in the Fund's External Balance Assessment.

workers, and firms' innovation capacity (Spain), and enhancing business conditions and streamlining regulations (Portugal).

**49. The EU is taking a proactive role in safeguarding the economic gains from trade liberalization**. The EU-Japan free trade agreement, which entered into force in February, created the largest open trade zone in the world. A number of trade arrangements with other partners are under negotiation, further demonstrating the EU's commitment to trade liberalization.[9] Staff supports the EC's recent initiative to develop a concrete proposal to strengthen the WTO, including by ensuring continued enforceability of existing WTO commitments through a well-functioning dispute settlement system, and tightening WTO rules in areas such as subsidies and notification obligations.

***Authorities' Views***

**50. The authorities stressed the role of national policies to reduce external imbalances at the country level**. The ECB and the EC estimated that the euro area current account in 2018 was about 1¼–1½ percentage points above the level that could be explained by fundamental factors. The ECB considered the euro's REER to be close to its equilibrium, after appreciating materially during 2018. Going forward, the authorities projected the current accout surplus to narrow, mostly reflecting weak external demand and robust domestic demand. In Germany the ongoing internal revaluation through higher relative wages could help reduce high corporate savings, while fiscal expansion would also compress the current account surplus, even though the effect is likely to be small.

**51. The EU continues its efforts to uphold the rule-based global trading system**. The authorities expressed concern about a potential shift toward managed trade deals, which violate WTO rules, as well as nonmarket-based actions by some trading partners. The EU remains committed to free trade and the rule-based system, and wishes to ensure a level playing field. Towards this end, they continue to work with trading partners to modernize the WTO, including by improving its governance and addressing market-distorting subsidies. They have received a negotiating mandate to pursue bilateral trade talks with the U.S. on eliminating tariffs on industrial goods and reducing nontarriff barriers through conformity assessments.

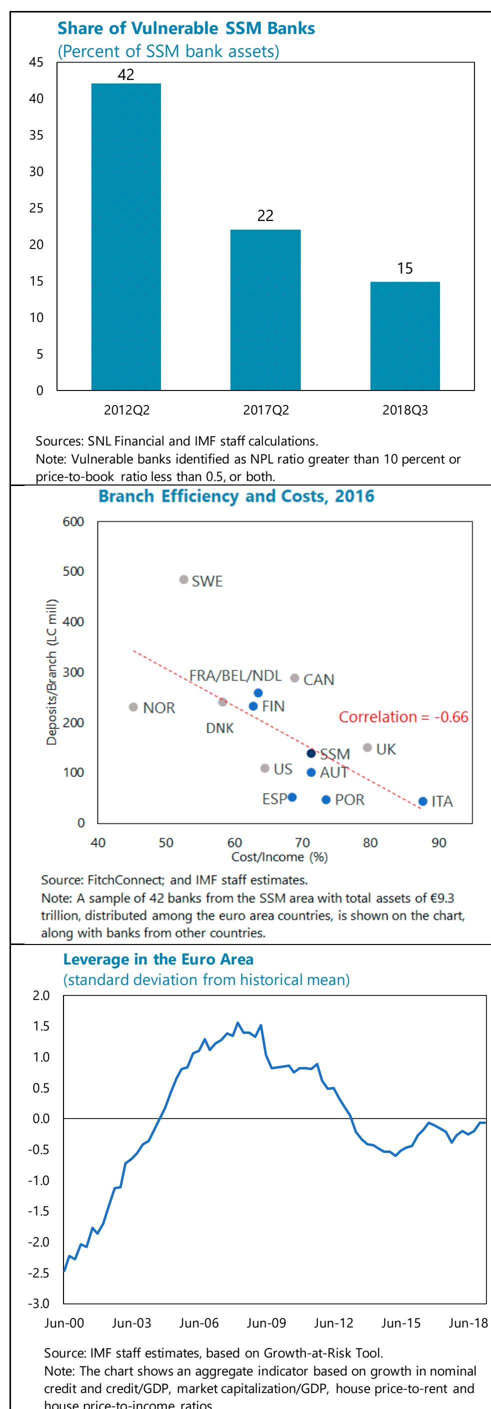
## E. Strengthening and De-Risking the Financial Sector

*Bold actions are needed to cut operating costs of banks to address the structurally low profitability. The authorities should continue to monitor financial stability risks in specific sectors and countries, proactively using macroprudential policy tools as necessary.*

**52. Banks have built significant capital buffers and reduced nonperforming loans**. Tier 1 ratios continued to increase in most countries, averaging 15.4 percent in June 2018. Substantial progress has been achieved in reducing nonperforming loans, which have fallen to just under

[9] Trade negotiations are ongoing with Australia, Chile, Indonesia, Mercosur, New Zealand, and Tunisia. The EU Council is reviewing the free-trade agreement with Vietnam.

4 percent of gross loans in 2018Q3, although the NPL ratio remains in double digits in four countries. Reflecting improved balance sheets, the asset share of banks with high NPLs or low price-to-book ratios declined to 15 percent of the total assets of Single Supervisory Mechanism (SSM)-supervised banks by 2018Q3. Moreover, the European Banking Association (EBA) stress tests from November 2018 showed that even with a sharp slowdown, no large bank would fail in the adverse scenario. However, continued supervisory pressure is needed for banks where NPL levels are still high. Moreover, while overall liquidity risks appear low, supervisors should carefully monitor short-term U.S. dollar funding mismatches in some banks.




Sources: SNL Financial and IMF staff calculations.
Note: Vulnerable banks identified as NPL ratio greater than 10 percent or price-to-book ratio less than 0.5, or both.

Source: FitchConnect; and IMF staff estimates.
Note: A sample of 42 banks from the SSM area with total assets of €9.3 trillion, distributed among the euro area countries, is shown on the chart, along with banks from other countries.

Source: IMF staff estimates, based on Growth-at-Risk Tool.
Note: The chart shows an aggregate indicator based on growth in nominal credit and credit/GDP, market capitalization/GDP, house price-to-rent and house price-to-income ratios.

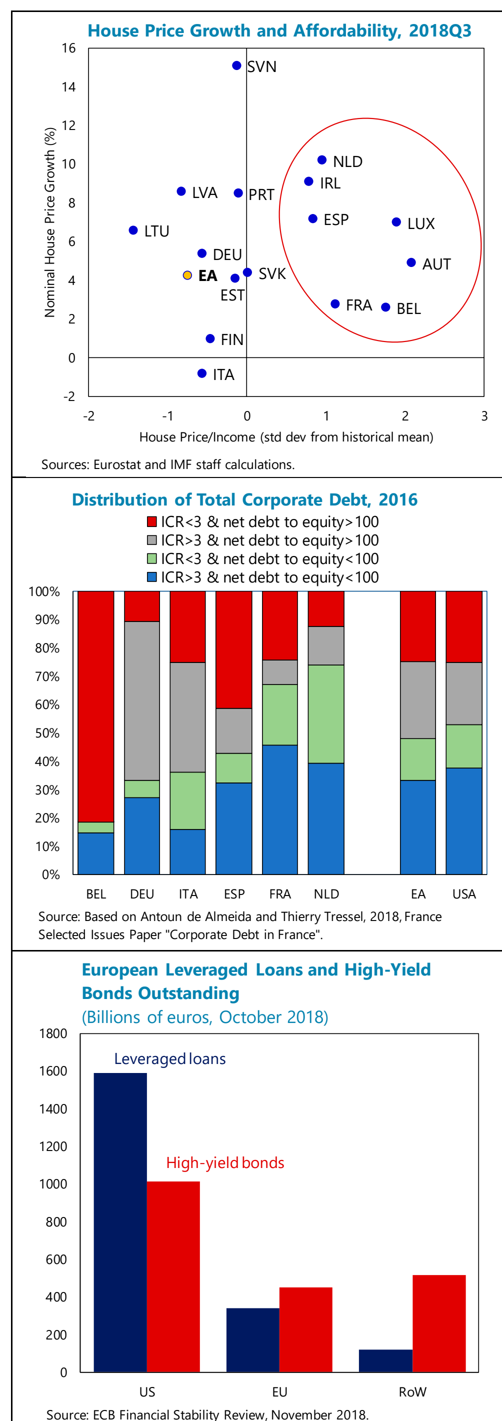
**53. Profitability is expected to remain low in the medium term amid high costs**. The return-on-equity (ROE) of the 100 largest banks remains low at 6 percent in 2018Q3, below the 8–10 percent cost of equity, and is expected to stay low in the medium term. Euro area banks, with operating costs higher than 65 percent of income on average, could emulate their Nordic neighbors that continue to have costs close to only 50 percent of income. In particular, banking systems with lower deposits per branch tend to have higher cost-to-income ratios.

**54. Supervisors should proactively encourage bold reforms to cut costs**. These could include simultaneously reducing branch networks and updating IT platforms. Supervisory actions should be forceful in assessing viability of banks' business models, pushing them to improve their internal capital generation and incentivizing consolidation, including from mergers and acquisitions.

**55. While there is little evidence of region-wide financial stability risks at this juncture, there is much heterogeneity across sectors and countries**. An index summarizing credit growth, equities, and house prices is at its historical mean. In some countries, such as the Netherlands and Luxembourg, house prices are increasing rapidly even as affordability diminishes. While German house prices do not seem elevated relative to income, there have recently been concerns about overvaluation in several big cities.[10]

[10] See IMF, 2019, "Germany: Staff Report for the 2019 Article IV Consultation."

**56. Likewise, leveraged loans do not appear excessive at the euro area level, but corporate indebtedness will require careful monitoring in some countries**. The total stock of leveraged loans issued remains relatively small compared to the total size of corporate loans, and banks' exposure to the leveraged loans is limited. However, recent research by Fund staff suggests that in some euro area countries a considerable share of corporate debt has either a low interest coverage ratio (ICR) or is high relative to equity. The ECB/SSM has warned about the risks and provided guidance for banks limiting issuance of highly leveraged loans.




**57. Macroprudential policies should be used more actively to manage financial vulnerabilities in both housing and corporate sectors**. France, for example, has tightened large exposure limits for big French banks lending to highly indebted corporates, and some countries have increased their countercyclical capital buffers. However, bank-based tools cannot address risks arising from nonbank loans. As recommended in the 2018 FSAP, borrower-based tools could be legislated where they are currently unavailable, and used more proactively against risky firms and households. In particular a range of borrower-based tools for corporates (such as limits on loan-to-value ratios for commercial real estate, debt/equity caps and minimum ICRs) should be explored, and national macroprudential supervisors should have the authority to use these tools for all financial institutions. The authorities should also monitor liquidity risks in investment funds that are increasingly exposed to lower-grade corporate debt and real estate in search for yield. In order to be effective, comprehensive and comparable credit information systems need to be available in all countries. Urgently addressing data gaps in the area of commercial real estate and nonbank financial institutions is also needed to allow a fuller assessment of financial stability risks.

**58. Financial sector preparations for a possible no-deal Brexit are well advanced, but there are residual risks**. Most U.K.-based banks and investment firms have secured licenses to operate in the EU-27. The Commission has provided conditional recognition to U.K.-based central counterparties to clear derivatives until March 2020 in case of a no-deal Brexit. For uncleared

derivatives, the European Securities and Markets Authority (ESMA) has temporarily reduced the regulatory costs of moving these contracts to EU-27 counterparts, and some countries are legislating under national laws to ensure the temporary continuity of these contracts even if they do not move. The prohibition on trading some European equities on exchanges in London if they are also traded in EU-27 venues may reduce the liquidity of these stocks.[11] Banks can continue to issue new Minimum Requirements for own funds and Eligible Liabilities (MREL) under English law provided a contractual clause is inserted recognizing the resolution powers of the Single Resolution Board (SRB) in case of a bank failure. A remaining, albeit unlikely risk, is that a British court might fail to recognize the SRB's resolution powers on existing MREL.

**59. Multiple money laundering breaches in the EU add urgency to centralized supervision in this area**. Recent experiences involving banks from Estonia, Finland, Germany, Latvia and Malta suggest continuing inadequacies in enforcing Anti-Money Laundering (AML) rules through national supervisory agencies. As recommended in the 2018 FSAP, stronger enforcement tools and better information-sharing is urgently needed. In this respect, EBA's strengthened mandate to ensure the quality and consistency of domestic AML and Countering the Financing of Terrorism (CFT) supervisory practices is useful. Over the medium term, an EU-level supervisory function could be established to enforce AML/CFT requirements.

**60. The authorities broadly agreed with the FSAP recommendations and have started to implement them (Annex 2)**. In addition to the progress on macroprudential and AML policies, the SSM is monitoring liquidity risks more closely and improving its early action framework. ECB Banking Supervision demonstrated its early intervention powers recently by replacing bank management with its own administrator in an Italian bank last year. ECB Banking Supervision is striving to reduce legal fragmentation of bank supervision by drawing up an action plan to feed into the next review of the CRR/CRD. But this review will not be completed before 2022. Progress on reforming the crisis management framework has also been slow; in particular, the comprehensive review of the Bank Resolution and Recovery Directive has been postponed to the next Commission.

***Authorities' Views***

**61. Recognizing profitability to be structurally low, the authorities are using their existing tools to assess business models**. Although bank profits were hit last year by trading income losses, the authorities acknowledged that weak profitability reflected deeper underlying problems with costs and revenue models that differed across countries and banks. However, the ECB Banking Supervision proactively assesses banks' forward-looking profitability projections and cost-reduction efforts—and, more broadly, the viability of their business models—as part of the process for setting Pillar 2 capital requirements.

**62. Cognizant of risks in the real estate sector, the authorities are taking a proactive approach**. Neither the ECB nor the European Systemic Risk Board (ESRB) see systemic risks to financial stability for the euro area as a whole. However, the combination of house price increases,

[11] Earlier, the prohibition also extended to a number of U.K. stocks, but these have now been exempted.

credit growth, and household indebtedness warrants close monitoring in some countries. The ESRB is considering warning several countries to activate macroprudential tools against real estate risks, including some large countries. Among these, countries that were warned previously in 2016 and failed to take adequate action could now receive recommendations that are subject to comply-or-explain rules. Among other efforts, the ESRB is surveying its member states on the availability of borrower-based tools for households and corporates, and the authorities' ability to use these tools. It is also amending its 2016 recommendation on closing real estate data gaps, asking Eurostat to help in the commercial real estate sector. The EC, in turn, will assess whether borrower-based tools for both households and corporates are needed in Union law as part of the CRR/CRD review in 2022.

**63. The EU authorities note good progress in alleviating remaining cliff-edge risks in the case of a no-deal Brexit**. In the area of uncleared derivatives, the authorities' contingency measures have made it easier and cheaper to transfer bilateral contracts from U.K.-based financial institutions to EU-based ones. Although clients have been slow to transfer these contracts, the EC reiterated that the contingency measures are meant to minimize risks to financial stability, not eliminate all costs related to Brexit. The ECB was concerned that financial markets have not adequately priced-in the risks of a no-deal Brexit, raising the possibility of sudden changes in risk premia in the event of a no-deal Brexit.

**64. The authorities are taking steps to address money laundering more systematically**. The ECB Banking Supervision has set up a new AML coordination function, that acts as a central point of contact and information exchange for systemic institutions, provides for a consistent SSM-wide approach for integrating AML/CFT concerns into prudential supervision, and develops training for supervisors. The ECB Banking Supervision has also signed an agreement to exchange information with 48 national AML/CFT authorities in the European Economic Area. While there is broad support for a more European approach to AML/CFT among the authorities, whether to set up a new European agency is a matter for the EU legislators to decide. The ECB feels that it should not be assigned these responsibilities, due to the nature of AML supervision and its interaction with criminal law at the national level.

## F. Advancing the Economic and Monetary Union

*Progress on euro area architectural reforms has been too slow. Political agreement is needed on a timetable for risk reduction and risk sharing to move forward together. There is scope for a renewed push for a Capital Markets Union (CMU) to improve private sector risk sharing.*

**65. A truly borderless single banking market will require further ambitious steps**. Currently, many national authorities continue to favor ring fencing of capital and liquidity, which runs contrary to the "banking without borders" vision behind the banking union. Addressing this will require ambitious regulatory reforms, including strengthening the power of the SSM on capital and liquidity requirements for cross-border groups. This is difficult to achieve while deposit insurance remains a national responsibility. But establishing a European Deposit Insurance Scheme (EDIS), will require political agreement on a timetable, in combination with properly defined risk reduction measures in

the banking sector. In addition, many important supervisory functions remain fragmented, being exercised by heterogenous national supervisors rather than the SSM.

**66. Progress on completing the banking union has stalled amid a lack of consensus on risk reduction and common deposit insurance**. EU leaders have agreed that the European Stability Mechanism (ESM) would serve as a backstop to the Single Resolution Fund (SRF), which could come into force before 2024 if there is sufficient progress on risk reduction by 2020. The Eurogroup has stated that this will require progress toward a 5 percent gross NPL target and the MREL targets for all SRB banks, but the details are unclear. A high-level working group set up to discuss EDIS has focused on the appropriate design of a common deposit insurance scheme in the steady state, while abstracting from transition issues. But these discussions have not yielded agreement so far. A technical working group has also been set up to examine proposals for liquidity post-resolution, i.e., to ensure that a newly resolved bank has adequate access to market and/or Eurosystem liquidity, even in the absence of sufficient high-quality collateral on its own balance sheet. But a broader review of the European bank resolution framework, initially scheduled for 2018, has been postponed to the next Commission.

**67. Discussions on a euro area budget represent a step in the right direction, but a stabilization component would be essential for the euro area**. Staff has advocated a central fiscal capacity for macroeconomic stabilization, to strengthen countries' ability to use fiscal policy to address shocks and reduce the overreliance on monetary policy. However, there is not sufficient political support for such a capacity at this stage, partly reflecting concerns about moral hazard amid weak compliance with the fiscal rules. EU leaders have agreed to work toward a small euro area budget for convergence and competitiveness, rather than stabilization.

**68. The authorities have taken various initiatives to develop specific markets and products to promote a CMU**. Capital markets in Europe remain small and fragmented, reflecting numerous and complex frictions. Based on a survey of regulators as well as on empirical work, staff has identified four key barriers to integration: limited data accessibility on both listed and unlisted companies, weak insolvency regimes, disparate and opaque withholding tax regimes, and divergent regulatory quality (Box 4). Notable progress has been made to improve certain markets, such as new legislation on simple, transparent and standardized securitization to boost SME financing, measures to promote more investment by venture capital funds in innovative SMEs, and political agreements on a portable personal pension product and common rules on covered bonds. Political agreements have also been reached on facilitating cross-border distribution of collective investment funds and cutting red tape for SMEs to access the new trading venue for small issuers, and an EU Directive has been adopted to improve restructuring regimes for viable companies in financial difficulties.

**69. However, much more is needed at the EU level to improve private risk sharing and to reduce market fragmentation in the EU**. Over time, the just-approved portable pension product could be improved to make it more cost and tax effective—including by providing the same tax treatment for cross-border PEPP providers as for domestic ones—for diversifying household savings. Transparency and disclosure could be improved with centralized issuer information disclosure,

## Box 4. Benefits of a Single Capital Market[1/]

**New empirical analysis in a recent Staff Discussion Note (SDN) sheds light on the benefits of and obstacles to a single European capital market**. Greater private risk sharing would diversify savers' exposures, enhance firms' financing choices, and soften the links between domestic demand and domestic economic shocks—the so-called "consumption smoothing" effect. The SDN also investigates the importance of various barriers in preventing cross-border flows.

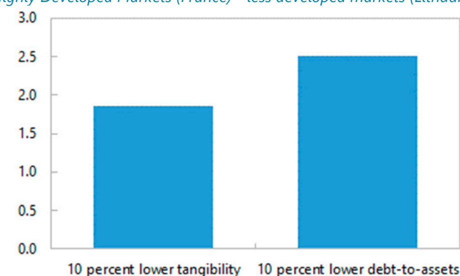
**Giving firms access to more developed financial markets within the EU could significantly lift economic growth**. With deep financial markets, firms are less constrained by their ability to post tangible (or fixed) assets as collateral. This is especially important for high-value added startups. Staff econometric analysis shows that, for example, the real value-added growth of a firm with a 10 percentage points lower share of tangible assets than average would be close to 2 percentage points more in France than in Lithuania. Moreover, firms in France are better able to grow without resorting to high leverage; a firm with 10 percentage point lower leverage than average can grow close to 2.5 percentage points faster in France than in Lithuania.

**Reducing barriers to capital market integration would increase consumption smoothing**. Staff econometric analysis shows that only 25 percent of risks are shared across euro area countries, while more than 80 percent is shared across the 50 states of the U.S. Better quality insolvency and regulatory regimes could improve overall risk sharing by 25–30 percentage points in the eurozone. Average cross-border portfolio assets would almost double with 1 standard deviation improvements in insolvency, regulatory quality, and taxes taken together.

**Market Size and Growth**

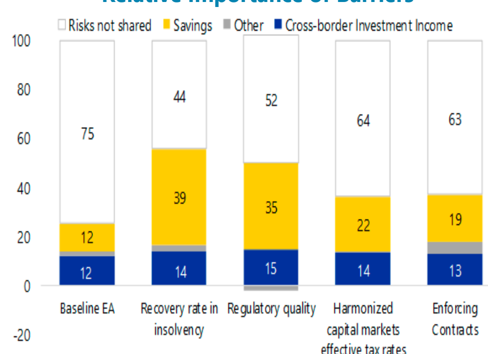
Differential in Real Value-Added Growth of Firms

*Highly Developed Markets (France) - less developed markets (Lithuania)*



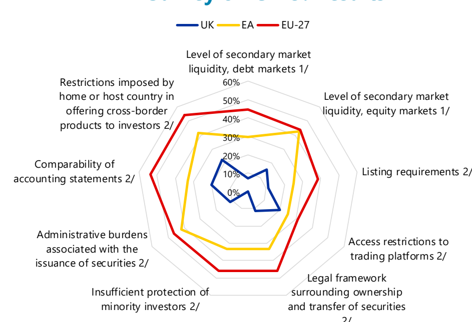

Source: IMF staff estimates.

**Relative Importance of Barriers**




Source: IMF staff analysis.

**IMF Survey on CMU: Results**




Source: IMF staff calculations.

Note: 1/ Percent of respondents assessing as "low" or "very low."
2/ Percent of respondents assessing as "somewhat a deterrent" or "a high deterrent."

**A new IMF survey of asset managers and security regulators provides insight into the most important barriers to an integrated capital market**. Deficiencies in insolvency frameworks, regulatory quality and quality of auditors are significant obstacles to cross-border investment in most of the EU-27 countries. Restrictions on access to trading platforms and onerous listing requirements hinder firms' ability to raise funds from cross-border venues. Market liquidity for both debt and equity markets is significant lower in the EU-27 countries and the euro area than in the U.K. Furthermore, many participants felt that protectionist policies hindered cross-border M&As.

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1/ See Mitra, Weber, and others, 2019, "A Capital Markets Union for Europe," IMF Staff Discussion Note (forthcoming).

greater data dissemination on unlisted corporations, and simplified procedures for reclaiming withholding taxes. The regulatory and supervisory powers of the European Supervisory Authorities could be sharpened, centralizing powers over systemic entities. While insolvency regimes are enshrined in national law, the EU could define and monitor minimum standards. The authorities should also seek maximum cooperation with third countries on capital market issues, reflecting the global nature of capital market finance.

***Authorities' Views***

70. **The authorities welcomed progress toward an agreement on an ESM backstop for the SRF**. There is political agreement that ESM resources for bank resolution will be provided swiftly in a crisis. In view of this commitment, the ESM is confident that adequate governance arrangements, which in some countries may require parliamentary involvement, will be found to take decisions in the foreseen time span of 12 hours or, in exceptional cases, 24 hours. Moreover, the Eurogroup has agreed to the introduction of an emergency procedure based on qualified majority voting rather than unanimity.

71. **Liquidity post resolution is being actively discussed**. For small and medium-sized banks, the combined resources of the SRF and the backstop of around €120 billion should suffice, unless there were multiple bank resolutions at the same time. But calculations by the SRB show that globally systemic institutions could potentially have much higher financing needs. The ECB has emphasized that it can only provide liquidity against adequate collateral including possibly a guarantee from a highly rated European entity. Thus, there is an ongoing debate about how and by whom this collateral and/or guarantee can be provided so that the ECB can act as liquidity provider to banks coming out of resolution. Proposals range from an ESM guarantee to appropriately rated bonds issued by the SRF/SRB.

72. **Further progress on common deposit insurance is seen as essential to create an integrated banking market**. It is viewed as necessary to ensure that insured deposits in all member states are equally safe and to reduce ring fencing by national banking supervisors. In the past, the debate had centered on risk reduction versus risk sharing, which revealed significant divisions among EU member states, and led to a stalemate in negotiations. In December 2018, the Eurogroup set up a high-level working group, mandated to define a roadmap for starting political negotiations on EDIS. A report from this group in June revealed that disagreements remain on several key issues and that further work is needed.

73. **The authorities agreed on the importance of completing the CMU**. Making progress on some more ambitious elements, such as improving insolvency regimes or centralizing supervisory power in some areas, will be difficult since it will require political consensus among EU member states.

# STAFF APPRAISAL

**74. The euro area is at a challenging juncture**. While growth is expected to recover from the recent slowdown, downside risks are substantial. Even if growth recovers, the monetary union will continue to be challenged by sizeable imbalances at the national level, in particular large external surpluses in some countries and high public debt in others. At the same time, there is little political consensus on further steps to improve the euro area architecture. The incoming European Parliament and European Commission should use their term to forge a renewed consensus around strengthening the foundations of the monetary union.

**75. Growth is projected to firm up over the course of this year, but inflation will take longer to pick up**. Growth slowed in 2018, after a long expansion, due mainly to slowing external demand and some, mostly temporary, domestic factors. The improvement is predicated on continued robust domestic demand—supported by tight labor markets and accommodative policies—and a global trade recovery. Inflation is projected to converge to the ECB's objective only gradually, reflecting subdued core inflation.

**76. Serious risks could derail the upswing**. A continuation or escalation of global trade tension could undermine external demand and weaken confidence. The risk of a no-deal Brexit remains high. And high-debt countries' failure to rebuild fiscal buffers and implement reforms leave them vulnerable to shocks. Even in the absence of a major shock, the euro area could enter a prolonged period of anemic growth and inflation.

**77. The persistent undershooting of inflation calls for prolonged monetary accommodation, although this is not without risks**. The current stance is already—and appropriately—strongly accommodative. The ECB should consider further extending its forward guidance to support a sustained pickup in inflation. Macro-prudential instruments should be used proactively to address any potential financial stability risks. If the inflation outlook were to be substantially downgraded, or if inflation expectations continued to decline, further accommodation may be necessary.

**78. Countries with high public debt should pursue a prudent path of debt reduction**. Despite robust growth in recent years, high-debt countries have not consolidated sufficiently, and in some cases have even eased fiscal policy. Yet, these deviations have been met by lenient enforcement, weakening countries' incentives to respect the rules and making it hard for the EU institutions to credibly react to new violations. Even with growth slowing, countries with high debt should rebuild fiscal buffers to be prepared in case the growth outlook worsens significantly.

**79. Countries with fiscal space should invest to lift potential growth**. The fiscal easing planned this year in countries with ample fiscal space such as Germany and the Netherlands is in line with staff's advice. Going forward, there is scope for greater investment in growth-enhancing areas such as infrastructure, innovation, and education.

**80. In a severe downside scenario, a more active fiscal policy response is needed**. The escape clause in the fiscal framework could be activated, allowing countries to use fiscal policy to support growth, while being appropriately differentiated across countries according to the severity of the shock, fiscal space, and financing conditions.

**81. Reform efforts should be stepped up at the national level to reduce potentially unsustainable productivity and competitiveness gaps**. Further deepening the Single Market for services could help address sluggish productivity growth in the services sector. EU-level instruments can be used to incentivize efforts at the national level. Reforms that increase product and labor market flexibility and improve the functioning of corporate insolvency regimes can help economies to adjust more rapidly in the face of adverse shocks.

**82. Policy efforts should pursue external rebalancing and defend trade openness**. Policies that incentivize investment and lift potential growth will also help reduce surpluses in net external creditor countries. For net external debtor countries, reforms to boost productivity growth will lower competitiveness gaps. The EU should continue its proactive approach to safeguarding the gains from trade and reforming the rules-based global trading system to address its current weaknesses.

**83. Further strengthening the banking sector is critical to making the euro area more resilient**. Banks have built significant capital buffers and reduced nonperforming loans, but bold actions are needed to address their structurally low profitability. Progress has been made in tackling FSAP recommendations on macroprudential policies, AML, liquidity monitoring, and early intervention of problem banks, but an overhaul of the bank supervision and crisis management frameworks have been postponed to the next Commission. Addressing data gaps in several areas is urgently needed to fully assess financial stability risks. Over the medium term, to address gaps and fragmentation along national lines, AML supervision should be centralized at the EU level.

**84. The European institutions should use their next term to forge a renewed consensus on completing the foundations of the monetary union**. The agreement on an ESM backstop for the SRF is welcome, but the final design must allow for a rapid deployment of the backstop in a crisis. A truly borderless banking union will also require a common deposit insurance scheme, to be phased-in alongside agreed risk-reduction measures. To fully unlock the potential of the CMU, there is a need to increase information transparency, move to more efficient insolvency regimes, and simplify withholding tax rules. The proposal for a euro area budget for convergence and competitiveness is encouraging, but the common currency area also needs an instrument for macroeconomic stabilization.

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

## Table 1. Euro Area: Main Economic Indicators, 2016–24

| | 2016 | 2017 | 2018 | Projections 1/ 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|---|---|---|---|
| Demand and Supply | | | | | | | | | |
| Real GDP | 1.9 | 2.4 | 1.9 | 1.3 | 1.6 | 1.5 | 1.4 | 1.4 | 1.3 |
| Private consumption | 1.9 | 1.7 | 1.3 | 1.4 | 1.5 | 1.5 | 1.4 | 1.4 | 1.3 |
| Public consumption | 1.8 | 1.2 | 1.0 | 1.0 | 1.1 | 0.9 | 0.8 | 0.9 | 1.0 |
| Gross fixed investment | 3.9 | 2.7 | 3.4 | 2.8 | 2.7 | 2.5 | 2.3 | 2.1 | 1.9 |
| Final domestic demand | 2.3 | 1.8 | 1.7 | 1.6 | 1.7 | 1.6 | 1.5 | 1.4 | 1.4 |
| Stockbuilding 2/ | 0.1 | 0.0 | 0.1 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Domestic demand | 2.4 | 1.8 | 1.8 | 1.4 | 1.7 | 1.5 | 1.5 | 1.4 | 1.4 |
| Foreign balance 2/ | -0.3 | 0.7 | 0.2 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Exports 3/ | 3.0 | 5.1 | 3.2 | 2.6 | 3.4 | 3.4 | 3.4 | 3.3 | 3.2 |
| Imports 3/ | 4.2 | 3.9 | 3.2 | 3.0 | 3.8 | 3.7 | 3.6 | 3.5 | 3.5 |
| Resource Utilization | | | | | | | | | |
| Potential GDP | 1.2 | 1.4 | 1.3 | 1.3 | 1.4 | 1.4 | 1.4 | 1.4 | 1.4 |
| Output gap | -1.2 | -0.3 | 0.3 | 0.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 |
| Employment | 1.4 | 1.6 | 1.5 | 0.9 | 0.6 | 0.4 | 0.3 | 0.2 | 0.2 |
| Unemployment rate 4/ | 10.0 | 9.1 | 8.2 | 7.7 | 7.5 | 7.3 | 7.2 | 7.1 | 7.1 |
| Prices | | | | | | | | | |
| GDP deflator | 0.9 | 1.1 | 1.4 | 1.5 | 1.6 | 1.7 | 1.8 | 1.9 | 2.0 |
| Consumer prices | 0.2 | 1.5 | 1.8 | 1.3 | 1.6 | 1.6 | 1.8 | 1.9 | 1.9 |
| Public Finance 5/ | | | | | | | | | |
| General government balance | -1.6 | -1.0 | -0.5 | -0.9 | -0.8 | -1.0 | -1.0 | -1.0 | -1.0 |
| General government structural balance | -0.8 | -0.7 | -0.6 | -0.8 | -1.0 | -1.1 | -1.2 | -1.1 | -1.1 |
| General government gross debt | 89.2 | 87.1 | 85.1 | 83.7 | 81.9 | 80.3 | 78.7 | 77.1 | 75.6 |
| External Sector 5/, 6/ | | | | | | | | | |
| Current account balance | 3.1 | 3.2 | 2.9 | 2.8 | 2.6 | 2.5 | 2.4 | 2.3 | 2.2 |
| Interest Rates (end of period) 4/, 7/ | | | | | | | | | |
| EURIBOR 3-month offered rate | -0.3 | -0.3 | -0.3 | -0.3 | ... | ... | ... | ... | ... |
| 10-year government benchmark bond yield | 1.3 | 0.9 | 1.2 | 0.9 | ... | ... | ... | ... | ... |
| Exchange Rates (end of period) 7/ | | | | | | | | | |
| U.S. dollar per euro | 1.05 | 1.18 | 1.14 | 1.12 | ... | ... | ... | ... | ... |
| Nominal effective rate (2005=100) | 98.9 | 106.1 | 107.7 | 107.0 | ... | ... | ... | ... | ... |
| Real effective rate (2005=100, ULC based) | 81.2 | 86.7 | 86.2 | 85.6 | ... | ... | ... | ... | ... |

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

1/ Projections are based on aggregation of *WEO* July 2019 projections submitted by IMF country teams.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent.
5/ In percent of GDP.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2019.

## Table 2. Euro Area: External Sector Assessment

| | Euro Area |
|---|---|
| **Foreign Asset and Liability Position and Trajectory** | **Background**. The net international investment position (NIIP) of the euro area fell to about -17 percent of GDP by the end of 2009, but has since recovered, reaching about -4 percent by the end of 2018.[1/] The rise has been driven by stronger current account balances (CA) and modest nominal GDP growth. Gross foreign positions were about 228 percent of GDP for assets and 232 percent of GDP for liabilities in 2018. However, net external assets reached elevated levels in large net external creditors (for example, Germany and the Netherlands), whereas net external liabilities remained high in some countries, including Spain and Portugal.<br>**Assessment**. Projections of continued CA surpluses suggest that the NIIP-to-GDP ratio will improve further, at a moderate pace, and the euro area is expected to soon become a net external creditor. The region's overall NIIP financing vulnerabilities appear low. Despite improved CAs, large net external debtor countries still bear a greater risk of a sudden stop of gross inflows. |
| 2018 (% GDP) | NIIP: -3.8 · Gross Assets: 228.0 · Debt Assets: 89.7 · Gross Liab.: 231.8 · Debt Liab.: 94.6 |
| **Current Account** | **Background**. The CA balance for the euro area increased steadily from 2011, when it was close to zero, reaching a peak of 3.2 percent in 2016–17. In 2018, the CA balance narrowed to 3.0 percent of GDP, reflecting higher oil prices and weaker external demand from key trading partners (China, Turkey, and United Kingdom) in the context of rising trade tensions and Brexit-related uncertainties. Some large creditor countries, such as Germany and the Netherlands, continued to have sizable surpluses, reflecting strong corporate and household saving and weak investment.<br>**Assessment**. The EBA model estimates a CA norm of 1.1 percent of GDP, against a cyclically adjusted CA of 2.9 percent of GDP. This implies a gap of 1.8 percent of GDP. Staff's analysis indicates a higher CA norm than estimated by the EBA model, consistent with the assessed external positions of euro area member countries. The higher CA norm takes into account the large net external liabilities positions in some countries (for example, Spain) and uncertainty about the demographic outlook and the impact of the recent large-scale immigration (for example, Germany). In addition, adjustments to the underlying CA for measurement issues are considered in a few cases (for example, Ireland and the Netherlands). Considering these factors and uncertainties in the estimates, staff assesses the CA gap to be 1.3 percent for 2018, with a range of 0.5 to 2.1 percent of GDP.[2/, 3/] |
| 2018 (% GDP) | Actual CA: 2.9 · Cycl. Adj.: 2.9 · EBA CA Norm: 1.1 · EBA CA: 1.8 · Staff Adj.: -0.5 · Staff CA Gap: 1.3 |
| **Real Exchange Rate** | **Background**. The CPI-based real effective exchange rate (REER) appreciated by about 3.0 percent from 2017 to 2018, reflecting that the nominal appreciation of about 5.2 percent was partly offset by weaker inflation in the euro area relative to its trading partners. Estimates through May 2019 show that the REER has depreciated by 3.1 percent relative to the 2018 average, partly reflecting the euro area's relatively weaker growth and inflation outlook.<br>**Assessment**. Consistent with the assessed REERs of euro area member countries, staff assesses the average euro real exchange rate gap in the range of -5 to -1 percent, with a mid-point of -3 percent.[4/, 5/] As with the CA, the aggregate masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 8 to18 percent in Germany to overvaluations of 0 to 10 percent in several small to mid-sized euro area member states. The large differences in REER gaps within the euro area highlight the continued need for net external debtor countries to improve their external competitiveness and for net external creditor countries to boost domestic demand. |
| **Capital and Financial Accounts: Flows and Policy Measures** | **Background**. Mirroring the 2018 CA surplus, the euro area experienced net capital outflows, largely driven by portfolio debt and FDI outflows. These were somewhat tempered by inflows into portfolio equity.<br>**Assessment**. Capital outflows in portfolio debt and inflows into portfolio equity over the past couple years likely arose in large part from the ECB's monetary accommodation through its asset purchase program, which has lowered yields on debt and spurred interest in equity. |
| **FX Intervention and Reserves Level** | **Background**. The euro has the status of a global reserve currency.<br>**Assessment**. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating. |

1/ The reported NIIP reflects the euro area's position *vis-à-vis* the rest of the world.
2/ 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 the GDP-weighted and trade-weighted averages, respectively, of the assessments of the individual countries listed above.
3/ When applying GDP-weighted aggregation for the euro area, the CA norm is subtracted by 0.6 percent of GDP, which is the difference between the sum of the individual 11 countries' CA balances and the CA of the entire euro area.
4/ The EBA REER level model indicates an overvaluation of 1.1 percent, whereas the index model points to an overvaluation of 6.0 percent in 2018.
5/ The staff-assessed REER gap of -3 percent is within the (-5 percent, +5 percent) interval described as broadly in line with fundamentals.

### Overall Assessment

**Overall Assessment**:
*The external position in 2018 was moderately stronger than the level implied by medium-term fundamentals and desirable policies. Going forward the current account surplus is projected to narrow modestly as surpluses decline in large net external creditor countries, supported by a gradual realignment of price competitiveness and solid domestic demand.*

Nevertheless, imbalances at the national level are expected to remain sizable. Countries with excess CA surpluses should continue to strengthen investment and potential growth, whereas those with weak external positions should work to further raise productivity and competitiveness.

**Potential Policy Responses**:
Monetary policy should remain accommodative until inflation has durably converged to the ECB's medium-term price stability objective, facilitating relative price adjustments at the national level by enabling greater inflation differentials across monetary union members. Area-wide initiatives to make the currency union more resilient (for example, banking and capital markets union, fiscal capacity for macrostabilization) could also reinvigorate investment and reduce savings-investment imbalances. At the country level, efforts are needed to address imbalances. Countries with stronger-than-warranted external positions should use available fiscal space to expand investment and promote structural reforms to foster entrepreneurship and raise their potential growth. Meanwhile, countries with weaker-than-warranted external positions should continue consolidating to reduce their debt and increase their buffers, while undertaking competitiveness-enhancing reforms. In general, a more balanced policy mix with the implementation of priority institutional and structural reforms at the country level would help to reduce external imbalances, including within the euro area.

**Table 3. Euro Area: Risk Assessment Matrix** [1/]

| Sources of Risk | Likelihood of Risk (High, Medium, Low) | Expected Impact of Risk (High, Medium, Low) | Policy Response |
|---|---|---|---|
| Rising protectionism and retreat from multilateralism | **High**<br>In the near term, escalating and sustained trade actions could reduce global and regional policy collaboration with negative consequences for trade, capital and labor flows, investment, productivity, sentiment and longer-term growth. Over the medium term, geopolitical competition and fraying consensus about the benefits of globalization could lead to economic fragmentation, with adverse effects on growth and stability. | **High**<br>• A retaliatory cycle of trade restrictions. Undermining of the rules-based international trading system.<br>• Lower growth due to trade barriers.<br>• Increased policy uncertainty, exacerbating low investment, weak productivity and weighing on growth. | • Continued support for the multilateral rules-based trading system, trade liberalization and free-trade agreements.<br>• Redouble efforts to secure the benefits of economic integration and cooperation across the EU.<br>• Measures to support growth and productivity, such as scaled up domestic public investment. |
| A disorderly Brexit | **High**<br>A disorderly Brexit could have serious economic consequences. | **High**<br>• Significant disruptions, including border delays and a sudden increase in tariff and nontariff costs, and long-term efficiency losses from a disorderly Brexit, especially for countries with closer links to the U.K. | • Contingency planning and collaboration between U.K. and EU authorities to reduce cliff-edge effects and disruptions. |
| A shift in market sentiment against some high-debt euro area countries | **High**<br>Policy slippages with weak growth outturns in some high-debt euro area countries could raise concerns over debt sustainability, while disregard for the common fiscal rules and rising yields test the euro area policy framework in the medium term. | **High**<br>• Both sovereign and bank spreads higher, given the significant sovereign-bank linkages.<br>• Loss of credibility of the euro area policy framework. | • Fiscal consolidation is needed in high-debt countries.<br>• Risk reduction needs to continue to sever the sovereign-bank nexus.<br>• Reform the Stability and Growth Pact to simplify the rules and strengthen their enforcement. |
| Weaker-than-expected global growth | **Medium**<br>Synchronized slowdown in the U.S., Europe, and China could be mutually re-enforcing. Confidence could wane in the U.S., leading to abrupt closure of output gap. Policy easing in China may not fully offset a slowdown in the short term reflecting trade tensions and/or a housing market downturn. Over the medium term, insufficient progress in deleveraging and rebalancing in China could lead to disruptive adjustment with adverse international spillovers. | **High**<br>• Lower growth potential and higher output gaps compared to baseline due to slower export growth, weaker investment and persistent long-term unemployment.<br>• Further deterioration in public debt sustainability, private balance sheets, intra-euro area rebalancing. Slower export growth, higher output gap. | • Accelerate structural reforms to spur investment, productivity and competitiveness, advance rebalancing of bank, corporate, and household balance sheets to enhance monetary transmission.<br>• Adopt more accommodative fiscal stance in countries with available fiscal space and financing conditions.<br>• Continue accommodative monetary policy to raise inflation and support demand. |
| Further pressure on traditional bank business models | **Medium**<br>Legacy problems, structurally high cost of bank operations, and potential competition from nonbanks curtail banks' profitability could lead to financial distress in one or more major banks, especially in an environment of weaker growth. | **Medium**<br>• Given insufficient progress in balance sheet repair in some countries and broader profitability concerns, such an event could reverberate through the entire financial sector and widen sovereign yield spreads within the banking union. | • Forceful supervisory actions when assessing banks' business model.<br>• Insolvency reform, further development of distressed debt markets, cost cutting, and banking system consolidation, including from cross-border mergers and acquisitions, would facilitate the sector's adjustment.<br>• The ECB's guidance on NPL management should be followed with strict supervisory monitoring of all banks.<br>• Greater inter-agency coordination and data sharing and improved readiness for early intervention in problem banks. |
| Intensification of security risks could lead to a sharp rise in migrant flows into Europe. | **Medium**<br>New geopolitical tensions could lead to socio-economic disruptions. | **Medium**<br>• Failure to implement and improve the common policy to deal with asylum seekers and other migrants to the EU could deepen political divisions.<br>• Lack of integration of migrants could raise unemployment, put pressure on national budgets and put social cohesion at risk.<br>• Border controls could restrict movement of goods, services, and labor in the single market. | • Refugees should be rapidly integrated into host country labor markets.<br>• Temporary costs related to refugee expenditures should be accommodated within current fiscal targets on a case-by-case basis.<br>• A new system to relocate refugees is needed to reduce the burden on frontline countries. |

[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** | Improve the functioning of the labor market to lower structural unemployment and improve opportunities for disadvantaged groups.<br><br>Improve the business environment and strengthen competition in service sectors.<br><br>Reform government spending to put debt on a firm downward path and attain MTO. | • The government enacted key reforms of the labor code in 2017, including: (i) limiting the automatic extension of branch-level agreements and allowing firms more freedom to opt out from such agreements; (ii) further reducing judicial uncertainty surrounding dismissals (notably through capping damages and limits on the time for recourse to labor tribunals); and (iii) simplifying social dialogue.<br>• In the context of the 2018 budget, the authorities legislated tax reforms supporting investment and job creation, including lowering the tax wedge in a budget-neutral way, reducing the CIT gradually, and simplifying capital taxation.<br>• Key reforms of the apprenticeship and professional-training systems were legislated in 2018, aimed at improving opportunities and skills particularly for vulnerable groups.<br>• Measures to further reduced gender gap were introduced, including a novel index measuring gender pay inequalities.<br>• A reform of the public railway company in 2018 introduced measures to increase competition in passenger transport.<br>• A new law legislated in 2019 aimed at simplifying the process associated with firm creation, encouraging firm growth, promoting entrepreneurship and innovation, supporting a reallocation of savings toward longer term investment, and improving the insolvency regime. | • Fully implement recent labor market reforms (e.g., labor code, apprenticeship and training), monitor their effects, and reinforce them as needed, including through ambitious implementation of the planned reform of the unemployment benefit system (aiming to bring the generosity of the system more in line with peers and deter the use of precarious work arrangements).<br>• Continue to pursue complementary product and service market reforms to ease the administrative burden on startups and foster competition in regulated professions, retail trade, and the sale of medicines in order to support productivity growth and improve resilience.<br>• Provide specific plans on how to reduce public spending over the medium term in order to put debt on a firm downward path while protecting social objectives. Implementation of the planned reforms of civil service (which should provide the tools to streamline and make the public sector more efficient) and the pension system (aimed at unifying the existing pension systems under one umbrella to improve transparency, efficiency, and equity while incentivizing longer work) will be key in this regard. Additional efforts to underpin consolidation efforts while improving efficiency and supporting social objectives could focus on tax expenditures and subsidies, health, education, better targeting social benefits, and eliminating overlaps between central and local government functions. |
| **Germany** | Increase labor force participation of women, older workers, and refugees, and facilitate immigration of qualified workers.<br><br>Increase productivity through:<br><br>Increasing investment in human capital;<br><br>Enhancing competition, especially in the services sector; | *Increase labor force participation*<br>• Progress is being made in expanding child care provision: for example, Germany adopted (i) a program called "child care financing" to support the expansion of childcare places (June 2018); and (ii) a bill on quality in early childhood education and care (came in effective in January 2019).<br>• To reduce financial disincentives to work after pensionable age, the Act to Flexibilize the Transition from Working Life to Retirement and to Strengthen Prevention and Rehabilitation in Working Life was introduced in 2017. The government plans to review the law in 2022.<br>• Refugee integration is gaining momentum thanks to the measures taken in 2015–16 to broaden access to training and active employment services to refugees and asylum seekers have been supporting.<br>*Increase investment in human capital*<br>• The Basic Law has recently been amended to allow the federal government to provide financial assistance to Länder in key investment areas, including in education. | • Lower the tax wedge on low-income households and secondary earners.<br>• Further expand the provision of child care.<br>• Enhance education and lifelong learning.<br>• Explicitly link the statutory retirement age and life expectancy.<br>• Facilitate labor market integration of migrants.<br><br>• Increase further investment in education and lifelong learning. |

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

| | Reform Priorities | Recent Progress | Staff Recommendations |
|---|---|---|---|
| **Germany** | Advancing digitalization;<br><br>Supporting innovation and venture capital and reduce administrative burden;<br><br>Reduce uncertainties about energy transition. | • The Skills Development Opportunities law came into force in January 2019, aiming to improve access to vocational education and training for workers whose professional activities can be replaced by technology or affected by structural reforms, or those who seek training in occupations affected by skill shortages.<br>*Enhance competition*<br>• Action plan on professional regulations submitted to the EC in January 2016. In 2019, the government plans to undertake a review of regulations in professional services, with the goal of reforming the Professional Law in this area. To promote further competition, the government plans to evaluate the Railway Regulation Act.<br>*Advance digitalization*<br>• The government has set out a strategy and allocated budget resources of up to €12 bn to support a nationwide fiber-based gigabit network. Investment-friendly regulation, in accordance with the European Electronic Communications Code, to incentivize private investments is to be implemented by end-2020. The government is also preparing a master plan to expand mobile coverage and deploy 5G.<br>*Support innovation and reduce admin. burden*<br>• To support innovation, especially of SMEs, the government is drafting a bill on R&D tax credit. To further support venture capital, the government plans to continue its co-investment strategy to crowd in private investment, especially by institutional investors. The government is making progress in implementing the National e-Government Strategy.<br>*Reduce uncertainties about energy transition*<br>• The government published the Electricity Grid Action Plan in August 2018, laying out strategy to expand the power grid. The government has also introduced measures to promote green tech and reduce the cost of renewable energy. The forthcoming National Energy and Climate Plan for 2021–30 will include concrete measures to attain the 2030 target on reducing greenhouse gas output, while steps to phase out coal-fired power generation by 2038 are under preparation. A carbon tax is under discussion in the government. | • Address teacher shortages, especially in vocational education and training and primary education.<br>• Further deregulate professional services, especially accountants, architects, and engineers.<br>• Strengthen the regulator's powers to stop discrimination against the incumbent operators' competitors in railways and postal services.<br>• Strengthen incentives for private sector participation in expanding the coverage of high-speed fiber optic internet at the national level.<br>• Facilitate the scaling up of venture capital by attracting institutional investors and encouraging cross-border investment, including in the context of the EU-wide Capital Markets Union.<br>• Expand the total envelope for R&D tax credit.<br>• To reduce administrative burden, push ahead with the National e-Government Strategy.<br>• A clearer strategy for curbing greenhouse gas emissions would help reduce uncertainty about the energy transition. This should include measures to promote public transportation and sustainable mobility, as well as concrete plans to phase out coal-fired power production by 2038, as recommended by the Commission on Growth, Structural Change and Employment in January 2019 and decided by the government.<br>• The introduction of a carbon tax could be part of the solution. |
| **Greece** | Preserve and further expand labor market flexibility.<br><br>Foster competition in service and product markets. | On *labor market* reforms:<br>• The core 2011 reforms were effectively reversed (August 2018), the statutory minimum wage was increased by 10.9 percent (February 2019), while the sub-minimum wage for workers under 25 was abolished. These reversals increase downside risks to the employment recovery and competitiveness. A collective dismissal framework reform features elements | • Pursue more flexible labor market policies, including favoring firm-level agreements over sectoral ones in wage setting to reflect specific circumstances. Transparent application and periodic assessment of collective bargaining rules are warranted<br>• Accelerate reforms to reduce nonwage costs (business environment, tax policy, cost of financing). |

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

| | Reform Priorities | Recent Progress | Staff Recommendations |
|---|---|---|---|
| **Greece** | Improve the business environment. | on strike quorum. that may mitigate potential negative effects, but employment protection regulations have been amended, further restricting labor market flexibility. Other reforms are ongoing (e.g., on undeclared work and ALMPs)<br>On *product market* reforms:<br>• Progress has been made in some areas, including partial liberalization of professions, the modernization of the public works registries and easing trade restrictions. Although important legislative recommendations for key sectors have been adopted, their implementation has been weak.<br>On *business environment* improvement<br>• Investment licensing procedures have been simplified, but key sectors remain outside the new rules. | • Reassess the status of regulated professions to tackle bottlenecks to price competition.<br>• Take a fresh look at product market regulation, in particular secondary legislation. Strengthen the capacity of the Hellenic Competition Commission to identify bottlenecks to competition. Strengthen implementation of investment licensing reforms; extend its scope to other sectors. |
| **Italy** | Implement labor market reforms.<br><br>Increase competition in product and services markets.<br><br>Reform civil justice and insolvency.<br><br>Raise public sector efficiency. | • A "Dignity Decree" was adopted in mid-2018 with the goal of increasing hiring on permanent contracts and lowering dismissals by reducing incentives to use temporary contracts and increasing dismissal costs. A recent constitutional court ruling delinked dismissal costs from the length of employment, increasing uncertainty over such costs. The 2019 budget increased the retirement age with the view of incentivizing employers to hire young workers to replace those retiring. A "citizenship income" program was also introduced with incentives for unemployed recipients to seek employment more actively.<br>• The original provisions of the 2018 Competition Law were weakened over two years of discussion in parliament, as well as more recently (e.g., on the liberalization of energy tariffs, reform of local state-owned enterprises, and minimum fees for professionals).<br>• A new insolvency law was adopted in January 2019 and is expected to take full effect in August 2020. The reform focuses on rationalizing the insolvency system, incentivizing early restructuring and preventing insolvency. To speed up some insolvency procedural actions, the new law emphasizes digitalization of legal processes.<br>• The new government introduced a bill to reform public administration by cutting red tape, simplifying procedures through digitalization, and improving efficiency by reforming managerial roles and fighting absenteeism. In addition, the authorities | • Decentralize wage bargaining to facilitate the realignment of wages with productivity at the firm level, thereby also reducing regional disparities in labor outcomes by giving clear primacy to firm-level contracts. Lower the cost and uncertainty over dismissals. Extend the new Jobs Act contracts to all open-ended contracts in the private sector. Strengthen the role of ALMPs by ensuring effective coordination between the central and local administrations, with close attention to design and incentives.<br>• Ensure an annual process of adopting pro-competition laws. Enhance competition including in local public service provision, legal and professional services, energy, and retail. Refrain from reversing or weakening past reforms. Strengthen the enforcement powers of the Competition Authority.<br>• Significant implementation efforts of the new law are required, including by strengthening the regulation of insolvency administrators and finetuning the early warning mechanism. Reinforce the new insolvency law with the revision of creditor priorities and further streamlining of in-court processes. Improve out-of-court enforcement by providing greater legal certainty and increased flexibility of the mechanism. Fold the special insolvency regime for large enterprises into the modernized insolvency framework, with specific well-defined circumstances for potential state intervention if necessary, in line with international best practice. Further improve the efficiency of civil justice and court case management by simplifying judicial processes, ensuring sufficient court resources and applying best case management practices across Italy. |

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

| | Reform Priorities | Recent Progress | Staff Recommendations |
|---|---|---|---|
| **Italy** | | intend to simplify the procurement code. The implementation of the privatization or rationalization of public enterprises has been weakened and delayed to 2020. | • Given repeated shortfalls in reforming the public administration successfully, the priority is to improve the managerial and administrative capacity to implement reforms and address weaknesses in coordination between the center and regions. Upgrade the public sector skill mix, match positions with skills, align wages with productivity, and reduce high public-private wage premiums. Enhance the effectiveness of procurement reform by securing savings of the centralized purchasing units and tackling difficulties in public works. Streamline, consolidate or privatize local state-owned enterprises. Publish ambitious targets or key performance indicators to track and clearly communicate progress. |
| **Portugal** | Preserve labor market flexibility.<br><br>Review the composition of public expenditure. | • The government coordinated tri-partite negotiations on labor regulations, aimed *inter alia* at increasing job security and reducing segmentation. The agreed reforms include measures that reduce firms' ability to flexibly manage their labor, such as new constraints in the use of "banks of hours" and a reduction in the maximum duration of temporary contracts; but they also permit an increase in the duration of probation periods in permanent contracts and take into account industry-specific practices in the design of some regulations. These agreements are still in parliament.<br>• Capital spending has increased in recent years from a low base. The authorities recently negotiated a modest pay rise for teachers and others in similar professions to compensate them for past freezes. | • Preserve recent labor market reforms. Promote managerial skills; more inclusive labor support systems; link minimum wage increases to productivity growth and use alternative policies to fight poverty; reduce duality by making permanent contracts more flexible.<br>• A comprehensive review of the level and composition of public employment is needed to help identify ways to control the wage bill growth without affecting service delivery. Capital spending needs to increase further. |
| **Spain** | Make the labor market more inclusive, by addressing labor market duality, raising regional mobility, and tackling skills mismatches.<br><br>Enhance competition and facilitate innovation and growth of firms. | • The authorities intensified inspections and sanctions to reduce the abuse of temporary and involuntary part-time contracts.<br>• Progress toward raising the efficiency and effectiveness of active labor market policies has been limited.<br>• The authorities plan to improve coordination between the regions with enhanced profiling tools and information systems, as well as better identification of skills required by the labor market. The government is working on an action plan that aims to upgrade education outcomes, including through more vocational training and life-long learning.<br>• The implementation of the Market Unity Law has been slow despite efforts for greater coordination with the regions.<br>• The government started providing financial counseling to SMEs. | • Reduce labor market segmentation by improving the attractiveness of open-ended contracts.<br>• Address shortcomings in the labor legislation, while preserving wage flexibility.<br>• Ensure that active labor market policies are better targeted, evaluated, and coordinated. Increase capacity of the public employment services.<br>• Improve the quality of education and training.<br>• Consider measures to incentivize labor mobility, such as subsidies for moving expense, temporary and targeted housing assistance.<br>• Swiftly implementing the Market Unity Law and liberalizing professional services.<br>• Tackling the remaining size-related rules and regulations, including on reporting, auditing, and labor regulation.<br>• Increasing the efficiency of public R&D, improve public-private cooperation, and enhance private R&D investment. |

Source: IMF country teams.

# Annex I. Progress Against IMF Recommendations

| Policies | 2018 Article IV Policy Advice | Actions since 2018 Article IV |
| --- | --- | --- |
| **Structural Policies** | Countries should grasp the opportunity afforded by strong growth to redouble reform efforts. | Compliance with the 2018 Country-Specific Recommendations (CSR) under the European Semester continues to disappoint. See Table 4 for country-specific information on reform progress. |
| | Linking EU financial support to incentivize reforms. | The newly proposed reform delivery tool and technical support instrument by the European Commission under the 2021–27 EU budget, while limited in size (0.2 percent of the EU-27 GDP), can incentivize national reform efforts. |
| | The EU should stay committed to free trade and the rules-based global trading system. | The EU-Japan free-trade agreement, which entered into force in February 2019, created the largest open trade zone in the world. Trade negotiations with Australia and New Zealand have started. The European Commission is developing a proposal to modernize the WTO. |
| **Fiscal Policies** | Countries with fiscal space should use it to promote public investment and structural reforms, while high-debt countries should adjust now to rebuild buffers. | Policy actions have been mixed. Some countries with fiscal space eased their fiscal stance while others tightened. High-debt countries have not adjusted enough, either easing or having a broadly neutral fiscal stance. |
| | Better compliance with and enforcement of the fiscal rules is needed. This would help build the political support required to establish a central fiscal capacity (CFC). The fiscal rules should be simplified and enforcement made more automatic. A CFC should be designed to better smooth macroeconomic shocks and improve the fiscal-monetary policy mix, while supporting fiscal discipline in good times. | Compliance with the fiscal rules has been weak and enforcement has become increasingly discretionary. There are currently no discussions on reforming the fiscal rules. In December 2018, euro area leaders endorsed a euro area budget contained in the EU budget. However, agreement on the size and financing of such an instrument has not been reached yet. |
| **Monetary Policies** | Strong monetary accommodation should be maintained until inflation is convincingly converging to objective. | The ECB stopped net asset purchases at the end of 2018. But monetary policy is expected to remain strongly accommodative at least through the first half of 2020. The ECB has committed to fully reinvesting maturing securities under the asset purchases program until well beyond the first rate hike, implying a repurchase of about €20 billion per month in a context of falling debt-to-GDP ratios in most euro area countries. Moreover, reflecting the worsening outlook for growth and inflation, the ECB Governing Council in June 2019 postponed the first rate hike to after mid-2020 at the earliest. A new quarterly series of targeted longer-term refinancing operations (TLTRO III) was announced in March 2019, to be launched between September 2019 and March 2021. |

| Policies | 2018 Article IV Policy Advice | Actions since 2018 Article IV |
| --- | --- | --- |
| **Financial Policies** | The link between low profitability and high NPLs underline the role of NPL reduction, and thus the need for strong supervision. | NPL levels continue to improve with the ratio falling to 4 percent of gross loans in 2018Q3. However, profitability fell to an ROE of 6 percent in 2018Q3, along with the growth slowdown, and bank stock prices fell by 35 percent in 2018. Supervisory efforts are underway with banks' business models reflected in Pillar 2 decisions on capital requirements. In March 2018, both the European Commission and the ECB proposed new risk reduction measures. The Commission's package includes measures to tackle both the flow and stocks of NPLs. These include changes to the Capital Requirements Regulation that would require for new unsecured loans to be fully provisioned no later than two years, and new secured loans no later than eight years, after they become nonperforming, with concomitant Pillar 1 deductions from banks' own funds. It also seeks to provide banks with efficient out-of-court mechanisms for value recovery on secured loans while pushing the development of distressed debt markets supported by specialized credit servicers. A national blueprint for AMCs clarifies that, under exceptional circumstances, state aid may be permissible. The ECB's guideline sets provisioning expectations for all loans, new or existing, that become nonperforming going forward. As part of the supervisory dialogue, banks will be expected to cover the full value of unsecured loans no later than two years, and secured loans no later than seven years, after default, with more ambitious interim expectations than the binding requirements proposed by the Commission. |
| | The FSAP calls for closer interagency coordination and data sharing, including to facilitate earlier intervention in problem banks. | The SSM used its early intervention powers for an Italian bank, putting in place an administrator. |
| | Careful steps should be taken to encourage a gradual reduction of home bias in financial intermediaries' sovereign exposures. | No EU-level action has been taken yet. Concentration risk with sovereign exposures is assessed as part of Pillar 2 discussions. |

| Policies | 2018 Article IV Policy Advice | Actions since 2018 Article IV |
| --- | --- | --- |
| | Completing the banking union, by establishing a common deposit insurance scheme with a common fiscal backstop, would foster the free flow of liquidity and provide reassurance to supervisors that the bank-sovereign link is severed. Further integration would also be helped by corporate insolvency and foreclosure framework harmonization and a speedier implementation of the BRRD's minimum requirement for own funds and eligible liabilities (MREL) and related resolution planning. | Discussions on architecture has been slow. However, EU leaders agreed that the ESM would serve as a backstop to the SRF that would come into force before 2024 if there is sufficient progress on risk reduction by 2020.<br><br>Discussions on common deposit insurance have not progressed far.<br><br>SRB published two sets of MREL policy—on November 20, 2018 for banks without presence outside the banking union, and on January 16, 2019 for the more complex cross-border groups. The SRB intends to set binding targets for all banking groups within the SRB's remit by 2020. |
| | Rather than waiting, supervisors and resolution authorities should push the largest banks to issue more capital and junior debt now given still-supportive financial conditions, yet should remain alert to cross holdings of MREL among banks as well as potentially uneven profitability impacts. | Financial conditions were weak in 2018. EBA reports show that EU banks would need an additional EUR 39 billion of additional capital to meet Basel III needs in the next eight years. |
| | Faster progress on the capital markets union (CMU) action plan would foster greater international private risk sharing. | Many items in the CMU Action Plan have been implemented or reached political agreement. Legislations for simple, transparent, and standardized securitization, a new Prospectus Regulation, and EU Venture Capital Funds have been implemented. Political agreements have been reached on a pan-European personal pensions product, covered bonds, cross-border distribution of collective investment funds, review of investment firms, and preventive restructuring/second chance procedures, and some others. |
| | In the area of macroprudential policies, increase national authorities' flexibility, improve the transparency of ESRB warnings and ECB decisions on top-ups, legislate borrower-based tools, strengthen reciprocity arrangements, and close data gaps in commercial real estate and shadow banking. | Not done. |

# Annex II. Progress Against IMF FSAP Recommendations

| Recommendation* | Timing** | Actions |
|---|---|---|
| **Supervision** | | |
| Reduce the fragmentation of national legal frameworks for bank supervision (EU) | MT | SSM has drawn up an action plan to inform the next CRD/CRR review. |
| Revise legal provisions to close regulatory gaps with international standards (EU) | MT | Partially addressed in the most recent review of the CRD/CRR that was concluded in 2019. Some examples include interest rate risk in the banking book (BCP 23), capital adequacy (BCP 16), and liquidity risk (BCP 24), especially the 2018 amendments to the Liquidity Coverage Ratio to bring it in line with international standards. |
| Improve planning of supervisory resources (SSM) | ST | Some actions taken, for example: a Simplification Group, comprising ECB and NCA staff, has been set up to reduce complexity and duplication of work; improvements of the SSM planning module will be made in 2019. |
| Raise standards for handling of loan classification and provisioning (SSM) | ST | There were improvements in supervisory expectations on loan loss provisioning through the: (i) publication of the Addendum for new NPEs as of April 1, 2018; (ii) SREP recommendations for the stock of NPEs as of March 31, 2018; and, (iii) a new automatic Pillar 1 backstop for NPEs from newly originated loans as part of the EU Banking Reform package approved in 2019. |
| Improve coordination and information sharing regarding AML/CFT (ECB, national authorities) | ST | ECB/SSM has set up a new AML Coordination Function (ALMCO) with responsibilities: (i) to act as a central point of contact for Sis; (ii) to set up a network for achieving consistent SSM-wide prudential approach; and (iii) to act as an internal center of expertise on prudential issues. In January 2019, the ECB also signed an agreement for information exchange with nearly 50 national AML/CFT, as mandated by the 5th review of the AML Directive. Following the ESA review, the EBA is playing a coordinating role on AML/CFT supervision issues across sectors and the EU. |

| Recommendation* | Timing** | Actions |
|---|---|---|
| Transfer supervision of systemic investment firms and third country branches to the SSM (EU) | ST | A political agreement has been reached on a new Investment Firm Regulation and a Directive that would require the largest and more systemic investment firms (above €30 billion under solo, group or branch level) to be registered as credit institutions and fall under the ECB/SSM supervision. The new parliament will be expected to pass it into law later in 2019. |
| Ensure the availability of a full set of borrower-based macroprudential instruments (EC, ESRB) | MT | The ESRB has recently amended its recommendation on closing real estate data gaps. It aims at establishing a more harmonized framework for monitoring developments in real estate markets in EU countries through the adoption of harmonized definitions and methods for measuring indicators related to both residential and commercial real estate markets. It has also done a detailed survey on the availability and usability of borrower-based tools in the EU countries.<br><br>The EC will assess, as part of the 2022 review of the CRD/CRR, whether borrower-based instruments for both households and nonfinancial corporates could be added to the EU-level macroprudential toolkit. |
| **Preparations for the U.K. exit from the EU** | | |
| Accelerate discussions on action to ensure continuity of service and data access (ECB, ESAs, SSM) | I | Several actions taken in case of no-deal Brexit. Conditional recognition to U.K.-based CCPs until March 30, 2020; ESMA reduced regulatory costs of moving uncleared derivative contracts to EU-27 counterparts; specified the EU-27 dual-listed stocks that would need to trade in an EU-27 trading venue to meet the share-trading obligation requirements under MiFID II.<br><br>In March, the ECB and the BoE announced the activation of the currency swap arrangement for the possible provision of euro to U.K. banks and of GBP to euro area banks. |

| Recommendation* | Timing** | Actions |
| --- | --- | --- |
| **NPL resolution** | | |
| Prescribe rules for valuation of immovable loan collateral, including repossessed collateral (EU) | MT | -- |
| Set consistent NPL definitions and reporting standards (EC, EBA, SSM) | ST | Based on work done by EBA, the revised CRR introducing the common NPE definition (along with the Pillar 1 prudential backstop) was adopted in April 2019. |
| Establish minimum standards for insolvency and creditor rights regimes (EU) | MT | The June 2019 Directive on Preventive Restructuring established minimum standards in certain areas, including for preventive debt restructuring mechanisms and debt discharge for entrepreneurs. |
| **Crisis management and financial safety nets** | | |
| Strengthen the early action framework and advance resolution preparation (SRB, SSM, EC, NRAs) | I | In 2018, the ECB crisis management framework was further improved by refining the escalation procedures with a set of qualitative and quantitative indicators of deterioration of bank conditions. |
| Proceed quickly with the buildup of MREL and internal MREL, prioritizing large banks (SRB) | I | SRB published two sets of MREL policy—on November 20, 2018, for banks without operations outside the banking union, and on January 16, 2019 for the more complex cross-border groups. The SRB intends to set binding targets for all banking groups within the SRB's remit by 2020. New EU rules on the revised EU MREL framework (integrating TLAC) will enter into force in July 2019, applicable from early 2021.<br><br>All EU GSIIs already comply with TLAC as of January 2019. |
| Ensure availability of liquidity in resolution (SRB, EC, Eurosystem) | ST | In December 2018, the Eurogroup has mandated the Eurogroup Working Group (EWG) and the Task Force on Coordinated Action to develop terms of reference for liquidity in resolution by June 2019. In June 2019, the Eurogroup agreed that the work should continue in the second half of 2019. |
| **Crisis management and financial safety nets** | | |
| Designate and make operational the SRF backstop (such as the ESM) (EU, SRB, ESM) | ST | At the December 2018 summit, EU leaders agreed that the ESM will serve as the SRF backstop, which could come into force before 2024 if there is sufficient progress on risk reduction by 2020. A broad agreement was reached on revising the ESM Treaty in June 2019, and work will continue in the second half of 2019 to finalize the legal texts. |

| Recommendation* | Timing** | Actions |
| --- | --- | --- |
| Establish an EDIS with a backstop (EU) | ST | A high-level working group published its report in June 2019. Disagreements remain on a number of issues such as the level and metrics of risk reduction, regulatory treatment of sovereign exposures. The report identifies topics for further analytical work. |
| Ensure consistency of triggers for action such as resolution, liquidity assistance, and precautionary recapitalization (EC, ECB, SRB) | ST | -- |
| Align the relevant state-aid loss-sharing requirements (in resolution) with the BRRD/SRMR, while introducing flexibility through a financial stability exemption subject to strict criteria (EU) | ST | -- |
| Further harmonize the hierarchy of creditor claims in bank insolvency (EU) | MT | The new revisions to the BRRD (as part of the Banking Reform package) includes a new paragraph to Article 48 specifying that all own funds items have a lower priority ranking in insolvency than non-own funds items. |
| Introduce an administrative liquidation tool for the SRB (EU) | ST | -- |
| Pare back state-aid oversight of the use of the SRF and deposit insurance funding on a least-cost basis (EC) | ST | -- |
| Buttress SRB independence and powers (for example, by granting permanent observer status at the SSM Supervisory Board) (SSM, EC) | I | In practice, an SRB Board member is already being invited to attend the SSM Supervisory Board meetings as an observer if a relevant topic is discussed. |
| **Liquidity management** | | |
| Articulate an explicit financial stability mandate for the ECB/Eurosystem (ECB) | MT | -- |
| Intensify "horizon scanning" involving supervisory and operational functions (ECB, SSM) | I | -- |
| Further harmonize and ultimately centralize ELA arrangements (ECB) | ST | -- |
| Manage the transition from crisis-related policy settings and develop the future operational framework to reflect regulatory and market developments (ECB) | MT | -- |

* In this table, EU will refer to the Council of the EU, the European Parliament, and the European Commission.
**I: Immediate, within one year; ST: short term, within 1 to 2 years; MT: medium term, within 2 to 5 years.

# Annex III. Statistical Issues[1]

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

**1. The transition to the new international statistical standards is complete; minor enhancements are still expected**. With regard to data availability, most countries received derogations from the European System of National and Regional Accounts (ESA) 2010 data transmission requirements up to 2020. A review of these derogations showed that data availability has improved significantly and an updated list of remaining derogations was published.[3] In most cases, EU member states have resolved the issues that gave rise to the derogations, and a significant number of member states have started providing part of the data covered by derogations even before the first expected transmission date. In addition, there has been a strong effort in ensuring that globalization-related issues are properly reflected in the statistics. In 2018, data on accrued to date pension entitlements in social insurance were released for the first time.

**2. Eurostat and the ECB continued working on the 20 recommendations of the second phase of the G20 Data Gaps Initiative (DGI-2), as members of the Inter-Agency Group on Economic and Financial Statistics**. Substantial progress has been already achieved and it is intended that all DGI-2 recommendations are fully implemented by 2021.

**3. Eurostat and the ECB jointly support the Special Data Dissemination Standard Plus (SDDS Plus), the third and highest tier of the IMF's Data Standards Initiatives established in**

[1] Prepared in consultation with Eurostat and the ECB.

[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's statistical function is based on Article 5 of the Statute of the ESCB and of the ECB.

[3] Commission Implementing Decision (EU) 2018/1891 of November 30, 2018 amending Implementing Decision 2014/403/EU on granting derogations to member states with respect to the transmission of statistics pursuant to Regulation (EU) No. 549/2013 of the European Parliament and of the Council concerning the European system of national and regional accounts in the European Union (notified under document C(2018) 7943) (text with EEA relevance: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2018.309.01.0005.01.ENG).

**2012**. By April 2019, 10 euro area countries (and 14 EU member states overall) have adhered to the SDDS Plus.

**4. Eurostat and the ECB continued their efforts to ensure the quality of statistics underlying the Macroeconomic Imbalance Procedure (MIP)**. Starting in 2018, two auxiliary indicators from the Consolidated Banking Data published by the ECB were included in the MIP Scoreboard, namely the leverage ratio (assets to equity) and the amount of gross nonperforming loans. In 2018, Eurostat and ECB/DG-Statistics continued the implementation of their Memorandum of Understanding on the quality assurance of statistics underlying the MIP.[4] This included: i) the publication of the first harmonized domain specific quality reports for BOP and IIP statistics;[5] and ii) visits to Luxembourg (July 2018), Poland (September 2018) and Germany (January 2019).

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

- *Streamlining the flash releases of key national accounts (NA) indicators*. Following the introduction of the preliminary (T+30) GDP flash estimates for the EU and the euro area in April 2016, Eurostat and NSIs tested the feasibility of European employment flash estimates. This led to the publication of t+45 employment flash estimates starting November 2018 and to advancing the regular employment estimates from about t+75 to t+65 days, partly implementing a Eurostat and NSI agreed strategy to move to a regular estimation schedule based on country estimates available after 30, 60, and 90 days. The testing of European t+30 employment flash estimates continues.

- *Improvements to quarterly BOP and IIP statistics are forthcoming with the amendment of the ECB Guideline on External Statistics*.[6] These changes will bring in 2021, amongst others, (i) more detailed information by sector, including a distinction between households and nonfinancial corporations and a more granular presentation of the financial sector; (ii) a comprehensive breakdown of the IIP by currency of denomination; (iii) bilateral data *vis-à-vis* all G20 countries for the main accounting entries; and (iv) an instrument breakdown of the BOP and IIP to facilitate the link with NA. The ECB is also working towards the medium-term objective of collecting fit for purpose data for Special Purpose Entities (SPEs) following the enhanced definition approved by the IMF Balance of Payments Committee.

[4] http://ec.europa.eu/eurostat/documents/10186/7722897/Final-signed-MoU-ESTAT-ECB.pdf

[5] https://www.ecb.europa.eu/pub/pdf/bopips/ecb.bopips201806.en.pdf

[6] https://www.ecb.europa.eu/ecb/legal/pdf/celex_32018o0019_en_txt.pdf

- *Guidance on the recording of financial derivatives is being prepared by the ECB with the support of relevant international organizations, including the IMF*. A task force under the aegis of the ESCB Statistics Committee was established at the end of 2018 with the objective to identify current best practices to achieve high coverage of financial derivatives and consistent recording in macroeconomic statistics by 2020.

- *A new medium-term strategy for quarterly financial accounts is being developed by the ECB*, with a view to meeting new user demands, and incorporating new approaches and data sources to the compilation of the accounts. The strategy pursues five objectives: (i) addressing globalization challenges; (ii) improving information on non-bank financial intermediation; (iii) understanding interconnectedness at macro level; (iv) enhancing household analysis; and (v) increasing serviceability of existing financial accounts data.

- *The regular reporting exercise on the quality of ESA 2010 data transmitted by EU member states to Eurostat is now well established*. Based on the agreed modalities,[7] Eurostat assessment reports on 2016 and 2017 data transmissions were published in 2018. They show overall that the completeness and timeliness of national accounts is relatively high, and that improvements were achieved in most countries.[8] A process to complement Eurostat's existing metadata with national metadata[9] and more detailed metadata has started. Eurostat published practical guidelines for revising the ESA 2010 based accounts.[10]

- *To fully exploit the data available under ESA 2010 Transmission Programme, Eurostat and some EU member states will aim to extend the production and the publication of productivity indicators*. This will be achieved within the new phase of the Growth and Productivity Accounts project. Productivity indicators tuned to digital technologies and skills can complement available statistics for the analysis of their contribution to growth under the EU Digital Agenda. The feasibility of such productivity measures will be assessed. A task force with NSIs has been set up with a two-year mandate (2019–21) to further develop high-quality indicators for labor, capital and multifactor productivity for all EU member states and also improve the underlying data and metadata.

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[7] Commission Implementing Regulation (EU) 2016/2304 of December 19, 2016 on the modalities, structure, periodicity, and assessment indicators of the quality reports on data transmitted pursuant to Regulation (EU) No. 549/2013 of the European Parliament and of the Council.

[8] https://ec.europa.eu/eurostat/web/esa-2010/esa-2010-implementation-and-data-quality

[9] https://ec.europa.eu/eurostat/cache/metadata/en/na10_esms.htm

[10] https://ec.europa.eu/eurostat/documents/3859598/9530664/KS-GQ-18-012-EN-N.pdf/19dc3542-aa34-4b6b-a981-8a4f244074e8

- *Eurostat concluded its Task Force on the recording of illegal economic activities in NA and BOP*. The Task Force published a handbook in March 2018, providing the first comprehensive overview of conceptual and practical issues for the compilation of statistics on illegal economic activities in the accounting frameworks.

- *Eurostat drafted a handbook 'Maritime Cluster—Guidance for BOP Data Compilers*' that treats the complexity of activities and transactions related to companies operating in the maritime cluster. As a follow up, a Eurostat-led task force is working on a revised version of the handbook.

- *Eurostat started to release core inflation and other special aggregates derived from more granular data*. The individual components of the series, starting in January 2017, are based on the subclass level of the European 'classification of individual consumption according to purpose'.

- *Concerning commercial real estate indicators*, the Task Force for Commercial Real Estate Indicators (TF CREI) was created in 2018, with delegates from NSIs and NCBs. It will be a forum for the exchange of experiences with pilot projects focusing on data sources, preparation of the structure of a methodological framework, facilitation of European training resources and developing a way forward for the long term to close data gaps. In addition, a Task Force CREI_STS will start its work in 2019, which will focus on the development of indicators on construction starts, completions, and vacancy rates. Finally, the ESCB Statistics Committee's Real Estate Task Force has completed exploring the feasibility of a broad set of financial real estate (both residential and commercial) indicators, and AnaCredit as a possible data source. The General Board of the ESRB, with input from the STC, amended Recommendation 2016/14 on closing real estate data gaps in March 2019, taking into account the need to align more closely the definition of CRE with that in AnaCredit.

- *The EuroGroups Register (EGR)*—the central European register for multinational enterprise groups managed by Eurostat—is constantly improving in coverage and quality. More than 21,000 multinational enterprise groups active in the EU are now part of 2017 EGR data, finalized in March 2019. In the same vein, the ESCB's Register of Institutions and Affiliates Data (RIAD) contains data of key importance on financial and nonfinancial entities and groups. A fourth generation of the RIAD system has been delivered in March 2018 to support counterparts to the AnaCredit dataset (see para. 6). Around 8 million entities are currently recorded and updated at high frequency.

- *There is an ongoing modernization of intra-EU trade in goods statistics*. To reduce the reporting burden while maintaining quality, international trade in goods statistics have been in the

spotlight of modernization over recent years in the ESS. A deployment project 'Modernization of the system of compiling intra-EU trade in goods statistics' has focused on preparing European legal provisions to modernize intra-EU trade in goods statistics with concrete technical implementation, including preparing the exchange of micro-data on intra-EU exports.

- *Further progress has been made in government finance statistics (GFS) to enhance economic and fiscal surveillance*. Annual and quarterly ESA 2010-based GFS time series continue to be available for all countries. European GFS are consistent with the data supplied under the Excessive Deficit Procedure, which undergoes strong verification procedures. For most countries, annual data are mapped, with additional information from countries, to the Government Finance Statistics Manual (GFSM) 2014 framework and reported to the IMF. Quarterly data are mapped for all countries. Progress in data availability was made on detailed Classification of the Functions of Government (COFOG) data, and on more detailed data for transactions with the EU institutions, detailed financial instruments and breakdowns of government debt. Eurostat continues to publish data on contingent liabilities and non-performing loans of the government.

- *EU inter-country supply, use and input-output tables*. The Full International and Global Accounts for Research in Input-Output Analysis project (FIGARO), a cooperative effort by Eurostat and the EC Joint Research Centre, is establishing annual production of EU multi-country input-output tables and a five yearly production of EU multi-country supply, use, and input-output tables (EU-IC-SUIOT) to support studies on competitiveness, growth, productivity, employment and international trade, and assessment of the position of the EU and the euro area in the world.[11] The first deliverables of EU-IC-SUIOT for 2010 were released in April 2018. The project will compile a time series of EU inter-country input-output tables from 2010 to 2017 by end 2020, both in current and previous years' prices.

- *The ECB has started implementing a new regulation on statistical reporting requirements for pension funds (PF)*. The new regulation, published in February 2018,[12] aims at increasing transparency and improving data comparability in this fast-growing sector. The reporting of the first PF data under the new regulation is expected by end-2019 and the first publication by mid-2020.

[11] FIGARO book is available as "EU inter-country supply, use and input-output table (FIGARO)." Data for 2010 are available as the FIGARO tables.

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

- *The ECB published annual data on Financial Corporations engaged in Lending (FCLs) in September 2018 for data up to 2017*. FCLs are financial intermediaries principally specialized in asset financing for households and nonfinancial corporations, including activities such as financial leasing, factoring, mortgage lending and consumer lending. Balance sheet statistics on FCLs are provided to the ECB by NCBs on a best-efforts basis, and currently cover the euro area except Finland, Ireland, and Luxembourg.

- *Aggregated banking statistics covering significant institutions were extensively enhanced in 2018*. The publication now includes new indicators such as level 1, level 2 and level 3 assets, total exposures to general governments and internal ratings-based credit risk parameters. Each year, the ECB also publishes solvency and leverage indicators at bank level, as disclosed by banks in line with their Pillar 3 requirements. In 2018 this publication was expanded to include individual information on risk-weighted assets by risk type and by computation method for ECB-supervised global and other systemically important institutions.

**6. The ECB continued several projects to enhance the availability and quality of statistics based on new granular databases to support policy decisions**.

- *Money Market Statistical Reporting (MMSR).* The regular publication of aggregated indicators, started in 2017 for the unsecured market, and was extended in January 2019 with the secured segment.

- *Euro short-term rate.* The Governing Council of the ECB decided to develop a euro short-term rate based on MMSR data. The rate will be produced by the ECB from October 2, 2019, which has been selected as the euro risk-free rate by a working group of private financial institutions.

- *Securities holdings statistics.* The data collection on securities held by individual banking groups has been extended to cover more banking groups and attributes. Starting with the reference period 2018-Q3, the enhanced reporting now covers all banking groups that are directly supervised by the ECB. The new attributes are reported in-line with the concepts of AnaCredit so that data for loans and securities can be combined and analysed jointly in a harmonised manner. The enhanced set of data is highly granular; data can be broken down to the level of the individual member of the banking group and to the security.

- *Analytical credit datasets (AnaCredit Project).* The first reporting took place in mid-November 2018 based on data as of September 2018. A number of countries took the transitional period and started reporting data in end-March 2019.

**7. The ECB, Eurostat and the OECD actively cooperate on statistics and research concerning the joint distribution of income, consumptions and wealth (ICW) as well as linking macro and micro data on household wealth**. Two meetings of the *OECD/Eurostat Expert Group on Disparities in National Accounts* took place in 2018. A new data compilation round has started and progress was achieved towards the publication of the methodological manual. The *ECB Expert Group Linking Macro and Micro Data* concentrates on household wealth, taking advantage of the Household Finance and Consumption Survey, which is aimed to be bridged to National Accounts.

**8. Technical work by Eurostat is also ongoing towards modernizing and harmonizing public sector accounting in the context of the European Public Sector Accounting Standards (EPSAS)**. In May 2018, Eurostat presented the draft EPSAS Conceptual Framework to the EPSAS Working Group. Technical work underway covers key public sector accounting issues from the EPSAS perspective, such as the accounting treatment of discount rates and grants. The collection of information for impact considerations continued in 2018 and is at an advanced stage.

**Statement by Anthony De Lannoy, Executive Director**
**for the Dutch-Belgian Constituency**
**on behalf of the Euro Area Authorities**
**July 8, 2019**

In my capacity as President of EURIMF, I submit this Buff statement on the Article IV consultation with the euro area. It reflects the common view of the Member States of the euro area and the relevant European Union Institutions in their fields of competence.

The authorities of the euro area Member States and the EU Institutions are grateful for the open and fruitful consultations with staff and their constructive policy advice. The authorities are in broad agreement with the findings and recommendations in the Article IV Staff Report, notably the concerns expressed about the downside risks to the outlook. We also welcome the acknowledgement of recent reforms to the euro area architecture, while noting the call for more progress in certain key areas.

*More specifically, we have the following comments on the Fund Staff Report:*

***Economic outlook***

**The authorities share the Fund staff's baseline forecast of strengthening economic growth and continued job creation in the short term, as well as their assessment of risks**. The main impulse for growth will come from domestic demand, supported by increasing real income and accommodative policies, though the strengthening may be felt slightly later than expected in spring. We note that the reference to a "sharp slowdown" starting in 2018 are somewhat exaggerated. Net exports will contribute only marginally to growth in 2019, as global trade growth is projected to bottom out this year but remains weak amid continued trade policy uncertainty. The EU institutions' real GDP growth forecasts for 2020 are closely aligned with those of the IMF. We also agree with the staff assessment that risks are skewed to the downside. The main risks are a further escalation of trade disputes, a possible no-deal Brexit and renewed uncertainty about policy developments in certain high-debt Member States. Moreover, the situation would be particularly challenging if these risks were to materialize simultaneously. Still, the euro area would be shielded from the worst impacts of such developments by its strengthened institutional framework. Moreover, reform momentum at the euro area and national level and the commitment to sound policies can bolster confidence. On Brexit, the authorities note that a 'no deal' Brexit would dampen economic growth mainly in the U.K. The impact on EU27 overall appears to be much more contained but differentiated, with some individual euro area members significantly affected.

**Our assessments of the medium-term outlook are also aligned**. Demographic developments, weak productivity growth and the legacy of the crisis in some Member States are weighing on potential growth. That is why we support the conduct of prudent fiscal policies, in full respect of the SGP, that prioritize public and private investment, and improve

the quality of public expenditure and revenues. Stepping up the implementation of structural reforms and making progress towards strengthening the Economic and Monetary Union, across all its dimensions, will also be important to enhance private investment and productivity and to reduce vulnerabilities.

***Monetary policy and inflation outlook***

Underlying inflation remains generally muted. It is expected to increase only gradually over the medium term. Further employment gains and increasing wages continue to underpin the resilience of the euro area economy and should remain supportive to gradually rising inflation.

The ECB's accommodative monetary policy stance—including the June's Governing Council expectation that key ECB interest rates will remain at their present levels at least through the first half of 2020, the continued reinvestments, and the new series of TLTROs—ensures that financial conditions will remain very favourable, supporting the euro area expansion, the gradual buildup of domestic price pressures and, thus, headline inflation developments over the medium term.

Looking ahead, the Governing Council is determined to act if contingencies warrant it. It stands ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its inflation aim in a sustained manner.

***Fiscal policies***

**The authorities agree with the Fund's staff that national fiscal policies need to be better differentiated**. Member States with high public debts need to rebuild fiscal buffers by pursuing fiscal adjustment, in a growth-friendly manner, in line with the EU's fiscal rules. Countries should support achievement of these objectives with policies to strengthen economic growth potential. Conversely, Member States with fiscal space and low levels of investment could prioritise investments to boost potential growth, as advised in the IMF Staff Report, while preserving long-term sustainability.

**Temporary adjustment of fiscal balances in a downturn, as advocated by staff, is allowed under the SGP in case of a severe downturn, provided that fiscal sustainability is not endangered**. In such an event, discretionary easing would have to be tailored to country-specific macro-economic, fiscal, and financing conditions. Moreover, it would also need to take into account a number of challenges. It is difficult to detect a severe downturn in real time and there are lags affecting policy diagnosis. Policy reaction, including enacting fiscal measures, may be too slow, particularly if contingency planning is insufficient. Improving the quality of public finances both on the revenue and expenditure sides is important to create the necessary space for both consolidation and more spending in growth-enhancing areas.

**On the enforcement of fiscal rules, the authorities would like to note that in general the SGP has contributed to the pursuit of sound public finances. It is important to note that public finances in the euro area as a whole compare very favourably to those in other jurisdictions, which can be attributed partly to the fiscal framework in place**. As regards the adequacy of the rules, the forthcoming review of the fiscal framework will provide a basis for a thorough assessment.

***Structural reforms***

**We concur with the staff recommendation to accelerate structural reforms at the national level and to continue deepening the Single Market**. The Staff's findings on the impact of national structural reforms on resilience are similar to those produced by EU Institutions. Beyond product and labour market regulations and insolvency regimes stressed in the Staff Report, reforms in the areas of business climate, public administration, education, and in relation to the digital economy and climate change would also be relevant. We note the need to strengthen reform implementation at national level, notably in services, tax-base broadening, and improving the regulatory framework, while highlighting the need to carefully sequence reform implementation over the business cycle and mitigate exclusion and inequality impacts in order to avoid reform fatigue and reversal. We expect the dialogue on reforms under the European Semester process to be further enhanced by the newly created National Productivity Boards. Furthermore, there could be synergies between the reforms to deepen the Single Market for Services described by staff, and further action at EU level, e.g., in network industries.

***External sector policies***

**The authorities take note of the staff's assessment of the euro area's external position**. The Fund's staff notes that the euro area current account surplus has narrowed and that the euro area's real effective exchange rate has appreciated by 3 percent on average in 2018. While the Fund still assesses that it is marginally undervalued, the text of the report should remain fully consistent with past exercises and stress that the euro's valuation remains well within the interval of +/- 5 percent considered as broadly in line with fundamentals according to the Fund's External Balance Assessment framework. In any case, the EU institutions consider the euro's real effective exchange rate to be close to its equilibrium.

**The staff report could mention that the external surplus is trending downward, and not only due to weaker external demand**. We project the euro area current account surplus will continue to narrow going forward also due to robust domestic demand in large-surplus countries reflecting both the ongoing fiscal expansion and higher relative wages which could help reduce high corporate savings. Overall, the main external sector policy levers are at national level. Member States—both net creditors and net debtors—need to continue to take steps to reduce those excessive imbalances that are driven by domestic policy. Further integrating financial markets and the broader EU single market, in the context of deepening

of the Economic and Monetary Union, could also help to reduce imbalances among Member States.

The authorities welcome staff's acknowledgment that the EU is taking a proactive role in safeguarding the economic gains from trade liberalization. The European Union continues to support free trade within an open, rules-based multilateral system with a modernized WTO at its core and remains committed to resisting all forms of protectionism and distortions.

***Financial sector policies***

**We recall the progress made in bank capitalisation and risk reduction, including tackling NPLs**. **However, we acknowledge the need for further reducing high NPL ratios in some Member States**. As regards the structural factors driving the low profitability of the banking sector, we are assessing their implications for supervisory policies. As mentioned in the staff report, weak profitability reflects structural problems that differ across countries and banks. For this reason, projections of banks' profitability and assessments of the viability of their business models are taken into account in the supervisory review and evaluation process under Pillar 2. In this context, consolidation in the banking sector is also relevant.

**We are also proactively monitoring potential financial stability risks**. Emerging risks in the real estate sector are closely monitored and may call for greater use of macro-prudential and borrower-based tools by national supervisors in certain Member States. Authorities have made good progress in addressing the potential cliff-edge risks to financial stability resulting from a hard Brexit by taking action where necessary (for example, in the area of market infrastructures), and the private sector has also made some progress to mitigate risks. We continue to communicate the importance of further private sector action, both publicly and directly to supervised firms. There is still a risk financial markets have not yet fully priced-in the possibility of a no-deal Brexit, which may lead to abrupt adjustments to risk premia in the event of such an outcome. We fully take on board the Fund staff recommendations to address money laundering more systematically and are taking steps in this direction, while noting that the establishment of an EU-wide agency for supervision could be a medium-term solution.

***Advancing the Economic and Monetary Union (EMU)***

**As mentioned in the Staff Report, there has been further progress in the EMU deepening agenda**. The Euro Summit of 21st June welcomed the progress on the strengthening of the EMU and invited the Eurogroup in inclusive format to continue working on all the elements of a comprehensive package. It also took note of the broad agreement reached by the Eurogroup on the revision of the European Stability Mechanism (ESM) Treaty and on a budgetary instrument for convergence and competitiveness (BICC) for the euro area and ERM II Member States on a voluntary basis. The ESM will provide the common backstop to the Single Resolution Fund (SRF) and its toolkit will be updated. Work will continue until December to finalise related legal documentation. On the BICC, the

Eurogroup and the Commission will work further on all the pending issues and the Eurogroup has been mandated to report back swiftly on the appropriate solutions for financing. The size of the BICC will be set in the context of the next Multi-annual Financial Framework. We take note of the IMF staff view on the need for a stabilisation function.

**Work on further strengthening the Banking Union, including through a European deposit insurance system, will continue**. The staff assessment that progress on Banking Union has stalled is too pessimistic. While political negotiations on a common deposit guarantee scheme have not started, progress was made in the last six months in the discussions in the High-Level Working Group on helping to identify what the key elements of a steady-state Banking Union could look like and the principles that should guide its further strengthening. Further technical work will be needed on defining a transitional path to the steady-state Banking Union, adhering to all the elements of the 2016 roadmap, including a roadmap for beginning political negotiations on a European deposit insurance system. The Eurogroup has mandated the High-Level Working Group to continue this work and report back by December 2019.

**The authorities also note the work of the staff on the benefits of the Capital Markets Union and agree on its importance**. The analysis summarized in the report makes clear the significant risk-sharing potential of a Single Capital Market and the importance of accelerating efforts to reduce market fragmentation in the EU. The experience of the last four years in implementing the Capital Markets Union Action Plan suggest that the more ambitious recommendations of the report are complex and multifaceted, where more assessment is needed in order to identify efficient solutions delivering on the objectives of the Capital Markets Union. However, the development of the Capital Markets Union will continue to feature in the next European legislature.