INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/231

EURO AREA POLICIES

2013 ARTICLE IV CONSULTATION

July 2013

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

- **Staff Report** for the Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 12, 2013, with the officials of euro area on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 11, 2013. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Staff Supplement** dated July 18, 2013 updating information on recent developments.
- **Press Release** on the Executive Board Discussion.
- **Statement by the Executive Director** for Netherlands.

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

Selected Issues paper

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

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INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

July 11, 2013

KEY ISSUES

Context. Substantial collective actions have addressed important tail risks. But the recovery remains elusive. Growth has weakened further and unemployment is still rising, and the risks of prolonged stagnation and inflation undershooting are high. Mounting social and political tensions pose an increasing threat to reform momentum.

Policies. Further efforts are needed to address the twin challenges of reviving growth and creating jobs. This requires actions on multiple fronts, which are mutually reinforcing:

Repairing banks balance sheets. This is essential to restore confidence and revive credit growth. A comprehensive, forward-looking assessment of banks' asset quality should quantify any capital shortfalls. A clear plan is needed on how potential capital requirements will be met—including through a common backstop such as European Stability Mechanism direct recapitalization. The involvement of an independent third party is essential to ensure the transparency and credibility of the exercise.

Making further progress on banking union. This is critical to prevent ring-fencing, sever bank-sovereign links, and, ultimately, reverse fragmentation. The Single Supervisory Mechanism legal framework should be finalized without delays. A strong resolution mechanism, based on a centralized authority with power to trigger resolution and make decisions on burden sharing, is critical to ensure timely and least-cost resolution.

Providing sufficient near-term support. Additional unconventional monetary support (targeted long term refinancing operations, lower collateral haircuts) could also help reduce fragmentation. Given the weak growth and subdued inflation outlook, further monetary easing will likely be necessary to support demand as well. And fiscal adjustment should be paced to avoid an excessive drag on growth.

Advancing structural reforms. A targeted implementation of the Services Directive would remove barriers to protected professions, promote cross-border competition, and, ultimately, raise productivity and incomes. A new round of Free Trade Agreements could provide a much-needed push to improve services productivity through deeper integration. Improved portability of pensions and unemployment benefits would further increase labor mobility across the region. And continued labor market reforms would facilitate the needed adjustment in relative prices in the periphery, which should be supported by rebalancing efforts of the surplus countries.

Approved By
Reza Moghadam and Martin Mühleisen

Discussions took place during May 30–June 12, 2013. Mission members included M. Pradhan (head), P. Koeva Brooks, C. Allard, A. Al-Eyd, P. Berkmen, F. Bornhorst, T. Tressel, S. Wang (all EUR), and C. Mumssen (Senior Resident Representative). Executive Director M. Snel and his advisor L. Piana, as well as ECB Observer at the IMF G. Pineau and his advisor G. Pula participated in some meetings.[1]

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[1] The mission would like to thank euro area authorities, in particular President M. Draghi (European Central Bank), Chairperson A. Enria (European Banking authority), Head of Secretariat F. Mazzaferro (European Systemic Risk Board), Managing Director K. Regling (European Stability Mechanism), Vice-President O. Rehn (European Commission), and President H. Van Rompuy (European Council), as well as their staff for their time, support, and accessibility. The mission has also benefitted from the Fund's bilateral Article IV consultations with euro area countries and from discussions with national authorities during meetings of the Eurogroup and the Eurogroup Working Group.

TABLES

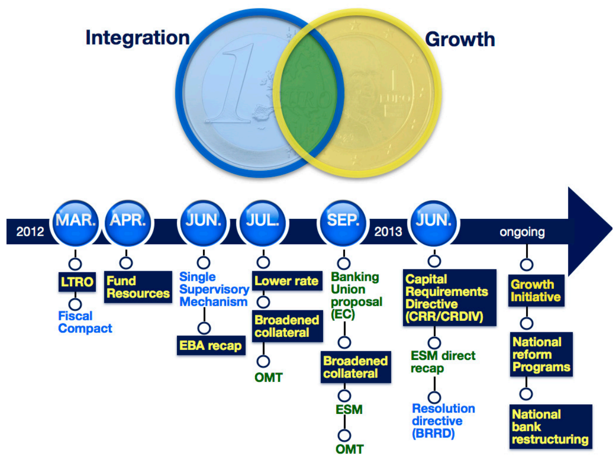
GLOSSARY

BSA	Balance Sheet Assessment
BRRD	Bank Resolution and Recovery Directive
CCI	Convergence and Competitiveness Instrument
CDS	Credit Default Swap
DGS	Deposit Guarantee Scheme
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EIB	European Investment Bank
EMU	Economic Monetary Union
ESM	European Stability Mechanism
ESR	External Sector Report
EU	European Union
FSB	Financial Stability Board
ICT	Information and Communications Technology
LTRO	Long Term Refinancing Operation
MIP	Macroeconomic Imbalances Procedure
MRO	Main Refinancing Operation
NPL	Nonperforming Loan
OMTs	Outright Monetary Transactions
REER	Real Effective Exchange Rate
SME	Small and Medium-sized Enterprises
SRA	Single Resolution Authority
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

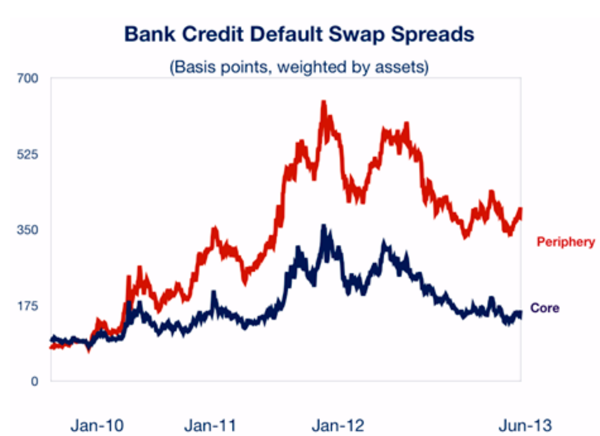
THE EVOLVING LANDSCAPE

Imminent tail risks have been addressed, but the growth crisis has deepened

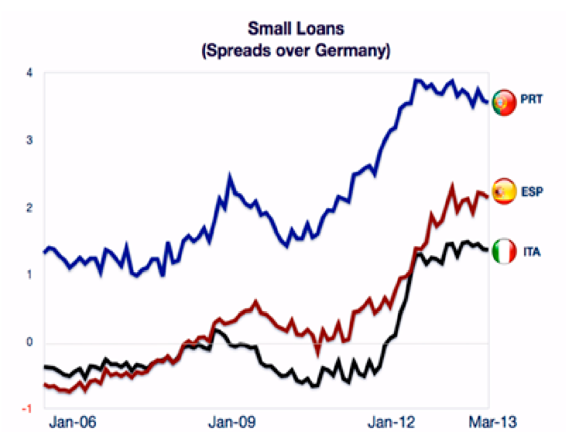
1. **Policy actions at the euro area and national level have reinforced the collective commitment to the euro.** The ECB's Outright Monetary Transactions (OMTs) framework has removed dangerous tail risks related to euro area breakup (Box 1). Initial progress on banking union—the Single Supervisory Mechanism (SSM) agreement, the European Stability Mechanism (ESM) framework for direct bank recapitalization, the Bank Recovery and Resolution directive (BRRD)—has demonstrated the commitment to improving EMU architecture. Other critical steps to address the crisis have included: the completion of the ESM firewall; the extension of official loan maturities to program countries; and the agreement on Greece and Cyprus. These actions, along with reductions in external imbalances and progress by national governments in restoring the health of public finances, have boosted confidence in the long-term viability of the monetary union.



2. **Severe market stresses have subsided, although private borrowing costs have remained too high in the periphery.** In these economies, sovereign borrowing costs have declined from unsustainable levels. This has led to slightly lower private borrowing costs, spurring bond issuance among some banks and firms. Capital flight has gradually eased, bank deposits have stabilized, and Target 2 imbalances have narrowed. This has contributed to some early repayment of official liquidity support (LTROs) by stronger banks, though largely from core countries. Still, periphery bank risks are significantly higher than in the core. And lending rates to corporations continue to vary widely among euro area members, especially for smaller enterprises.



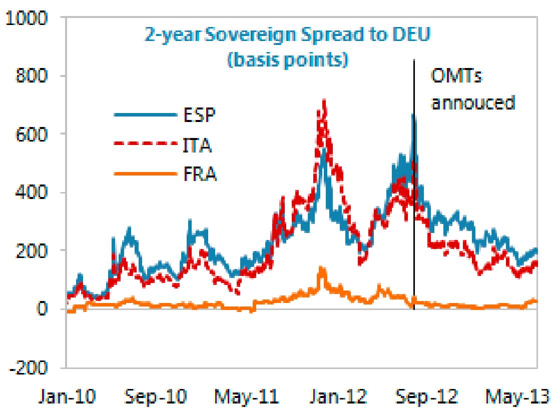
Periphery: Greece, Ireland, Italy, Portugal, and Spain. Core: Austria, France, Germany, the Netherlands, and Belgium

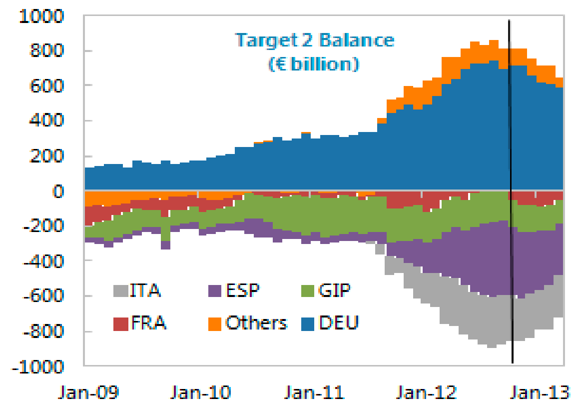


Box 1. The Impact of OMTs

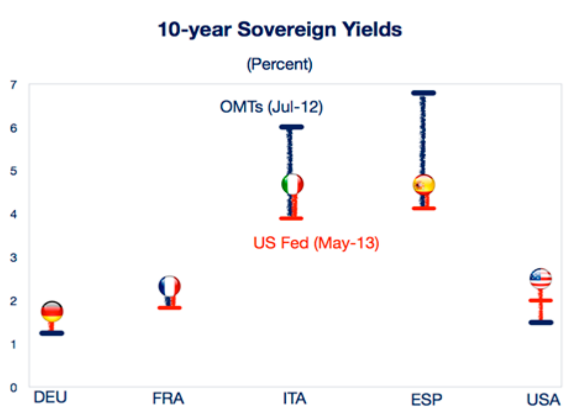
Financial market stresses in the euro area reached unsustainable levels by mid-2012. Sovereign yields for some large periphery economies were effectively on an unsustainable path that was reinforced by market panic. The liquidity crisis made monetary policy dysfunctional and generated tail risks of euro area exit. In this context, the ECB's commitment to do "whatever it takes"—including by establishing the OMTs framework—improved the functioning of monetary policy and safeguarded the viability of the euro.

The announcement of OMTs reduced tail risks (see Spillover Report). Spreads on periphery government bonds declined from unsustainable levels, translating into lower private borrowing costs in these economies. As perceptions of redenomination risk receded, capital flight from the periphery gradually reversed, and Target 2 imbalances narrowed. Outside the euro area, funding costs of emerging European sovereigns declined to record low levels; safe haven flows to small advanced European countries (Switzerland, Denmark) subsided. Financial market volatility declined across large systemic economies.





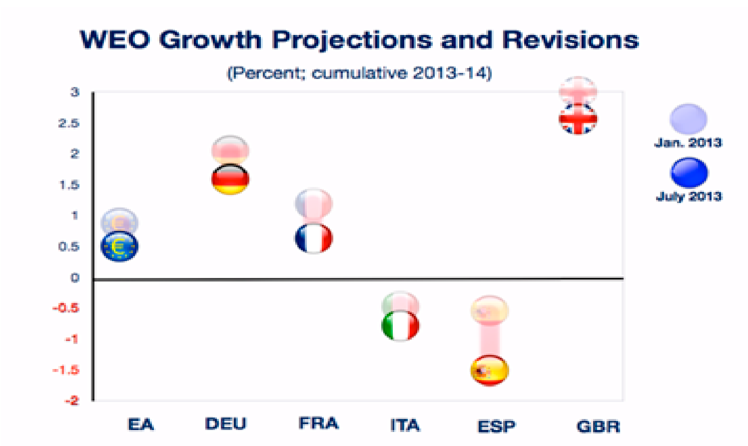
3. **Notwithstanding substantial stabilization over the last year, the recent turbulence in global markets has tightened financial conditions in the euro area.** The prospect of scaled-back U.S. monetary support—observed in the wake of the May 2013 Federal Open Market Committee meeting—has led to higher sovereign yields across the region, reversing some of the gains achieved in the periphery since the OMTs announcement. Unlike previous bouts of stress, German yields have

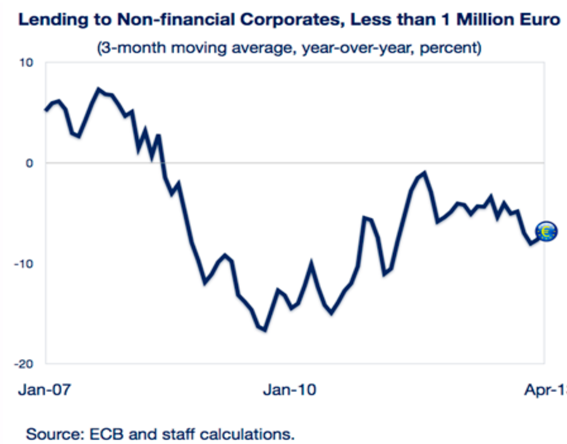


Sources: Bloomberg and staff calculations.

also increased, limiting the scope for periphery yields to decline without a further compression in their relative spreads. At the same time, euro area money market rates have also increased, raising expectations of higher interbank funding costs and leading to tighter monetary conditions.

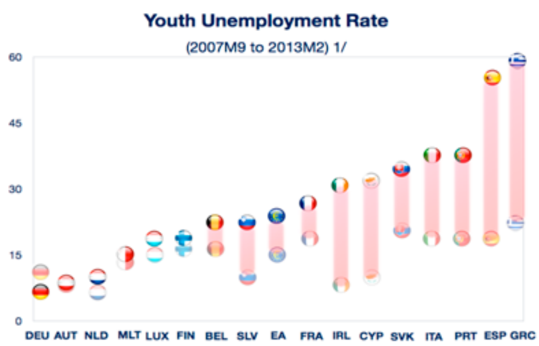
4. **Growth has continued to disappoint**. GDP contracted by 0.3 percent in the first quarter of 2013, after declining by 0.6 percent in 2012. Real activity in the euro area remains below pre-crisis levels. Recessionary forces have persisted in most periphery countries, as households and firms continue to struggle with heavy debt, high borrowing costs, and contracting credit. The growth weakness has also spilled over to core economies (France, Germany) added to budgetary pressures, and weighed on banks' asset quality across the area.



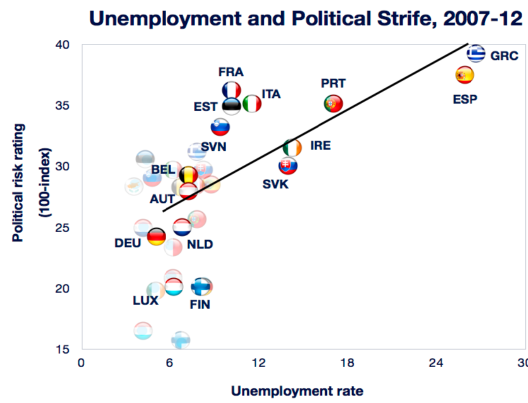


5. **Inflation has fallen below the ECB's primary objective and is expected to remain subdued, raising concerns about underlying deflationary trends.** Headline inflation, at 1.6 percent in June 2013, has declined to levels last seen in mid-2010. Inflation in the large economies (Germany, Italy, and Spain) is now close to the euro area average, while it is significantly lower or even negative in program countries. Core inflation has also moderated since early 2012—to about 1½ percent in the first quarter of 2013—reflecting increasing slack throughout the euro area. Although survey-based inflation expectations remain broadly anchored, market-based indicators for some large euro area countries have begun to drift downward. In turn, below-objective inflation has complicated relative price adjustment and the reduction in debt burdens.

6. **At the same time, mounting social and political tensions pose an increasing threat to reform momentum.** With real activity shrinking, the euro area unemployment rate has reached record highs (over 12 percent in May), especially among the youth. Rising social stresses threaten the political commitment to sustain adjustment efforts at the national level, especially in countries where policy space to support growth and tackle unemployment is limited.



1/ Cyprus and Slovenia: 2012M12; and Greece: 2013M1.



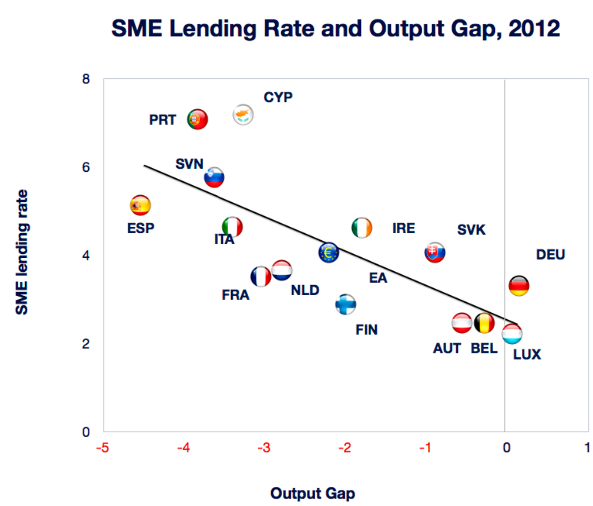
7. Although much needed, deeper integration is hard to accomplish. As important decisions on EMU architecture require national support by 17 members, the hurdle for reaching a collective agreement is always high. Moreover, building political support for such decisions can take considerable time, especially when they involve thorny issues such as burden-sharing or ceding national control. Hence, making swift progress on completing the banking union—by introducing a single resolution mechanism (SRM), agreeing on common backstops and safety nets—and moving toward greater fiscal integration are proving exceedingly difficult.

THE ELUSIVE RECOVERY

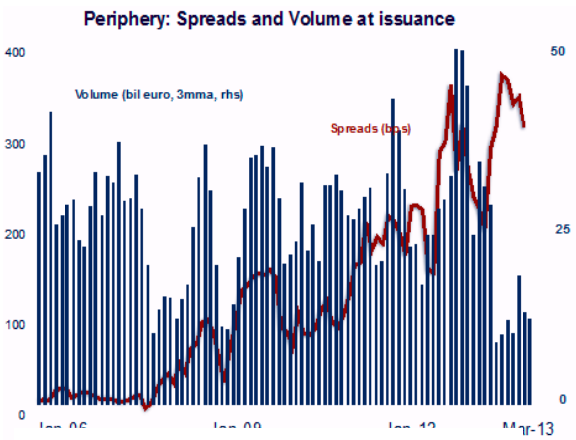
Legacies of the crisis are restraining growth

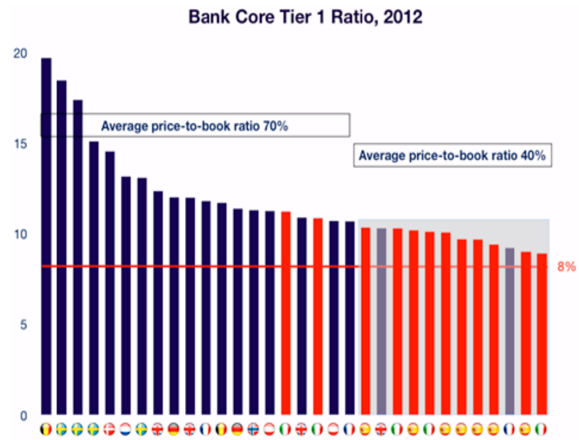
8. What is the root cause of the persistent and pervasive weakness in growth? Persistent financial market fragmentation, weak bank balance sheets, low demand, and creeping uncertainty, as well as structural weaknesses, all reinforce each other and contribute to contraction of real activity.

- *Financial market fragmentation* continues to undermine monetary transmission and the flow of credit to the periphery. In spite of the positive effect of the OMTs announcement, differences in sovereign and private risk premiums, stronger sovereign-bank links, and other factors (e.g., regulatory hurdles, national regulatory ring fencing) continue to hamper cross-border interbank activity and elevate funding costs for periphery banks. This pushes up private lending rates, preventing the transmission of easier monetary conditions to these economies. Access to credit for small and medium enterprises (SMEs) is the first victim of these pro-cyclical financial conditions.

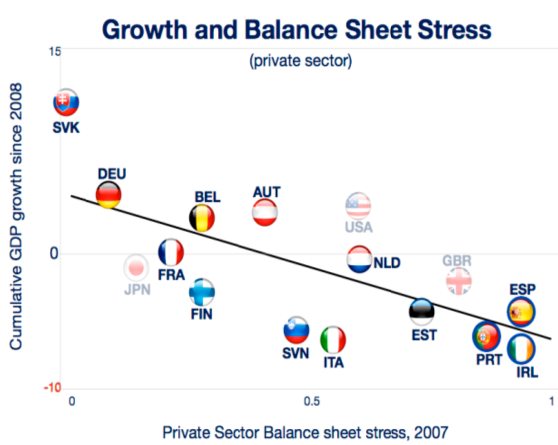


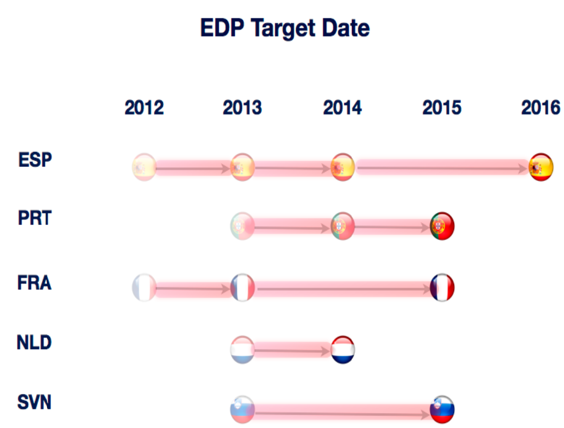
- *Weakness in bank balance sheets* is a key contributing factor to fragmentation. Despite improved capital ratios following the EBA recapitalization exercise, banks across the euro area continue to reduce leverage, largely by shedding assets. Meanwhile, profitability remains muted, partly reflecting increased provisioning needs due to nonperforming loans. Given the weak macroeconomic backdrop, bad loans will almost certainly increase further, placing additional pressures on banks' capital buffers and limiting their ability to support the recovery, especially in the periphery.





- *Low demand* is also weighing on real activity, as sovereigns, banks, firms, and households continue to repair their balance sheets. These headwinds are particularly strong in some periphery economies, especially where all sectors, including the government, are highly indebted (Box 2).[2] But core countries are not immune, as firms and households withhold investment and consumption amidst heightened uncertainty. Fiscal consolidation will continue to be a drag on growth even if the pace of adjustment is expected to moderate from last year: on current policies, fiscal adjustment for the aggregate euro area is expected to reach about 1 percent of GDP in structural terms, after a 1½ percent adjustment in 2012.



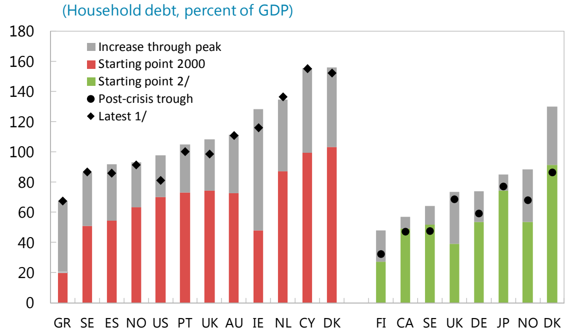


2 For further details, see 2013 *Selected Issues Paper* and *April 2013 Global Financial Stability Report* (on corporate indebtedness).

Box 2. Indebtedness and Deleveraging in the Euro Area

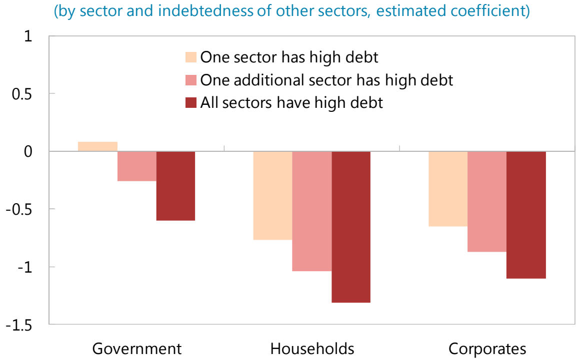
High debt and the simultaneous deleveraging of firms, households, banks, and the public sector can weigh on growth through various channels. High debt increases agents' vulnerability to asset price shocks, financial volatility, and uncertainty. Negative feedback loops between highly-indebted private sectors, a weak financial sector, and a sovereign under stress may constrain demand and credit conditions. In particular, uncertainty about the private sector's ability to service its high debt burden can raise questions about banks' asset quality, and impair financial sector intermediation. Asset holdings could buffer the impact, but they are often illiquid or unevenly distributed across agents.

Household Deleveraging Episodes
(Household debt, percent of GDP)



Sources: Eurostat; Haver; national statistical agencies; and IMF staff calculations.
1/ September 2012, except for Ireland , Denmark, Netherlands (June 2012) and Cyprus and Norway (end-2011).
2/ 1970 for Canada, 1990 for Japan and Germany, 1980 for others.

The Impact of High Debt on Growth
(by sector and indebtedness of other sectors, estimated coefficient)



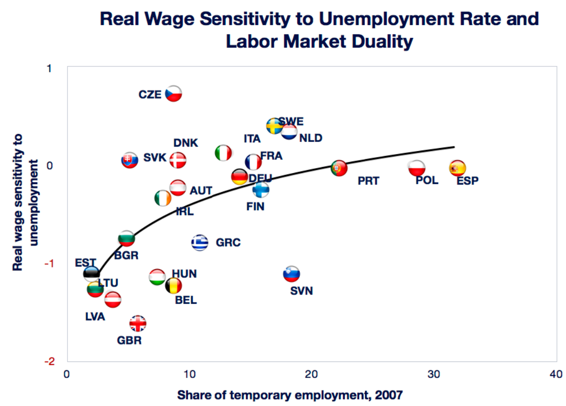
Sources: Staff estimates, see Selected Issues Paper.

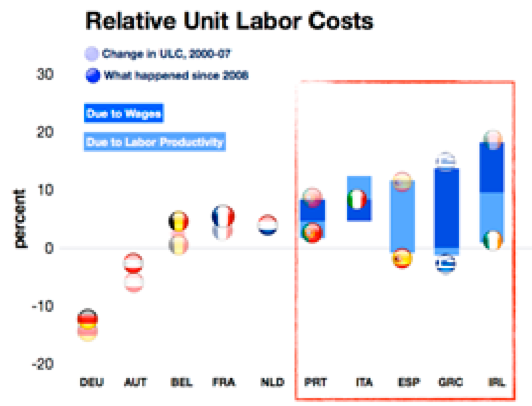
Balance sheet adjustment in the euro area may prove more challenging now than in other episodes and regions in the past.

- A look at previous episodes of household deleveraging is revealing: historically, almost all of the run-up in household debt (during the boom period) tends to be reversed. But in the euro area, the reduction in debt-to-GDP ratios has barely started, and the boom was more pronounced. Furthermore, in past deleveraging episodes, the debt reversal was largely facilitated by high inflation and growth, and supported by expansionary fiscal policy. Because these factors will not contribute much to the ongoing deleveraging process in the euro area periphery, the adjustment is likely to be protracted and have to rely more on reductions in nominal debt. The contrast with history is similarly sobering when it comes to corporate debt.
- Econometric analysis suggests that when all three sectors (government, households, and firms) are highly indebted, the negative growth impact of debt is highest. In addition, high corporate and household debt is associated with worse growth outcomes than public sector indebtedness. This suggests that headwinds are likely to be particularly strong in the periphery where all sectors are highly indebted.

Policies that directly support the workout of bad debt in the financial and private sectors can help avoid a protracted period of stagnation. While the policy space to support private sector deleveraging is more constrained than in the past, experience suggests that direct and decisive policy actions can support deleveraging. More specifically, at the national level, insolvency regimes need to be made more effective (e.g., by facilitating out-of-court settlements, reducing time for insolvency proceedings) and provide more flexibility in dealing with personal or corporate bankruptcy. Policies to encourage debt write-offs and help facilitate the transfer of non-performing assets to new owners would also support the repair of bank balance sheets (e.g., by fostering a market for NPL-backed securities).

- *Heightened uncertainty* about euro area prospects and policies is holding back private investment and durables consumption. With the crisis reaching the core, this uncertainty is amplifying own economic challenges that some core economies face (e.g., France).
- *Long-standing structural weaknesses in labor and product markets* are making it difficult to adjust relative prices, deploy resources into new productive sectors, and restore competitiveness in the periphery. This is despite ongoing adjustment efforts to rebalance these economies. At the same time, remaining gaps in product market reforms are constraining productivity (and trend growth) in the core and the periphery.





- *External imbalances within the euro area* are narrowing only gradually (see Box 4). This is mostly due to the slow adjustment in relative prices, given incomplete structural reforms and small inflation differentials (see ¶29).

9. Against that backdrop, the outlook remains for very weak growth and inflation.

- Euro area GDP is expected to contract for a second year in 2013, by 0.6 percent, before recovering modestly in 2014 on account of stronger external demand and a very gradual improvement in lending conditions to the private sector. Growth in 2014 is forecast to reach 0.9 percent, with a very sluggish recovery thereafter. In the absence of further policy action, staff sees trend growth at only 1 percent over the medium term.
- At the same time, large output gaps and base effects related to past indirect tax increases will place downward pressures on prices. Inflation is expected to stay at around 1½ percent over the next two years, and a level substantially below the ECB target is foreseen to persist even over the medium term.

10. Risks are tilted to the downside (see Table 1). Because policy space is limited, public debt ratios are very high and still rising, and economic slack is already substantial, further negative shocks—either domestic or external (e.g., sovereign bond stress, a bumpy exit from unconventional monetary policies (UMP) in other advanced economies, higher oil prices) could have a severe impact on the growth and inflation outlook.

- In the near-term, continued turbulence in global markets—due to expectations of earlier-than-anticipated UMP exit in the U.S.—could lead to additional, and unhelpful pro-cyclical increases in borrowing costs within the euro area. This could further complicate the conduct of monetary policy and potentially damage area-wide demand and growth. Financial market stresses could also quickly reignite, not only because sovereign debt levels remain high but also from incomplete or stalled delivery of policy commitments at the euro area level—progress on banking union, single rulebook, and final agreement on ESM direct recapitalization—or delays in fiscal adjustment and structural reforms at the national level.

- In the medium-term, there is a high risk of stagnation, especially in the periphery. This could stem from larger-than-envisaged effects from private and public sector deleveraging, entrenched fragmentation, and delayed structural reforms. Such an outcome could push the periphery toward a debt-deflation spiral. In the core, real activity could also suffer due to confidence effects and trade links. Persistently high unemployment and subdued investment would erode the region's growth potential. In such a scenario, euro area and global GDP levels might be about 4 percent and 1 percent below the baseline by 2018, respectively (see Spillover Report).

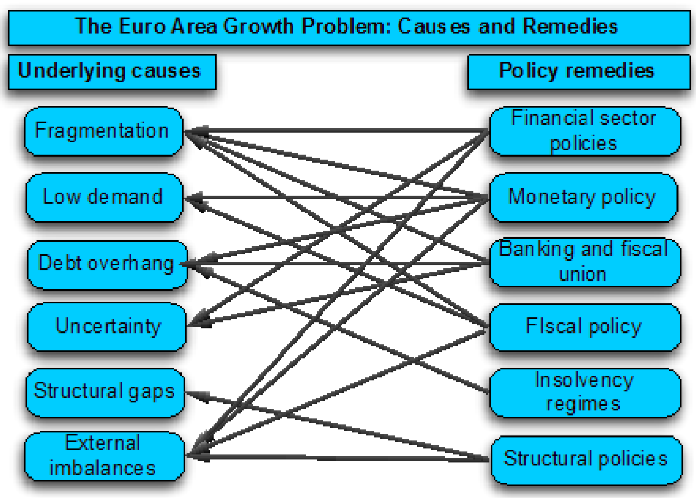
Table 1. Risk Assessment Matrix[1]

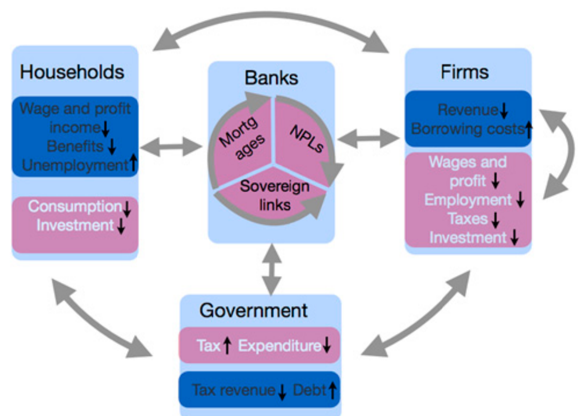
Nature/Source of Main Threats	Likelihood of Risk (high, medium, or low)	Expected Impact of Risk (high, medium, or low)	Policy Recommendations
1. Financial stress re-emerges and bank-sovereign links re-intensify (triggered by stalled or incomplete delivery of *euro area* policy commitments)	**Medium** • Lack of agreement on a common backstop to bank resolution and/or deposit insurance • ESM direct recapitalization is delayed • Uneven transposition of the Fiscal Compact at the national level	**High** • Undermine fragile market confidence • Re-intensify the adverse feedback loops between bank and sovereigns • Threaten sovereign debt trajectories • Undermine growth and jobs prospects	• Complete banking union, in particular single resolution mechanism and common safety nets (¶18-22) and allow direct recapitalization of banks by the ESM (¶ 16). Make progress towards greater fiscal integration (¶28)
2. Financial stress re-emerges and bank-sovereign links re-intensify (triggered by stalled or incomplete delivery of *national* policy commitments)	**Medium** • Social discontent with austerity increases, with political and economic fallout • In this context, implementation of fiscal adjustment falters (most euro area countries) and implementation of structural reforms stalls (Greece, Italy, Spain)	**High** • Undermine fragile market confidence • Intensify cross-border financial contagion and bank deleveraging • Drive sovereign and bank spreads back to very high levels • Undermine growth prospects	• Pace fiscal adjustment and make flexibility contingent on reforms (¶27) • Implement structural reforms to encourage job creation and raise competitiveness (¶29) • Strengthen the implementation of the Macroeconomic Imbalance Procedure
3. Protracted period of slower European growth	**High** • Negative impact of public and private deleveraging larger than expected • Persistence of very weak investment and high unemployment further reduce potential growth and make job skills obsolete	**High** • Undermine fragile market confidence • Emergence of unfavorable debt deflation dynamics, especially in the periphery • Undermine growth prospects, including in the core, and further raise unemployment	• Use monetary policy to tackle fragmentation and support demand (¶23-25) • Repair bank, corporate, and household balance sheets (¶13-17) • Implement structural policies to spur growth (¶29) and advance rebalancing (¶32)
4. Advanced economies bond market stress	**Medium/Low** • Lack of fiscal sustainability triggers a sharp rise in sovereign risk premium: a. in Japan (Medium) b. in the United States (Low)	**Medium** • Undermine fragile market confidence • Intensify cross-border financial contagion and bank deleveraging • Increases sovereign and bank spreads in the periphery	• Strengthen financial stability (see above recommendations) to make the euro area more resilient to external shocks
5. Distortions from unconventional monetary policy in other advanced economies	**High** • Mispricing of assets leads to a broad-based correction in valuation • Market volatility and higher-than-expected increases in long-term rates as side effects from exit modalities.	**Medium** • Undermine fragile market confidence • Increases sovereign and bank spreads, in particular in the periphery, only partially mitigated exchange rate movements	• Enhance monetary policy communication, e.g., through forward guidance (¶25) • Strengthen financial stability (see above recommendations) to make the euro area more resilient to external shocks
6. Oil price surge	**Low** • A spike in oil prices linked to geo-political events.	**Medium** • Damage economic activity further.	

[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).

THE IMPLICATIONS FOR POLICY

11. The challenge to revive growth and jobs calls for a comprehensive policy response. There are many factors weighing on growth. Therefore, no single action can address it (see text chart). Instead, reviving growth requires complementary policy actions on multiple fronts to: (1) reduce fragmentation (by repairing bank balance sheets, advancing the banking union agenda); (2) support demand (by undertaking further monetary policy measures, pacing fiscal adjustment); and (3) boost trend growth and foster rebalancing (by implementing structural policies). As these efforts proceed, it is imperative to maintain support from the center. This would contain adverse feedback loops between weak growth, weak sovereigns, and weak banks (see flow chart).





12. While difficult to achieve, unwavering political backing for institutional reforms remains critical and is in the interest of all EMU members. This would help reduce, in particular, the euro area policy uncertainty that has been holding back domestic demand, including in the core. Policies to address the multiple challenges would be mutually reinforcing. For example, measures to address fragmentation and improve credit conditions in the periphery would help foster investment and job creation in new productive (tradable) sectors. This, in turn, would help restore competitiveness and raise growth. Likewise, policies to boost growth and jobs would facilitate sovereign, corporate and household balance sheet repair. This would strengthen bank balance sheets and ultimately reduce fragmentation. Conversely, considering these policy actions in a piecemeal way could disappoint, and further undermine confidence. The dividends of such reforms could be significant over the medium term—about 3 percent and 1 percent in terms of euro area and global output levels within five years (see Spillover Report).

A. Reversing Fragmentation

Repairing banks' balance sheets is a prerequisite[3]

13. Restoring banking sector health is essential for the recovery. As discussed in the recent EU FSAP, the crisis has shown that frail banks have been unable to function as proper financial intermediaries during the recovery. Instead, they have relied on elevated lending rates to boost profitability and enhance capital buffers—especially where funding costs remain high. In addition, these banks have been either unable or unwilling to recognize and provision for higher losses, leading to further balance sheet weakness, limiting their ability to lend, and reinforcing fragmentation.[4] Reversing these dynamics means recognizing losses, filling capital holes, closing or restructuring nonviable banks.

14. By lifting confidence in the euro area banking system, a credible assessment of banks' asset quality would help lower funding costs and address fragmentation. Such an exercise would help resolve the uncertainty about bank balance sheets and improve the prospects for attracting private capital to weak banks. This, in turn, would help unclog credit flows.

- The forthcoming Balance Sheet Assessment (BSA) of euro area banks, required ahead of the start of the Single Supervisory Mechanism (SSM), to be followed by stress tests, provides such an opportunity. It is also critical to establish the ECB's credibility as a supervisor. Key elements to ensure the effectiveness of this approach include: (1) a forward-looking framework that incorporates risks to growth and is clearly communicated well in advance of the exercise; (2) harmonized methodologies and stringent standards for nonperforming loans, provisioning rules, and risk weights (as proposed by the EBA); and (3) full coverage of banks coming under direct supervision of the SSM.
- Independent third-party involvement (preferably from the private sector), along with the ECB, the EBA and national authorities, would be essential to ensure full credibility and transparency of the exercise. In the absence of such involvement, prospects for raising private capital would be jeopardized.

15. An agreed strategy on how to address capital shortfalls would be critical to prevent pro-cyclical deleveraging. Absent such a strategy, there is a high risk that the BSA and the following stress tests would be counter-productive: if banks shed assets to preemptively build buffers, this would reinforce fragmentation rather than resolve it. In addition, the incentives to conduct a thorough and credible exercise could be skewed. Conversely, a clear plan on filling capital gaps would encourage a realistic write-down of assets and full recognition of losses, which would encourage private capital. Where private funds are insufficient, the public sector would need to provide capital in countries with available fiscal space. However, in the event both private capital and

[3] The policy advice in this section stems from and is consistent with the analysis and recommendations of the EU FSAP, completed earlier this year.
[4] For more details, see *April 2013 Global Financial Stability Report*.

fiscal space are limited, clarity on a common backstop would be critical. In particular, it would avoid the re-ignition of adverse bank-sovereign links and improve incentives for regulators to recognize losses. Competition and state-aid rules may also need to be reassessed to ensure that conditions attached to public support do not lead to excessive deleveraging.

16. The ESM can serve as an effective common backstop. The recent agreement on the main features of the ESM direct recapitalization framework—including the conditions for access, time of entry, burden sharing, valuation, conditionality, and governance—is an important step forward. Nevertheless, several issues remain:

- *Timing*. The timing of the final agreement on the ESM direct recapitalization is still uncertain, as it is linked to the legislative processes of the BRRD and DSG Directive.
- *Conditionality and burden sharing*. State aid conditionality would be a prerequisite for ESM direct recapitalization, which could raise issues about the use of bail-ins under the forthcoming EC rules. The role of bail-ins in ensuring burden sharing with the private sector has been clarified usefully in the BRRD (see discussion in ¶21). But if its early activation is required for ESM direct recapitalization, the new regime should be applied consistently across countries and with due regard to any adverse consequences for financial stability, especially in the event of resolution of large systemic institutions.
- *Size and access*. Although it is difficult to pre-judge the eventual needs, the limit for ESM resources available for direct recapitalization has been set at €60 billion (subject to review by the ESM Board). However, when needed, ESM direct recapitalization should be available on a timely basis, so that the ESM can be seen as an effective and credible common backstop.

In parallel, policies at the national level can help address high private debt

17. Improved national legislative and judicial frameworks could support an orderly deleveraging of the non-financial sector. Where needed, addressing high private sector debt directly can facilitate the early rescue of viable firms and a speedy exit of nonviable ones, opening the door to a rebound in investment and a reallocation of resources to more productive sectors. Doing so would also strengthen the quality of banks' assets beyond the BSA, allowing for a revival in credit. If effective, national insolvency regimes would also support the clean-up of banks' balance sheets by accelerating the workout of bad private sector debt. Yet, out-of-court restructurings—a speedy, cost-effective alternative to court-supervised proceedings—are still underutilized tools in many jurisdictions, notwithstanding recent advances in insolvency regimes in several euro area countries. A stronger institutional infrastructure and supporting bank regulatory policies could provide further incentives for debtors and creditors to engage in debt restructuring.

A fuller banking union would solidify efforts on banks' balance sheets

18. The banking union has an essential role to play in supporting bank balance sheet repair and reversing fragmentation.[5] The recent agreement by the European Council on the BRRD is welcome. But swiftly advancing the roadmap for the banking union, outlined by the Council in December 2012, is key to ensure that all elements are in place—the SSM, the SRM, common safety nets, and the accompanying directives. Further delays and dilution of the roadmap, including on the SRM, would preserve an unsatisfactory status quo and run the risk of destabilizing confidence again.

19. An effective SSM is a precondition to a systematic approach to supervision, as highlighted in the EU FSAP. This would, in particular, help reverse fragmentation by restricting ring-fencing imposed at the national level.

- While posing significant challenges, the remaining steps to make the SSM operational need to be finalized without delay. These include: passing the SSM legislation through the European Parliament (expected in September); clarifying outstanding legal uncertainties (e.g., on the respective responsibilities of the ECB and national authorities); finalizing a common supervisory model and detailed manual; and ensuring full cooperation of national supervisors. Guaranteeing full sharing of supervisory information (between national supervisors and the ECB) and building up supervisory capacity at the ECB would be critical to establish the credibility of the new supervisor in the forthcoming balance sheet review.
- Early intervention powers are essential to prevent banks' problems from becoming systemic. The current crisis has shown the deleterious effects when those are lacking, especially in the absence of a robust resolution mechanism. To be fully effective, the ECB would need to be able to bring any bank under its direct supervision, take early intervention measures (e.g., capital conservation measures, the replacement of management, or sale of bank activities), and initiate resolution.

20. But without a strong SRM complementing the SSM, the credibility and effectiveness of the banking union would be jeopardized. As recommended by the EU FSAP, an SRM should become operational by the time the SSM becomes effective. Leaving resolution responsibilities at the national level while supervision is centralized carries significant risks, such as perpetuating bank-sovereign links and creating potential conflict (and deadlock) among national authorities in cross-border resolution. In that respect, such a framework would fail to break away from the current ineffective setting. Conversely, an SRM based on a centralized resolution authority—Single Resolution Authority (SRA)—would allow for swift decisions on burden sharing arrangements and ensure least cost resolution.[6] To effectively break bank-sovereign links, the SRA would need to have access to an effective common fiscal backstop, ultimately backed by a combination of ex ante and ex post industry levies. A credit line by the ESM could be a bridge to that permanent solution.

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[5] This builds on the recommendations of the *2012 Article IV Consultation for the Euro area* that the immediate priority is a banking union for the euro area, with a common supervisory framework, deposit guarantee scheme, and bank resolution authority. See also Staff Discussion Note 13/1 *A Banking Union for the Euro Area*.

[6] The powers and tools of SRM should be aligned with emerging best practices, as described in the *FSB Key Attributes of Effective Resolution Regimes for Financial Institutions*.

21. Clear rules on the role of bail-ins will reduce uncertainty for private investors. In particular, spelling out the pecking order in the event of bank intervention helps provide the right incentives for investors, allows for market discipline, and minimizes the cost of resolution to taxpayers. In this context, the Council's recent agreement is an important milestone.[7] It confirms the role of bail-ins as an instrument to ensure burden sharing for nonviable banks and specifies a minimum amount of "bail-in-able" instruments (8 percent of total liabilities). In addition, the bail-in provisions allow flexibility in application to allow for specific threats to financial stability or institutional factors. Keeping such flexibility to a minimum level will help promote a level-playing field across banks and countries. While allowing exceptions could open the door to inequality of treatment across countries, the "constrained discretion" will also make the framework more credible by addressing concerns about systemic cases and minimizing value destruction and risks to financial stability.

22. Enforcing depositor preference across EU member states will also play an important role in ensuring financial stability, along with progress on the DSG Directive. The BRRD and its new bail-in rules introduce tiered depositor preference—a major step forward that has been supported fully by IMF staff.[8] These rules are expected to come into force in 2018, but they may be applied on a case-by-case basis before then. Details on the mechanisms to constrain discretion and the criteria for exempting liabilities may need to be clarified. In this context, strong powers at the center (SRM) will make sure that the bail-in rules are applied predictably and consistently across countries. This will improve incentives for early intervention, sever the bank-sovereign links, and ensure least-cost resolution.

Targeted monetary policies are necessary to reduce fragmentation in the shorter run

23. While efforts to clean up bank balance sheets and strengthen the banking union proceed, the ECB should play a role in preventing an escalation in fragmentation.[9] At the current juncture, support to the corporate sector through reduced borrowing costs is critical to prevent a further deterioration of the macroeconomic outlook. On current plans, the BSA will not be conducted until early 2014, and the benefits of better capitalized banks and a more complete banking union will take even longer to accrue. Meanwhile, the risk of a vicious circle is setting in, with the recession and higher non-performing assets leading to further bank losses, and deeper fragmentation. To stem that risk, the ECB could provide additional term funding to avert a more severe contraction in credit and target measures to support SME financing—as a temporary bridge until the banking sector is in a position to intermediate growth again. While this strategy would require the ECB to take additional credit risks onto its balance sheet, these could be mitigated by offsetting measures or a potential backstop provided by the European Investment Bank (EIB).

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[7] Council of the European Union, June 27, 2013, *Council Agrees Position on Bank Resolution*.

[8] "Eligible" deposits (of natural persons and micro, small and medium-sized enterprises) will be preferred to other unsecured creditors, with insured deposits preferred to unsecured deposits.

[9] See Box 3 and 2013 *Selected Issues Paper* for further detail.

- *Providing term funding*. One possibility is for the ECB to build on the existing approach to provide term funding for weak but solvent banks, to better match the duration of their assets. A new LTRO of longer tenor (3-5 years) combined with a review of current collateral policies to lower haircuts on specific assets (e.g., additional credit claims linked to SME loans and asset backed securities) would achieve such a target. And taken together, these measures would be akin to credit easing.
- *Targeted credit easing*. Another complementary avenue is for the ECB to undertake targeted credit easing measures, by explicitly linking additional liquidity to new SME lending, along the following two options:

  i) *Targeted LTROs,* akin to the Funding for Lending Scheme implemented in the U.K., but with stronger incentives for banks to participate by keeping the cost of funding through the scheme low. In particular, costs close to ECB policy rates are likely to elicit interest from banks in stressed countries where term funding costs remain elevated, thereby supporting monetary policy transmission and credit.

  ii) *Direct ECB purchases of private assets:* Such purchases would have the advantage of bypassing the banking system while balance sheets are being repaired. Private assets could include: securitized assets (supporting SME financing), corporate bonds, commercial paper, and covered bonds. However, the impact would be constrained, at this stage, by the small size of the securitized market and regulatory hurdles that would take time to overcome.

B. Supporting Demand

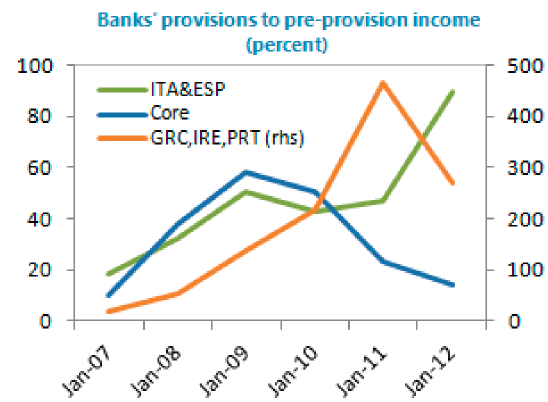
The weak growth and inflation outlook warrants further conventional monetary policy action

24. Further policy rate cuts, including negative deposit rates, would help support demand and bring inflation back in line with the primary objective. The room for cuts remains limited. Yet reducing the interest rates on the deposit facilities (marginally) below zero could help anchor expectations of a looser monetary stance and would be a strong form of forward guidance (see below). In particular, this would lower expectations of future increases in policy rates and further encourage banks with excess liquidity to reengage in the interbank market and extend credit. While lower bank profitability may either drive up interest rates on loans or fees on certain banking services for those banks (the "unintended consequences"), this is likely to affect mostly core banks, which on average are stronger at this juncture.

25. Explicit forward guidance would help anchor interest rate expectations and reduce funding uncertainty. The ECB's forward guidance introduced in early July is helpful in this regard, but it may need to be relied upon further if conditions worsen. This is particularly relevant given the ongoing decline in excess Eurosystem liquidity and risks to interbank rates from global monetary shocks (i.e., uncertainty about the exit from unconventional monetary policies in the U.S.). In this context, the ECB could consider various additional actions, including reducing interest rates into negative territory, continuing full allotment MROs at fixed rates beyond mid-2014, or extending this to additional LTROs. Intervening directly in short-term euro area money markets could be another (and potentially powerful) option to signal the intended policy stance.

Box 3. Fragmentation and Monetary Transmission in the Euro Area

Euro area financial markets remain fragmented, despite the range of ECB actions to address bank funding problems and eliminate excessive risk in sovereign markets. Following the introduction of OMTs, sovereign and corporate risk has fallen, but bank CDS spreads remain elevated. Term funding costs are still high for periphery banks, weighing on bond issuance, while declining asset quality is raising provisioning needs. Cross border banking flows remain low, and lack of market finance makes weak banks highly reliant on official liquidity. These factors have contributed to driving retail interest rates in stressed markets significantly above those in the core, impeding the flow of credit, and undermining the transmission of monetary policy.



Interest and credit channels are impaired. Declining interbank activity has undermined the interest rate channel. The bank lending channel is still impaired as a result of lack of term-funding for certain banks and weak bank balance sheets. In addition, ongoing corporate and household balance sheet adjustment is feeding into low demand for credit and higher nonperforming loans.

Fragmentation and the broken monetary transmission mechanism impact SMEs disproportionately, as evidenced by higher lending rates for small loans and high loan rejection rates for SMEs as compared to larger entities. Ensuring credit availability to viable SMEs is essential to support the recovery in the euro area, particularly as they account for about 80 percent of employment and 70 percent of value added in Italy, Spain, and Portugal.

A simple econometric model finds that interest rate pass-through has been affected by the above factors. In particular, the regression results support the notion that funding costs, credit risk, and leverage have become important determinants of lending rates since the onset of the crisis, particularly for stressed countries, and that these factors appear to be more relevant for small loans, typically associated with SMEs.

These findings highlight the importance of cleaning up bank balance sheets and other measures to increase access to credit to SMEs. Repairing bank balance sheets and making further progress on a banking union are essential to restore confidence in the financial system, weaken bank-sovereign bank loops, reduce fragmentation, and support credit and growth. At the same time, given that bank balance sheet repair will take time to complete, it is important to stem the decline in the real economy through various measures to support credit supply.

Pacing fiscal adjustment would also restrain headwinds to growth

26. For the area as a whole, the negative growth impact of consolidation could reach as much as 1-1¼ percentage point this year. Across the EMU, the pattern of adjustment remains highly pro-cyclical, with larger consolidations in the periphery and broadly neutral (or mildly expansionary) stances in Germany and Austria.

27. In this context, the challenge is to avoid excessive damage on demand while putting debt levels on a sustainable downward path. To ensure that negative growth surprises do not trigger additional consolidation, defining and assessing adjustment in structural terms is key, as was done in the context of the recent postponement of the EDP deadline. Nevertheless, given weak growth prospects, these deadlines may still prove to be overly ambitious in some cases, and even more flexibility may be useful, particularly if countries use that fiscal space to implement ambitious structural reforms (e.g., entitlement and tax reforms), or to recapitalize viable banks. In this context, the small projected loosening of the fiscal stance in Germany is appropriate. If downside risks materialize, countries that are not under market pressure would benefit from a slower pace of fiscal adjustment.

28. A credible medium term framework is a precondition to pace fiscal adjustment.

- *Budgetary frameworks*. To preserve credibility in the coordination process and ensure that consolidation is sustained over a longer horizon, there is a strong argument for using well-defined, multi-year budgetary frameworks—with fiscal measures identified in advance—and realistic macroeconomic assumptions underlying medium-term adjustment plans.
- *Implementation and enforcement*. Ownership of medium term objectives is expected to improve as national legislation and independent fiscal agencies assume a stronger role in the future, following the entry into force of the Fiscal Compact, Six Pack, and Two Pack. In this setting, the credibility of the framework would only be as strong as its implementation, especially regarding enforcement provisions. Therefore, achieving a timely implementation, a uniform degree of ambition across national setups, and consistent objectives between national and supranational layers would be important tests for the governance framework.
- *Complexity*. More broadly, the growing complexity of the current framework, in which the center has relatively weak enforcement capabilities, may cast doubt on its efficiency and acceptability by the public. Over time, a potential remedy could be to strengthen the role of the center and lay the foundations for greater risk sharing. This would help prevent idiosyncratic shocks (or policies) from morphing into a systemic crisis in the future.

C. Carrying on with Structural Policies

Ambitious structural policies are instrumental for growth, jobs, and rebalancing

29. A new growth agenda could help catalyze efforts at both the area-wide and national levels. Although the benefits from reforms will take time to accrue, a firm commitment to attainable targets could lift confidence, even in the short term.

- *Fostering job creation*. The ongoing rebalancing in the periphery has been skewed toward labor shedding, disproportionally affecting the young. Labor market reforms should be aimed at tackling labor market duality, promoting bargaining arrangements conducive to sustainable wage developments, and enabling firms to absorb shocks. Meanwhile, severance costs for permanent job contracts should be aligned with EU norms where they are significantly higher. At a minimum, employment protection should be more systematically linked to the length of employment in the firm, and increase continuously with tenure to avoid the threshold effects that characterize dual systems.[10] By promoting the incentives for companies to hire, these reforms would facilitate the reallocation of resources to exporting sectors and increase trend growth, thereby fostering job creation and more sustainable adjustment. Area-wide, improved portability of pension and unemployment benefits would contribute to increasing labor mobility across the region. Bilateral national initiatives can also support migration from regions of high unemployment to areas with skill shortages (e.g., through job and language training). Across the euro area, incentives targeted at female and older workers would help raise labor force participation rates where they are particularly low.

- *Promoting greater integration.* Although the Single Market has fueled European growth over the past decades, labor mobility and cross-border competition in services remain limited. A targeted implementation of the Services Directive would help reduce barriers to entry in protected professions, foster competition by promoting cross-border provision of services, and enhance productivity and living standards. In addition, a new round of Free Trade Agreements could secure access to growing markets, including in emerging Asia. It could also provide a much-needed push to improve services productivity through deeper integration, which is under discussion in the transatlantic trade and investment partnership.

- *Boosting competitiveness.* Allowing firms' wages to respond more flexibly to collective agreements and adjusting wage floors at the industry level would also foster internal devaluation. Lowering regulatory barriers to entry and exit of firms, simplifying tax systems, and tackling vested interests in the product markets—including measures to increase competition in the transportation, energy and other network industries—would support competitiveness and raise purchasing power throughout the euro area. (For instance, electricity prices for industrial users in Italy are some 50 percent higher than the European average.)

- *Supporting credit provision and investment.* The securitization schemes proposed by the EC and the EIB would provide some credit support to SMEs and therefore help reduce fragmentation. In the proposed options, SME loans would be securitized, using funds from EU and EIB amounting to €10.4 billion. The funds could be leveraged up to 10 times, depending on the degree of risk pooling among member countries. These options would support bank capital, SME lending, and capital market development over the medium term. However, the initial impact is likely to be limited, unless the scheme is front-loaded, covers new <u>and</u> existing loans, and risk pooling is

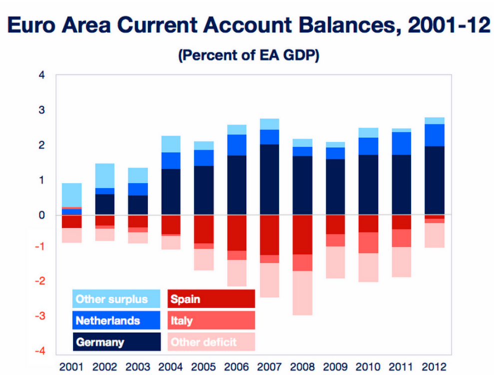
[10] For more details, see Blanchard O., F. Jaumotte, P. Loungani, (2013), "Labor Market Policies and IMF advice in Advanced Economies during the Great recession", IMF Staff Discussion Note 13/02.

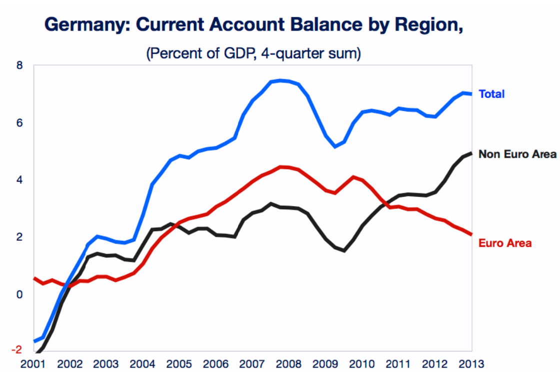
maximized through wide member participation. Over time, efforts to further develop capital markets would help reduce the dominance of bank-based financing, especially for SMEs.

Many of the above reforms, along with reforms at the national level, would also support rebalancing.

30. The overall current account balance has strengthened, but divergences within the euro area have persisted.

- The euro area current account balance reached 1.2 percent of GDP in 2012, up from a deficit of 1.5 percent of GDP in 2008. Part of the adjustment owes to cyclical factors, as weak demand compresses imports in the periphery. But it also reflects some competitiveness gains stemming from national adjustment efforts in the periphery. This is evident from the improvement in export performance of these economies. But wage adjustments have so far had a limited impact on export prices, and weak euro area demand has been a drag on exports.[11]
- The adjustment, however, has been somewhat asymmetric. Since the onset of the crisis, the current account balances in deficit countries have more than halved—due to both lower imports and higher exports. The overall external position in surplus countries, notably Germany, has barely changed, although Germany's current account balance with the rest of the euro area has narrowed significantly.





31. The euro is assessed to be consistent with its equilibrium value. Staff analysis—based on fundamental determinants, desired current account adjustment, and aggregation of views for individual member states—suggests that the euro real effective exchange rate is close to its equilibrium, after declining by 10-15 percent from its peak at the end of 2009.[12] On balance, this reflects a moderate undervaluation in surplus economies, and overvaluation in most deficit economies. Further adjustments in relative prices and sizeable real exchange rate depreciations—in

[11] See Box 4 and *2013 Selected Issues Paper* for more detail.

[12] Both External Balance Assessment and CGER estimates suggest that the 2012 euro area current account was about 1-2 percent stronger than implied by fundamentals, and that the real effective exchange rate (REER) was broadly in equilibrium, within a range of 0-5 percent. The External Sustainability (ES) approach indicates a REER undervaluation of up to 13 percent, based on the assumption of a constant net foreign asset (NFA) position. However, this assumption may not be appropriate for all countries in the euro area: given the large accumulated external debt in the periphery, the NFA position needs to be further strengthened in these countries.

the order of 5-15 percent according to the 2013 External Stability Report—are estimated to be necessary for some peripheral countries to regain competitiveness. Staff estimates suggest that the nominal exchange rate and the relative price adjustment have played a role in explaining recent export performance, although the magnitude of these effects is somewhat uncertain.

32. Further policy actions in both surplus and deficit economies are necessary to rebalance the euro area. In *surplus economies*, increasing productivity in non-tradable sectors would improve disposable incomes and consumption in these economies and lead to higher external demand, which could support the rebalancing efforts of the deficit countries. In addition, reducing euro area uncertainty would support a recovery in private investment, which would help narrow current account surpluses (notably in Germany). In *deficit economies*, continuing structural adjustment would deliver a shift of resources to tradable sectors where consumption booms led to excessive growth in non-tradable sectors in the run-up to the crisis (see *2013 External Sector Report*).

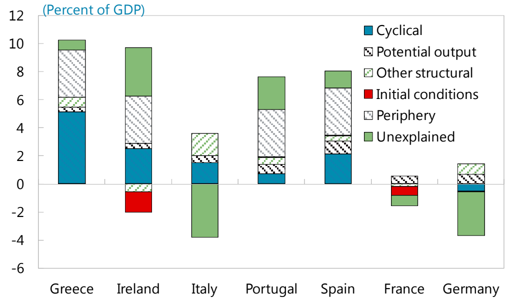
Box 4. Rebalancing the Euro Area: Where do We Stand and Where to Go?

Background: Before the crisis, large net foreign liabilities accumulated in the periphery (Greece, Ireland, Portugal, and Spain) as a result of deteriorating competitiveness and domestic demand booms fueled by intra-euro area capital flows. Meanwhile, export-oriented economies (Germany, Netherlands) experienced rising external surpluses. Since the crisis, current account deficits in the periphery economies have narrowed markedly, but these external adjustments could reflect depressed demand or more structural developments. Given downward pressures on demand (associated with public and private deleveraging) and limited policy space, the challenge for the euro area is to reduce internal imbalances while restoring growth and employment.

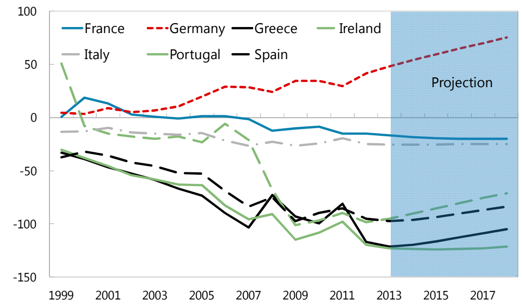
Main findings:

- Substantial REER adjustments have taken place in deficit economies, largely driven by declining unit labor costs through wage adjustments and labor shedding. CPI deflators have been sticky, while GDP deflators have declined in the periphery relative to trading partners.
- Nevertheless, there is limited evidence of reallocation of resources across sectors. And ongoing adjustment in current account balances is partly driven by cyclical factors, especially in Greece.
- While relative price adjustment plays some role, improvements in export performance are very dependent on external demand, including from within the euro area (Italy and Portugal), and remain partly determined by initial trade specialization.
- Further adjustment in relative prices would be needed to restore competitiveness (in the order of 5-15 percent in deficit economies based on current account or REER targets).
- Beyond price adjustments, resources need to be reallocated to more productive sectors and countries need to move up in the value chain, while labor and product markets need to become more flexible.
- Going forward, converging to net foreign asset positions considered safe elsewhere will prove challenging for some countries, while others are projected to continue accumulating large foreign surpluses.

Policy implications: Further improvements in competitiveness are important for deficit economies, which need to lower costs and shift resources to tradable sectors to spur growth and rebalance their external position. In addition to continued efforts to reform labor and product markets, easing credit constraints affecting SMEs would help support entry and investment in tradable sectors. In surplus economies, product market reforms would ease entry in non-tradable sectors and boost domestic demand, which could help support rebalancing the euro area. Also, a decrease in euro area uncertainty would support a pick-up in investment and domestic demand, notably in Germany. This would contribute to a sustained reduction in current account surpluses over the medium term.



Sources: WEO, EER, DOTS, and IMF staff



Note: NFA/GDP implied by WEO projections, assuming no valuation effects going forward.

THE AUTHORITIES' VIEWS

33. There was broad agreement between staff and authorities that more credible progress is needed on bank balance sheet repair and EMU architecture. With differences of views among member states becoming increasingly prominent in these areas, the authorities—the ECB and the European Commission (EC)—stressed the importance of decisive policy actions in boosting confidence in the euro banking system and the long-term viability of the monetary union. They concurred that while the situation is substantially better than in mid-2012, the challenge to restart growth and reduce policy uncertainty remains. The authorities agreed that more progress was needed to complete the EMU architecture, including by providing a fuller banking union and achieving greater fiscal integration, to address the underlying weaknesses, fully restore confidence, and lay the foundations for higher durable growth.

34. The authorities broadly agreed with the assessment of economic developments in the euro area, and the downside risks to growth. The authorities noted the strong headwinds to growth from ongoing fragmentation, private sector deleveraging, and still-weak confidence. They elaborated that while significant progress in deleveraging had been achieved in some countries, and stronger asset positions may lessen the overall need to deleverage (particularly in the household sector), overall balance sheet weakness is restraining growth.

35. A credible assessment of bank asset quality is essential to restore confidence in the euro area banking system. The BSA and following stress tests are seen as critical elements that will establish the credibility of the SSM, and that the quality and comprehensiveness of this exercise should not be compromised, though this will be challenging. The authorities underlined the importance of having the ESM backstop in place ahead of the BSA to motivate national authorities and to address capital shortfalls where fiscal space is insufficient. But they also recognized that full approval of the BRRD and the DGS directive is a pre-requisite for finalizing the ESM direct recapitalization framework, and this could take some time. Nevertheless, they agreed that pro-cyclical outcomes should be avoided by effectively communicating the exercise, involving third party expertise, and having in place clear strategies for recapitalization and restructuring.

36. The ECB and EC strongly prefer a centralized resolution mechanism to make a banking union work. They stressed that a single resolution authority with strong powers was essential for the credibility and effectiveness of the SSM.

- The EC noted that such an authority could be established within current EU Treaties, under the condition of giving the decision-making power to the EC since it is the only institution apart from the ECB that can lawfully take decisions at the European level. But some member states hold the strong view that a treaty change is necessary, and this could significantly delay establishment of a single resolution authority.
- There was common concern that a weaker proposal, based on a network of national resolution authorities, could prevail, limiting the SRM's ability to act in an efficient manner. In addition, the authorities fully supported the introduction of bail-ins as best practice resolution tools, but noted that this should only be deployed when a bank is deemed nonviable, and not as a recapitalization tool.
- The authorities welcomed the finalization of the CRR/CRDIV and Council agreement on the BRRD. However, they stated that other elements of the single rule book (e.g., the DGS Directive) should be agreed upon and transposed in national legislations as soon as possible. In late June, the European Council reiterated its goal of reaching agreement on adopting the BRRD and DGS directives by end-2013 for transposition into national law by end-2014. The authorities supported depositor preference (with full protection of insured depositors and a clear pecking order ranking uninsured depositors as the last to suffer losses among uninsured unsecured claimants), and favored minimizing the degree of flexibility left to national authorities in the application of resolution tools.

37. There was broad agreement on the potential need for further monetary policy action, particularly if conditions worsen substantially, although not all of staff's proposals could be implemented easily. The ECB introduced explicit forward guidance for interest rates in early July and would consider further standard and non-standard measures (including negative deposit rates) if domestic and external conditions worsen. At the same time, the authorities cautioned that the impact of such measures are likely to be more muted, particularly in comparison with the OMTs, given that fragmentation is not only due to capital market failures but also to higher overall macroeconomic risks. The authorities noted therefore that while monetary policy plays a role in demand management, structural policies play a more important role in managing overall macroeconomic risks. In addition, they stressed the risk that further monetary policy actions to relieve demand pressures could blunt incentives to take difficult measures at the national level. On direct asset purchases, the authorities emphasized that the small market size of securitized assets and regulatory hurdles could limit its effectiveness.

38. The authorities broadly acknowledged the importance of setting EDP targets in structural terms. They explained that while the targets are set in nominal terms, structural adjustment has always been critical for assessments. In this context, the European Commission noted that if the outlook worsens, they would be ready to extend the deadlines accordingly. The authorities cautioned that linking EDP extensions to structural reforms should not be seen as a tradeoff, as these extensions were justified on economic grounds. Nevertheless, they emphasized that structural reforms are being pushed through the European Semester, where the extensions have been granted.

39. Substantial progress has been made in strengthening governance over the past year. At the same time, the authorities concurred with staff on the need for ensuring strong implementation of the new governance frameworks at both the national and European levels.

- To strengthen the credibility of fiscal frameworks in the medium term, implementation of country specific recommendations, and evenhandedness in applying the frameworks were of particular importance. While acknowledging the complexity of the frameworks, the authorities pointed out the need to address country specific issues and changing economic circumstances within the current legal setup.
- There was agreement that greater fiscal integration, combined with stronger governance frameworks, including a stronger role for the center, could in principle provide the basis for more risk sharing, making the euro area more resilient to future shocks.
- The authorities argued that targeted and limited contractual arrangements, such as the proposed Convergence and Competitiveness Instrument (CCI), could provide a useful mechanism to incentivize reforms. The CCIs could be linked to the European Semester and the Macroeconomic Imbalances Procedure (MIP). It was noted that financial support would have to rely on existing budgets and that moral hazard would have to be addressed. The authorities called for a strong implementation and follow-up on recommendations issued in the MIP, in particular for those countries where imbalances were deemed excessive (Spain and Slovenia).

40. The authorities agreed that the ongoing rebalancing is incomplete. While wages are adjusting and exports are improving in the periphery, there are limited signs of symmetric adjustment in surplus countries. The authorities highlighted that higher total factor productivity is essential to boost competitiveness. They noted that adjustment would be facilitated by the implementation of the Services Directives, which will generate higher productivity and stronger demand in the surplus countries, while facilitating the provision of credit to SMEs.

41. On structural reforms, the authorities highlighted key priority areas. On labor markets, they noted that pan-European training initiatives would signal solidarity and enhance firms' incentive to hire young workers. Other priorities included implementing the Services Directive, reforming the energy sector, improving lending to SMEs, and fostering cross-border labor mobility.

42. There was general agreement with staff's risk assessment. The authorities noted that renewed financial market stress could result from policy complacency and still rising sovereign debt ratios. These could be compounded if stress triggered additional fiscal consolidation. In the medium term, they shared the view that the drag from private and public sector deleveraging could be higher than expected, but noted that a slow labor market response could be expected given euro area labor market institutions, and that hysteresis effects were unlikely. The authorities emphasized that they considered the likelihood of a stagnation scenario to be relatively low, because they saw adjustment well advanced in many countries. On external risks, they noted that a larger than expected slowdown in demand from emerging economies, coupled with a fall in commodity prices, could weaken external demand prospects for the euro area and exert downward pressure on prices. A rise in long term interest rates, particularly in excess of what may be warranted by a pickup in world or U.S. growth could have a very detrimental impact on sovereign financing costs for the euro area, though they noted that the impact would not necessarily discriminate against yields of crisis economies. While the authorities saw risks to inflation outlook as balanced, they expressed concern that in a negative scenario of protracted low inflation, inflation expectations could become unanchored.

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43. Substantial collective actions have reinforced the commitment to the monetary union. The ECB introduced the OMTs framework to address severe distortions in sovereign bond markets and thereby increase the effectiveness of monetary policy. The completion of the ESM firewall, the extension of official loan maturities to program countries, the improvement in the policy coordination framework, and the agreement on Greece and Cyprus have been equally important steps in combating the crisis. In addition, national governments continue to make progress in restoring the health of public finances and advancing structural reforms. These actions helped tackle dangerous tail risks related to the breakup of the euro area.

44. But the macroeconomic environment continues to deteriorate. Demand is weak and unemployment is increasing, stoking social and political tensions in parts of the euro area. Financial market fragmentation persists, hampering monetary transmission and the flow of credit to where growth is weakest. At the same time, consumers and businesses are restrained by large debt overhang and ongoing balance sheet repair, while fiscal policies are pro-cyclical. Structural weaknesses in labor and product markets are making it difficult to restore competitiveness. In turn, the risks of stagnation and long-term damage to potential growth are increasing, and this would cause broad negative spillovers to the rest of the world, particularly to other EU and southeastern European countries.

45. Further policy efforts are needed to address the twin challenges of growth revival and job creation. This requires policy actions on multiple fronts, many of which are mutually reinforcing (and cannot be effective if implemented in isolation): repairing banks' balance sheets and facilitating the resolution of private debt, making further progress on banking union, providing sufficient demand support, and advancing structural reforms.

46. Although hard to achieve, undisputed resolve and steadfast support for deeper integration will go a long way toward restoring confidence. Undivided support at the national level for collective initiatives can bolster area-wide stability. On the other hand, significant delays and perceived frictions among member states can create uncertainty for investors and consumers. Therefore, demonstrating swift progress on the remaining elements of the banking union and advancing toward greater fiscal integration would send a strong positive signal and underpin confidence.

47. Sound bank balance sheets are essential to reduce fragmentation and revive credit growth. A comprehensive, forward-looking balance sheet assessment is needed to quantify any potential capital needs before the SSM in place. But a clear plan on how capital shortfalls will be addressed must be in place before the results are announced. Clear communication, and the involvement of an independent third party, would ensure transparency and boost confidence. Losses should be fully recognized, failed banks should be closed and restructured, and frail systemic banks should receive public support where private capital is insufficient. For this, a credible national fiscal backstop needs to be available ahead of time. But where both private capital and fiscal space is limited, a common backstop, such as that provided by the ESM, should be used, making it necessary to reach agreement as soon as possible on its availability for direct recapitalization. If needed, the flexibility in the recently agreed framework should be used to the fullest to prevent a flare-up of negative sovereign-bank loops in the context of the BSA and stress test exercises. At the national level, efficient insolvency regimes and strong institutions are needed to facilitate the work out of excessive private debt, which would complement the cleanup of bank balance sheets.

48. A strong banking union is essential to reduce fragmentation. The SSM regulation should be approved without delay. A centralized and more systematic approach to supervision would prevent ring-fencing by national authorities, help reverse fragmentation, and reinforce incentives for early intervention in frail banks. A strong SRM, based on a centralized authority with the independent power to trigger resolution and make decisions on burden sharing, is critical to minimize risks to the credibility of the SSM and to ensure timely and least cost resolution while protecting financial stability. By contrast, compromise solutions that leave resolution at the national level while supervision is centralized carry significant risks, including of perpetuating bank-sovereign links and potential conflict between national authorities in cross-border resolution. The SRM should become operational at around the time when the SSM becomes effective in 2014. This will enhance the ECB's effectiveness as a supervisor. The ESM can initially provide a fiscal backstop, and access to its funds for direct recapitalization should not be unduly restrictive. Ultimately the SRM should also be backed by ex ante and ex post levies on industry resources. In addition, swift adoption of the

BRRD and the DGS Directive—including clarification on bail-ins, depositor preference, and deposit limits—is essential to advance the banking union.

49. **In the meantime, additional unconventional monetary support could help reverse fragmentation.** Taking its current approach forward, the ECB should ensure term funding needs for weak but solvent banks through an additional LTRO of sufficient tenor. This would be most effective if accompanied by lower collateral haircuts, particularly on SME loans. To tackle fragmentation and repair monetary transmission more decisively, the ECB should consider further unconventional policies, including through a targeted LTRO (linked to new SME lending), or direct purchase of select private assets.

50. **Additional monetary easing will likely be necessary, given the very benign inflation outlook.** Further policy rate cuts, including negative deposit rates, would support demand across the euro area and address deflationary pressures. The ECB's forward guidance will help anchor interest rate expectations, which is now even more necessary because of market uncertainty about the exit from unconventional monetary policies in the United States.

51. **Pacing fiscal adjustment remains key.** The extension of EDP deadlines is welcome, but current targets could still prove too ambitious. Additional flexibility may need to be given to countries, especially if that fiscal space is used to implement ambitious structural reforms (including to entitlement and taxes) or to recapitalize viable banks. Moreover, if downside risks materialize, the pace of fiscal adjustment should be slowed further.

52. **Recent reforms have strengthened fiscal governance, but there are several outstanding issues that need to be tackled.** The super-imposition of different layers of rules has made the overall framework increasingly complex. Moreover, concerns remain about the implementation, enforcement, and transparency of the various rules, including at the national level. In this context, proving by practice the capability of the framework to deliver credible medium-term fiscal anchors will be critical, not least to allow for sufficient short-term flexibility. In the longer run, fiscal governance will need to evolve further to strengthen the role of the center and lay the foundation for greater fiscal risk sharing.

53. **There is also a pressing need for further structural reforms.** Efforts at both the area-wide and national levels should be catalyzed, including through fostering greater integration. A targeted implementation of the Services Directive should be undertaken to remove barriers to protected professions, raise productivity, and promote cross-border provision of services and competition. A new round of free trade agreements could provide a much-needed push to improve services productivity. And within countries, labor market rigidities should be tackled to raise participation, address labor market duality, and promote more flexible bargaining arrangements.

54. **While the euro is assessed to be broadly in line with fundamentals, there are still substantial competitiveness gaps between countries**. Meanwhile, further productivity gains in the tradable sector and adjustment in relative prices should help rebalancing in the periphery. And

increasing productivity in non-tradable sectors would improve disposable incomes in surplus economies, which could support the rebalancing efforts of the deficit countries.

55. The staff proposes 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 2. Structural Reform Plans and Progress in Selected Countries

	Reform priorities	Recent progress	Staff recommendations
Germany	• Increase labor force participation and facilitate immigration of qualified workers • Increase productivity, in particular in the services sector	• Progress in extending the provision of child care • Corporate tax reform of 2008 improved Germany's tax competitiveness • A law to facilitate recognition of qualifications obtained abroad came to force. The EU blue card facilitates immigration of skilled workers • Additional allocation to research and development in the 2012/13 budget	• Lower the tax wedge, in particular for the low skilled • Improve quality and availability of early childhood education • Remove disincentives to invest in higher risk, higher growth sectors. Promote widespread use of ICT • Review the family policy to improve its efficiency • Accelerate the integration of pan-European transportation and energy networks and increase competition in network industries
France	• Improve the functioning of labor markets to re-absorb the unemployed, with a focus on youth unemployment • Increase competition in service sectors • Undertake a tax reform	• In 2011, approval of measures to accelerate pension reform implementation. Partial roll-back of the reform in mid-2012 • The G-20 commitment (Cannes) for further liberalization of some services has not been implemented • In 2012, Parliament approved a reduction in the labor tax wedge	• Achieve minimum wage moderation; reduce inactivity traps for young and low-skilled workers; support the unemployed in their job search • Empower an independent advocate of reform, for instance the competition authority with accrued powers to review practices and regulations • Undertake a growth friendly tax reform to support the consolidation
Italy	• Improve the functioning of the labor market • Boost product market competition	• In 2011, packages on wage bargaining decentralization and labor contracts • In April 2012, introduced Fornero labor market reform to encourage open-ended and apprenticeship contracts and to reduce cost of individual dismissal • Introduced reforms on product market liberalization and administrative simplification	• Clarify conditions for reinstatement via the judicial process • Introduce flexible open-ended contract; promote firm-level contracts • Consider regional differentiation in public sector wages, and support private wage flexibility • Need further steps on privatization, especially on local public services
Spain	• Improve the functioning of the labor market • Further reform in the service and product markets	• The labor reform reduced severance payments and eased the use of fair dismissals, and facilitated firm-level agreements (February 2012) • Reduction of the replacement rate for unemployment insurance and hiring subsidies In July 2012 • In February 2013, the government announced a strategy for youth employment and	• Commission and publish an independent evaluation of the reform • Reduce further severance payments, legislate against wage indexation, and simplify opt-outs from collective bargaining; • Reduce labor cost on the low skilled and the young, strengthen active labor market policies • Implement decisively the reforms in

		entrepreneurship	the NRP; set an independent "growth commission" to help define priorities and identify key measures
Greece	• Improve labor market flexibility • Foster competition in service and product markets • Improve the business environment	• Major labor market reforms were undertaken, including reduction of the severance pay; promotion of firm-level bargaining; lowering tax wedge, etc. • Legislation was adopted liberalizing restricted professions, transportation services and energy • Legislation to improve the business environment.	• Reduction in the labor tax wedge in a budget-neutral way and take additional measures to lower unit labor costs. • Define an action plan to tackle remaining rigidities in product market and facilitate investments • Simplify export legislation and finalize implementation of new licensing laws during 2013
Ireland	• Labor market reform • Increase efficiency and competitiveness of the overall economy	• Introduced law reforming sectoral wage-setting agreements; • Expanded number of activation and training places; strengthened the activation and training policies • Improved the enforcement powers of the Competition Authority through a new Competition Act in 2012.	• Further improve engagement with the long-term unemployed; finalize the reform of further education and training • Finalize the reform of the legal services to better align the costs. • Implement an ambitious program of state assets disposals, including associated regulatory reforms especially in the gas and electricity sectors
Portugal	• Improve the functioning of the labor market • Improve competition framework • Reduce costs in regulated network sectors • Further improve the business environment	• Implemented "organized decentralization" on collective agreements and introduced representation threshold for extension of sectoral agreements. • Severance payment has been reduced • Labor Code revisions to make working time arrangements more flexible • A new Competition Law was approved by Parliament; a framework law for regulators was recently submitted to Parliament • Privatization program on track.	• Promote firm-level wage bargaining; relax working time regulations • Streamline licensing processes for businesses and reduce rent • Reform the judicial system to improve efficiency and promote better out-of-court dispute resolution • Reform corporate insolvency regime

Source: IMF country teams

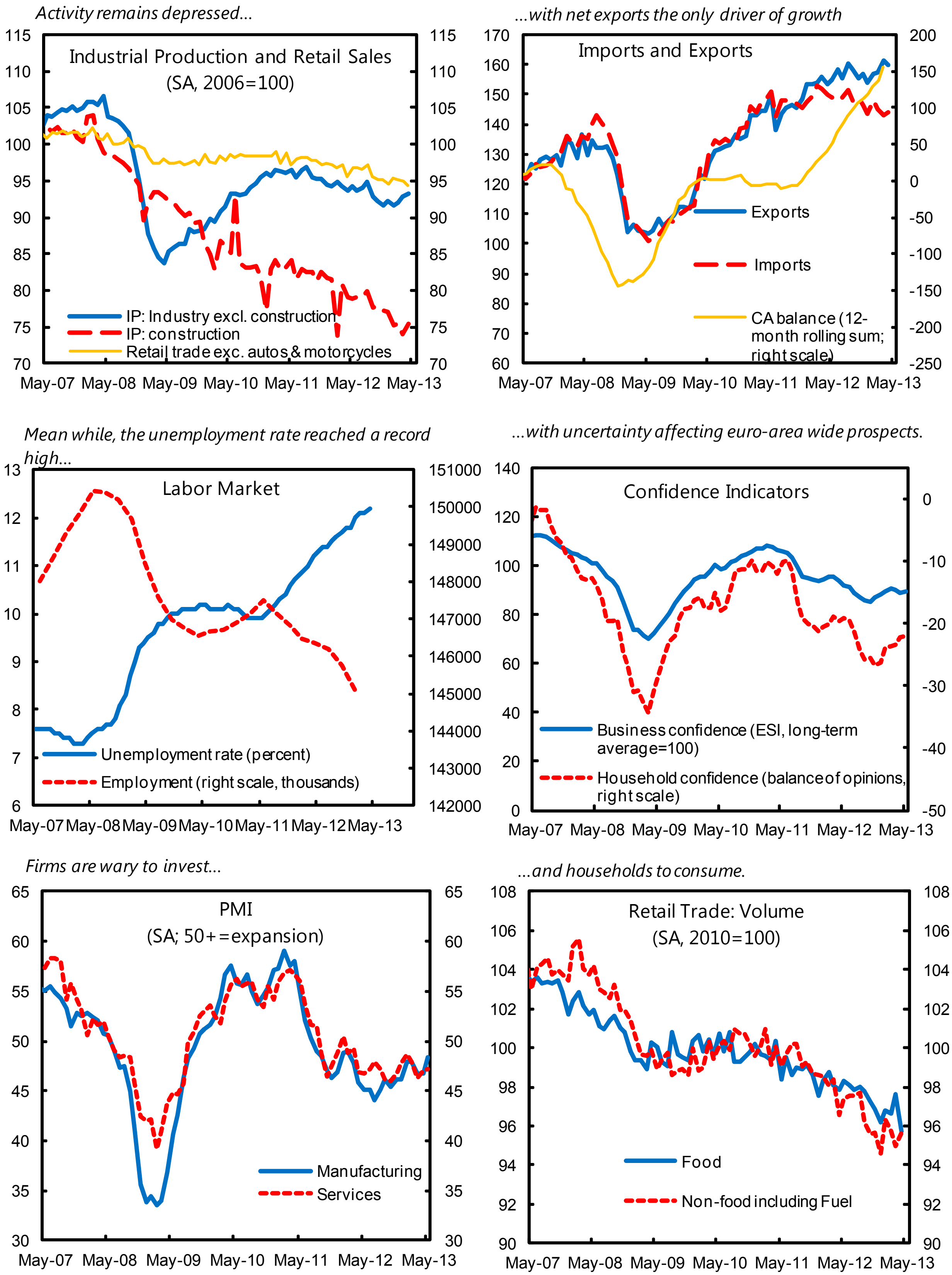
Table 3. Euro Area: Main Economic Indicators, 2010-2015

	2010	2011	2012	Projections 1/ 2013	2014	2015
Demand and Supply						
Real GDP	2.0	1.5	-0.6	-0.6	0.9	1.3
Private consumption	1.0	0.2	-1.3	-0.8	0.4	0.9
Public consumption	0.8	-0.1	-0.4	-0.2	-0.1	-0.1
Gross fixed investment	-0.3	1.4	-4.3	-3.4	1.2	2.0
Final domestic demand	0.7	0.3	-1.7	-1.2	0.5	0.9
Stockbuilding 2/	0.6	0.2	-0.5	-0.1	0.0	0.0
Domestic Demand	1.3	0.5	-2.2	-1.3	0.5	0.9
Foreign balance 2/	0.7	0.9	1.6	0.7	0.4	0.4
Exports 3/	11.2	6.3	2.7	1.5	3.7	3.9
Imports 3/	9.7	4.2	-0.8	-0.1	3.0	3.4
Resource Utilization						
Potential GDP	0.7	0.6	0.4	0.5	0.7	0.8
Output gap	-1.6	-0.8	-1.8	-2.8	-2.5	-2.1
Employment	-0.5	0.3	-0.6	-0.9	0.0	0.4
Unemployment rate 4/	10.1	10.2	11.4	12.3	12.4	12.1
Prices						
GDP deflator	0.8	1.2	1.3	1.2	1.3	1.3
Consumer prices	1.6	2.7	2.5	1.5	1.4	1.4
Public Finance 5/						
General government balance	-6.2	-4.2	-3.7	-3.1	-2.6	-2.1
General government structural balance	-4.6	-3.7	-2.3	-1.4	-1.1	-0.8
General government gross debt	85.7	88.0	92.8	95.9	96.5	95.8
External Sector 5/, 7/						
Current account balance	0.0	0.2	1.2	1.6	1.9	2.1
Interest Rates 4/, 6/						
EURIBOR 3-month offered rate	0.8	1.4	0.2	0.2	...	...
10-year government benchmark bond yield	3.8	4.3	2.3	2.7	...	...
Exchange Rates 6/						
U.S. dollar per euro	1.33	1.39	1.30	1.30	...	...
Nominal effective rate (2000=100)	103.2	104.2	99.7	103.1	...	...
Real effective rate (2000=100) 6/	95.3	95.0	90.3	92.2	...	...

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

1/ Projections are based on aggregation of WEO projections submitted by IMF country teams.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent.
5/ In percent of GDP.
6/ Latest monthly available data for 2013.
7/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

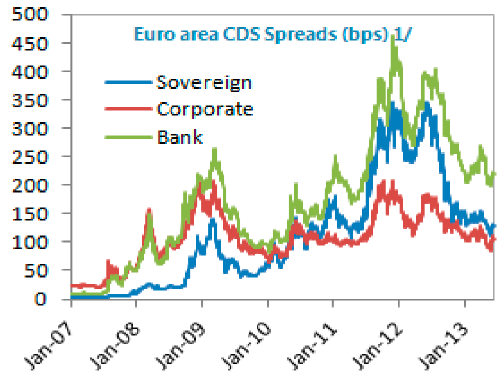
Figure 1. Euro Area: High Frequency Indicators



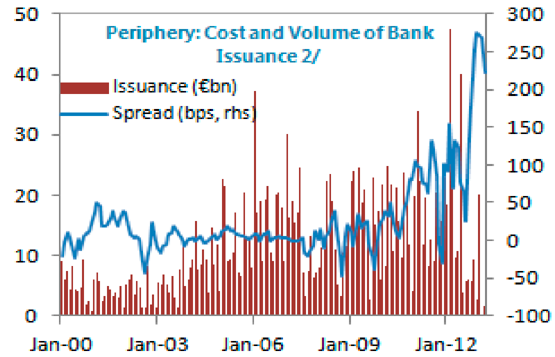
Sources: Haver Analytics and Eurostat.

Figure 2. Euro Area: Financial Market Fragmentation

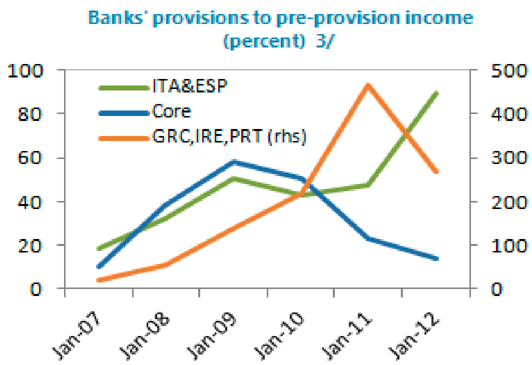
Euro area sovereign and corporate risk has declined markedly post OMTs announcements, but bank risk remains elevated...



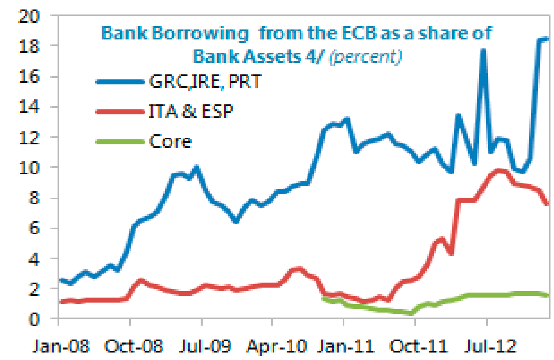
As a result, bank term funding costs have surged, particularly in the periphery relative to the core, driving issuance volumes down.



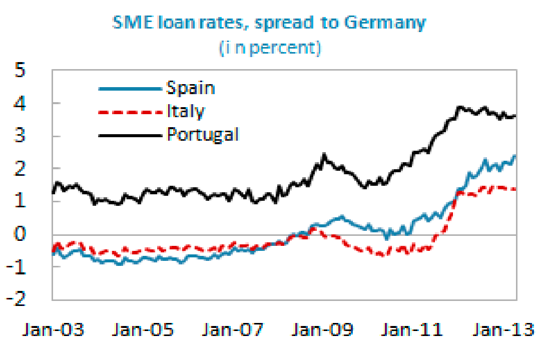
Declining asset quality and higher provisions in the periphery is associated with higher realtive lending rates.



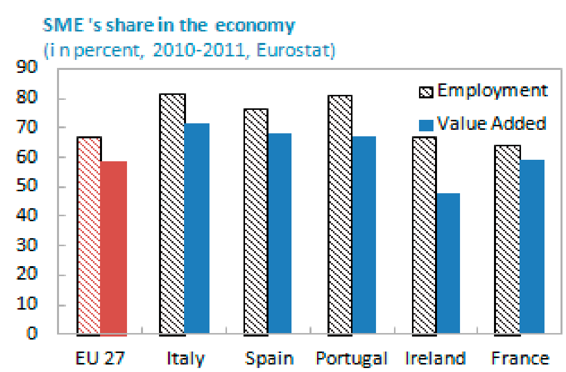
At the same time, banks in hard hit are hevily dependant on Eurosystem facilities, raising concerns over rising asset encumbrance.



As a result, lending rates, particularly for SMEs, in the stressed markets have been driven substantially above those in the core countries.



With SMEs playing an important role both in employment and value added, addressing the fragmentation is key to support growth in the stressed markets.



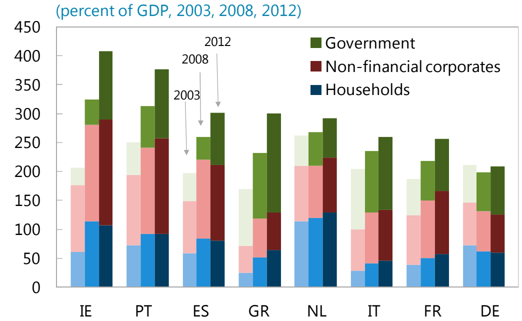
Sources: ECB; Haver Analytics; Dealogic; Bloomberg; and IMF staff calculations.
1/ Sovereign and bank CDS exclude Greece and are weighted by total debt.
2/ Periphery is defined as Italy, Ireland, Portugal and Spain. The spread is that of periphery bank issuance costs over those of the core banks. The bonds are 1-10 year in tenor.
3/ Banks are first averaged within own country, and then added across country groupings.
4/ Core is defined as France, Germany, the Netherlands, and Belgium.

Figure 3. Debt Overhang in the Euro Area

In the periphery public and private sector debt increased rapidly in the last decade....

Indebtedness in the Euro Area

(percent of GDP, 2003, 2008, 2012)

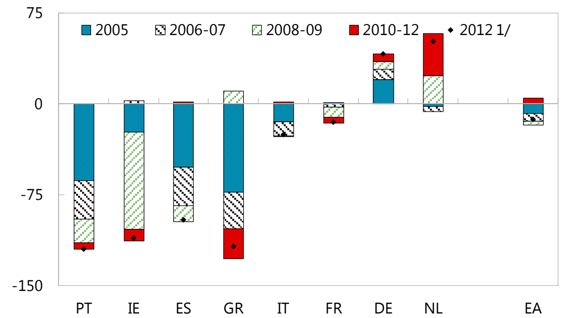


Note: For the Netherlands, first observation is 2005.
Sources: ECB, IMF staff estimates.

...and so did external indebtedness.

Net International Investment Position

(percent of GDP)

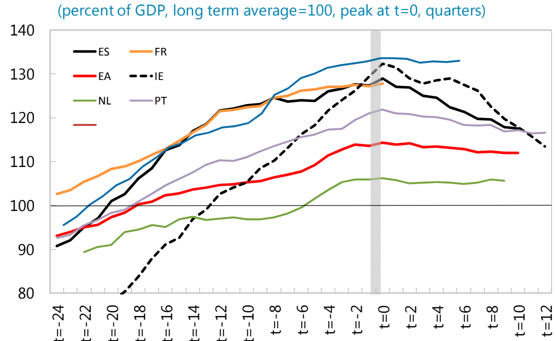


Sources: IFS.
1/ Data for France is 2011.

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

Household Debt

(percent of GDP, long term average=100, peak at t=0, quarters)

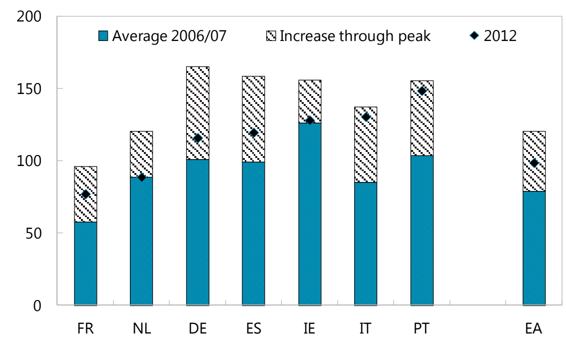


Note: long term average since 2000 but varies with data availability.
Sources: ECB, IMF staff estimates.

...and corporate leverage remains high where financing conditions are pro-cyclical.

Corporate Leverage in the Euro Area

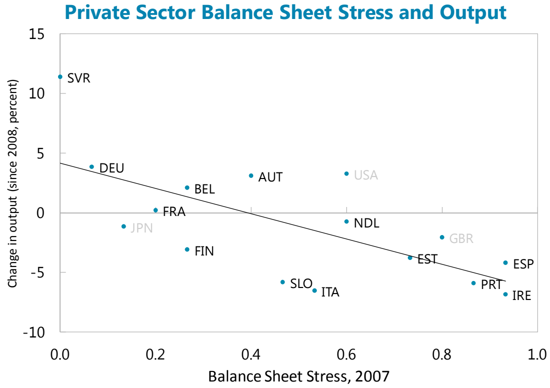
(NFC debt/equity ratio, percent)



Sources: Haver Analytics.

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

Private Sector Balance Sheet Stress and Output

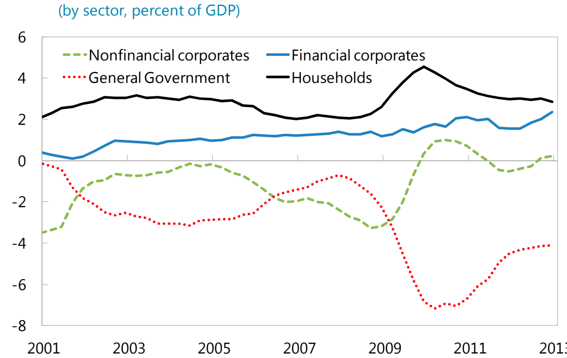


Sources: OECD, IMF Staff estimates

...as all sectors de-lever simultaneously

Euro area: Net lending/borrowing

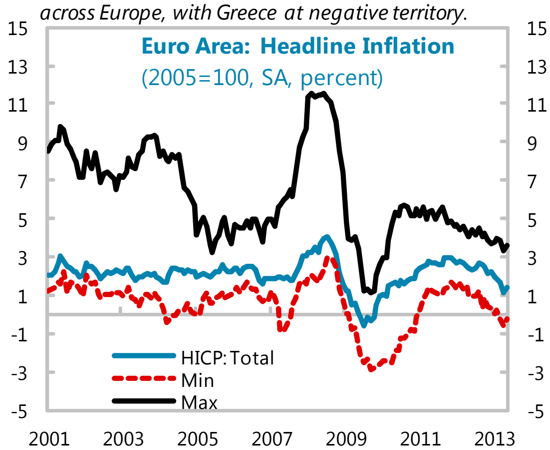
(by sector, percent of GDP)



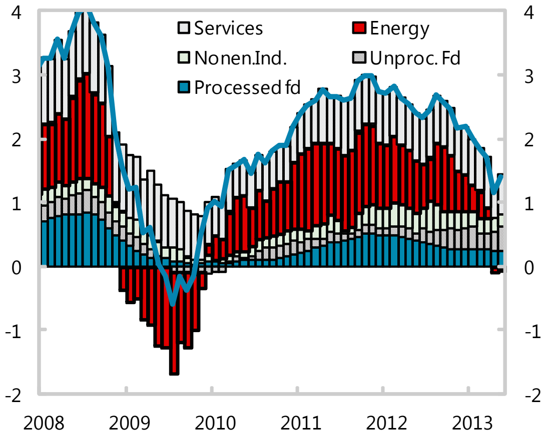
Source: ECB.

Figure 4. Euro Area: Inflation Developments

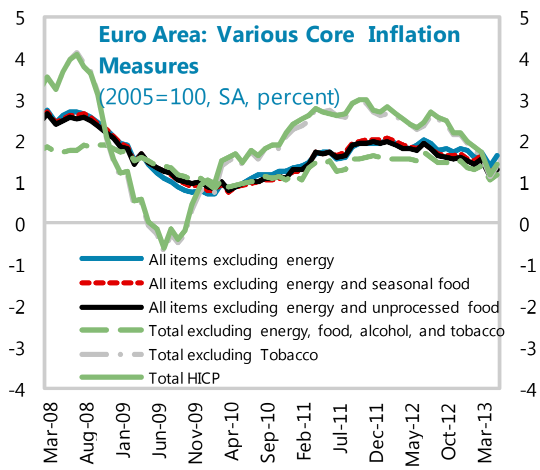
Annual headline inflation has fallen to below 2 percent since the beginning of the year and stands at 1.4 percent as of May, but there is a wide variation across Europe, with Greece at negative territory.



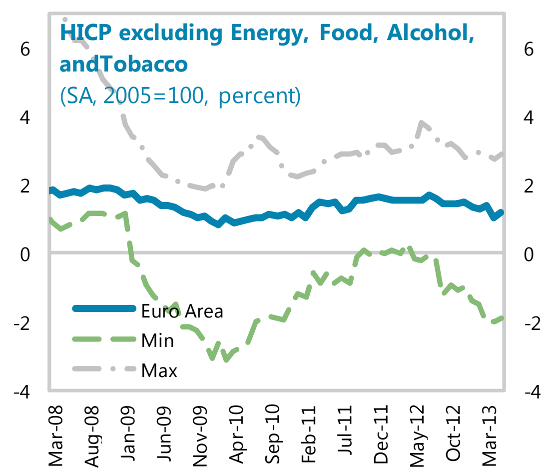
This is mainly driven by declining energy prices, also by some moderation in non-energy components.



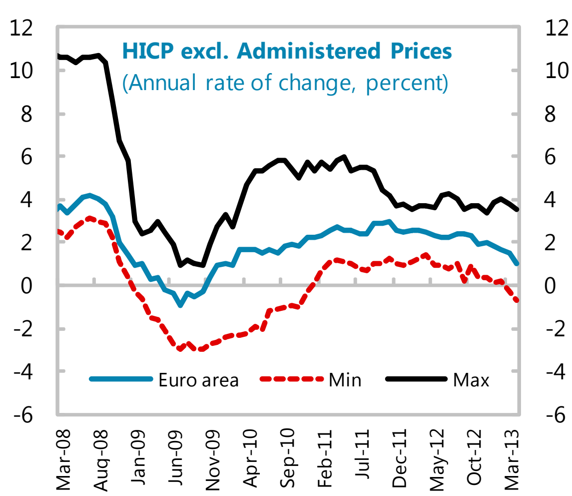
As a result, headline and core inflation are converging, with core fluctuating at around 1-1½ percent,...



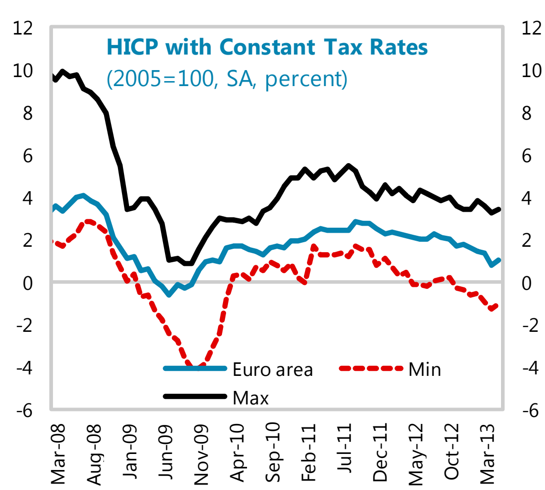
...again with a wide varion across the euro area, with a number of countries at zero or negative range.



The slowdown in inflation is also evident when the administered prices are excluded.



...and also measured at constant taxes.



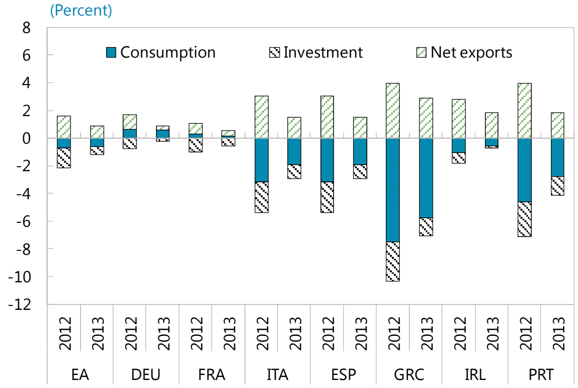
Sources: European Central Bank, Eurostat, Haver Analytics, and IMF staff calculations.

Figure 5. External Sector Developments

Net exports have been the most important source for growth recently…

Euro Area: Contribution to Growth

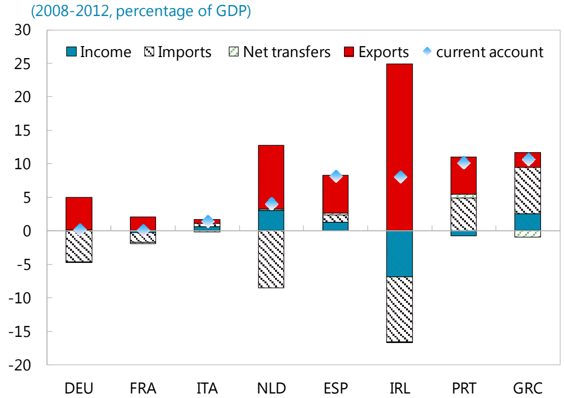
(Percent)



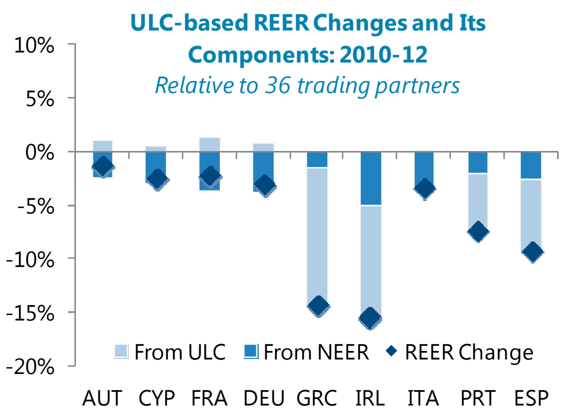
…and also explained most of the current account improvement across countries.

Contributions to change in current account:

(2008-2012, percentage of GDP)

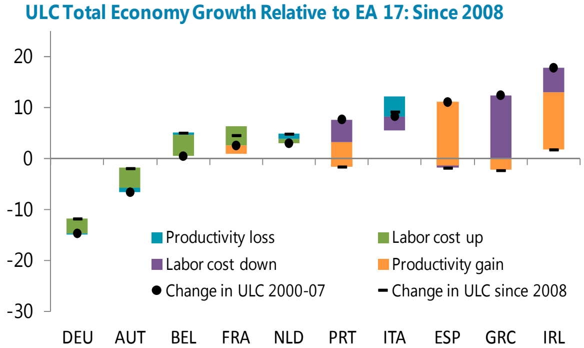


Substantial REER adjustments were driven by unit labor costs…



… as a mixed results of wage adjustments and labor shedding across countries.

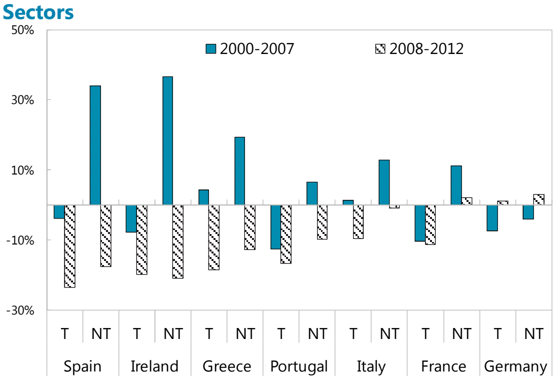
ULC Total Economy Growth Relative to EA 17: Since 2008



Note: The distance between the dots and bars represents changes from 2008 to the latest available data, in general 2012 Q4.

But there is limited evidence of re-allocating resources from non-tradable to tradable sectors …

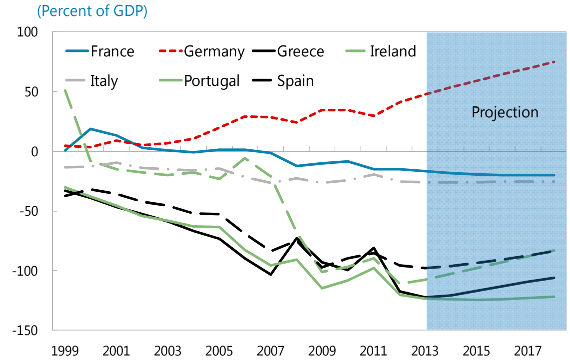
Employment Changes inTradable and Non-tradable Sectors



… and net foreign asset liabilities will remain very high in the periphery going forward.

Net Foreign Asset Postion

(Percent of GDP)



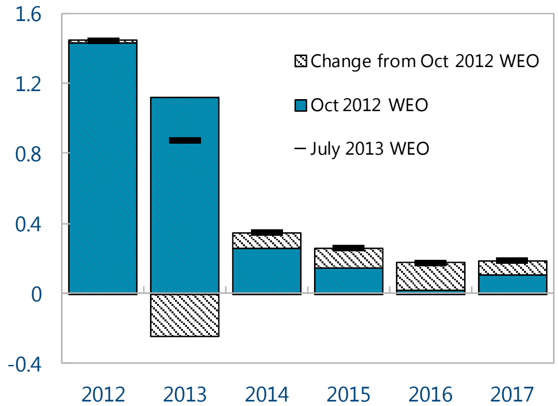
Note: NFA/GDP implied by WEO projections, assuming no valuation effects going forward.

Sources: Haver, WEO, and IMF Staff calculations.

Figure 6. Fiscal Developments and Policies

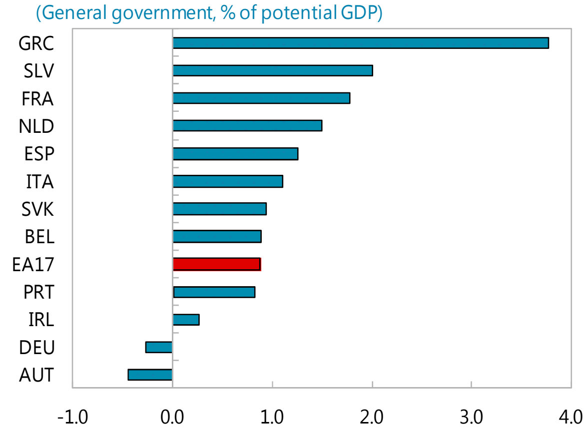
Fiscal consolidation will continue in 2013 before easing in the medium term....

Euro area - Pace of Fiscal Consolidation, 2012-17
(% change in GG structural balance, % of potential GDP)



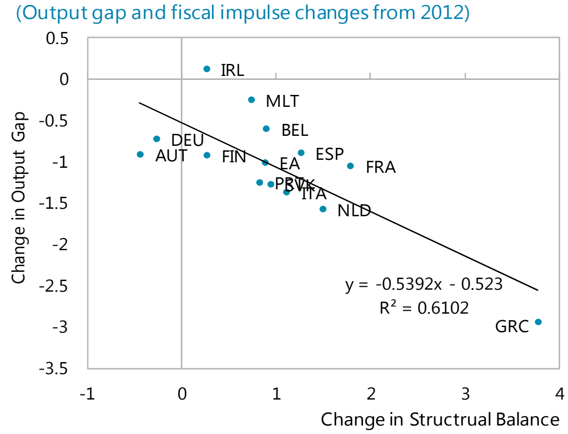
...with sizeable adjustment envisaged in the periphery.

Change in Structural Balance, 2013
(General government, % of potential GDP)



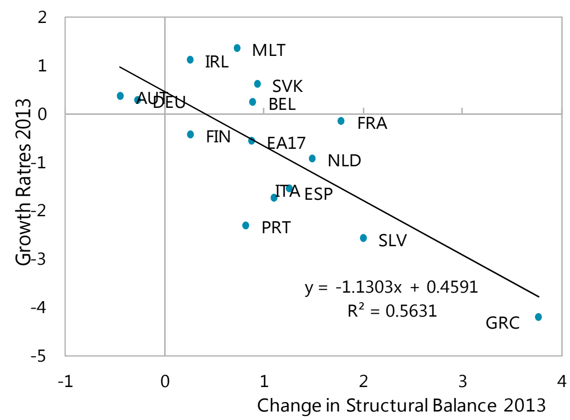
Fiscal policies remain largely pro-cyclical with widening output gaps...

Euro area countries - Procyclicality of Fiscal Policy , 2013
(Output gap and fiscal impulse changes from 2012)



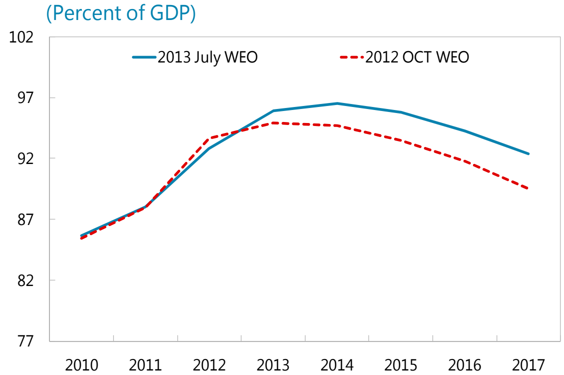
...in particular at the conjecture of dampened growth and weak outlook.

Euro area: Growth and Fiscal Consoliation 2013



As a result, public debt is expected to peak in 2014 before declining gradually...

Euro area: Public Debt-to-GDP ratio
(Percent of GDP)



Sources: IMF July 2013 WEO and WEO vintages.

...while remaining elevated in many countries.

Changes in Public Debt-to-GDP ratios
(percentage of GDP, changes from 2012 Oct WEO)

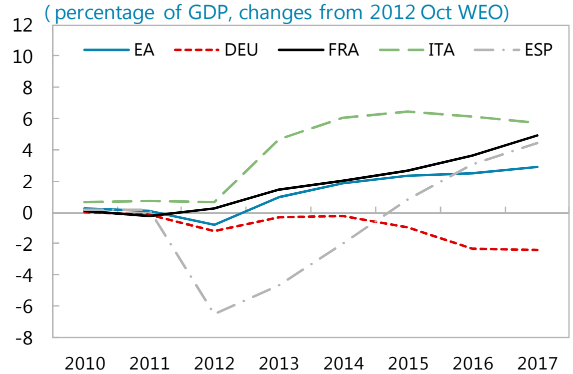
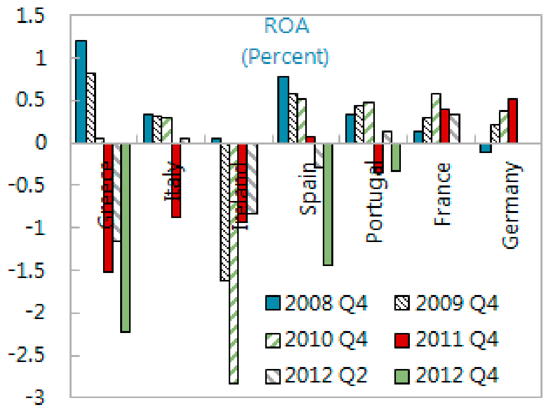
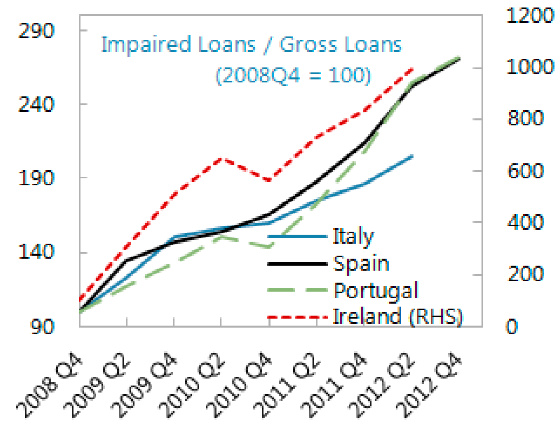


Figure 7. Banking Sector Health

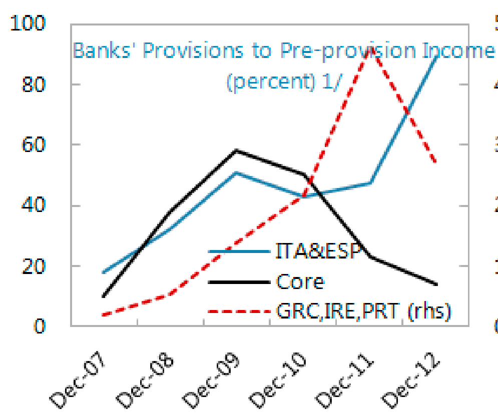
Profitability is low in the periphery ...



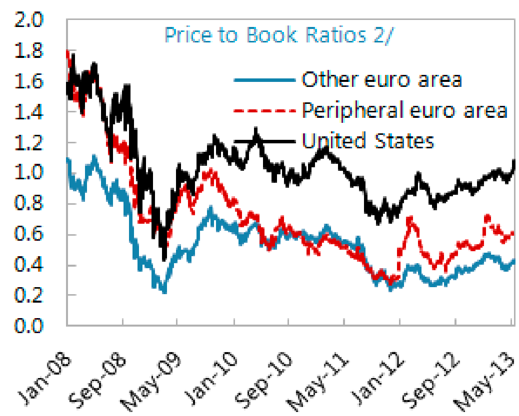
... as asset quality deteriorated



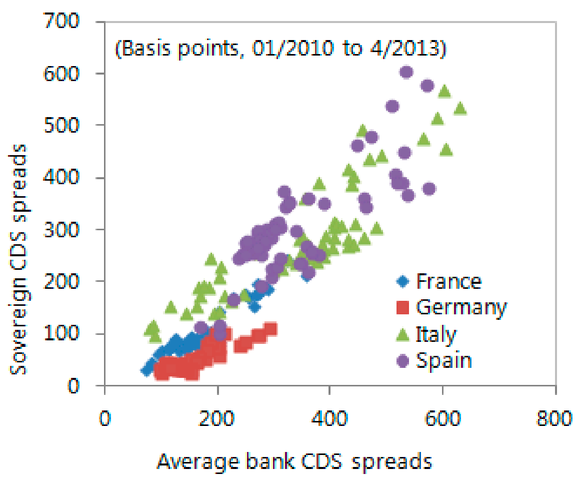
and provisions picked up as a share of income



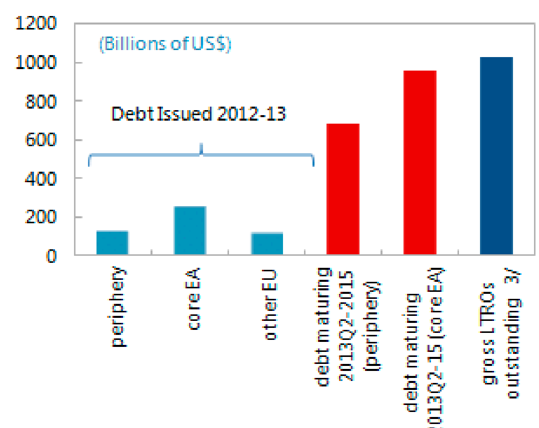
Lingering balance sheet weaknesses are reflected in low price-to-book ratios



Bank funding costs remain link to those of the sovereign



... and refinancing needs will be high in the coming years



Sources: BIS; Bloomberg; Dealogic; ECB; IMF FSI and staff calculations.

1/ Banks are first averaged within own country, and then added across country groupings.

2/ Periphery is defined as Greece, Italy, Ireland, Portugal, and Spain. Other euro area is defined as Austria, France, Germany, and the Netherlands

3/ Net liquidity provided minus repayments announced.

Appendix. Statistical Issues[1]

Statistical data for the euro area are produced by Eurostat and the ECB in collaboration with national statistical institutes (NSIs), and the national central banks (NCBs) of countries participating in the Economic and Monetary Union. The statistics are of sufficient quality, scope, and timeliness to allow for effective macroeconomic surveillance. This appendix summarizes developments and desirable improvements.

1. **Strengthened cooperation on European statistics.** The European Statistical System (ESS) and the European System of Central Banks (ESCB) cooperate under separate legal frameworks reflecting their governance structures. A Memorandum of Understanding (MoU) has recently been established between the ESS and the ESCB creating a new body—the European Statistical Forum, which includes the heads of the NSIs and the statistics departments of the NCBs—to further strengthen cooperation. The Forum will also ensure consistency of the statistical work programs of the ESS and of the ESCB. The MoU preserves the role of the Committee on Monetary, Financial and Balance of Payments Statistics (CMFB) to implement cooperation on transversal or cross-cutting issues between the two statistical systems.

2. **Developments in statistics to enhance fiscal and economic governance.** The Enhanced Economic Governance Package (so called "Six Pack")[2] contains legal requirements that have implications for the collection and dissemination of fiscal data and statistics.

- **Enhanced fiscal data reporting.** Eurostat established a Task Force on the implications of the Directive under the "Six Pack" on the collection and dissemination of fiscal data. The objective is to provide timely, regular and publicly accessible monthly and quarterly fiscal data based on public accounts for all sub-sectors of general government, data on contingent liabilities, and other indicators with potential impact on the general government deficit and/or debt. Conceptual frameworks to publish monthly and quarterly fiscal data and annual data on government contingent liabilities have been adopted. A detailed reconciliation table describing the link between nationally based fiscal data and the *ESA95* based data will also be published. Eurostat intends to collect and publish selected indicators (contingent liabilities, non-performing loans). The publication of data will start in 2014.

- **Proposal for a regulation on the provision and quality of statistics for the Macroeconomic Imbalances Procedure (MIP).** The Commission recently submitted a draft proposal for a regulation on the provision and quality of statistics for the MIP to the Council and the European Parliament. The draft regulation introduces new tasks for the Commission (Eurostat) on assessing and validating relevant data against various quality criteria. The proposal includes

[1] The European Department is grateful for the participation of experts from the IMF Statistics Department (STA) in the consultation. Claudia H. Dziobek acted as the STA coordinator.

[2] Enhanced Economic Governance Package, composed of five regulations and one directive, was adopted by the European Parliament and Council in November 2011.

analyzing member states' inventories of the sources and methods used to compile the MIP data, and developing and implementing an improvement action plan.

3. **Improved compilation and reporting of national accounts.** The revised *European System of Accounts (ESA 2010)* is to be implemented by member states by September 2014. It is an important contribution to reinforcing economic governance with efforts to update and improve the current methodological framework. The main methodological changes and challenges in the implementation of *ESA 2010* are:

- **Recognition of the investment nature of expenditure on research and development.** Research and development expenditure is to be recorded as gross fixed capital formation and no longer as current expenditure. The identification and treatment of research and development expenditure as investment is consistent with the Europe 2020 strategy.
- **More detailed analysis and presentation of pension schemes**. A compulsory supplementary table on pension entitlements will be required to show the liabilities of all pension schemes, including those of government, whether they are unfunded or funded. This will improve comparability across countries and quantify the implicit government liabilities from future pension obligations. These implicit government liabilities will not be reported in the core financial accounts and will not impact the Maastricht debt.
- **Challenges ahead:** The challenges ahead include improvements in the timeliness for the main national accounts aggregates (from t+70 to t+60 days) and quarterly sector accounts (from t+90 to t+85 days), and the backward calculation of time series.

4. **Recent developments in European statistics to support monetary policy.** Several recent advances in European statistics help to improve the calibration of conventional and unconventional monetary policy:

- **Financial sector surveillance supporting monetary policy decisions.** Since 2013, individual balance sheet information on some 246 large euro area banks is transmitted on a monthly basis to the ECB. This supports the analysis of deposit and lending decisions of the non-financial private sector, and provides insights into the sources of bank funding. Quarterly data on the activities of non-bank financial institutions, including investment funds other than money market funds and including hedge funds, financial vehicles engaged in securitization and insurance companies and pension funds, are now collected by the ECB, complementing existing data relating to money market funds. These data facilitate the study of the shadow banking system.
- **Further improvements in data reporting.** The ECB and the IMF Statistics Department are finalizing the migration of the balance sheet data for depository corporations to the IMF's Standardized Report Forms (SRFs) for monetary statistics. Work continues on mapping data for Other Financial Corporations.
- **Household Finance and Consumption Survey.** Complementing existing surveys of the non-financial corporate sector, the ECB published first results of the Household Finance and Consumption Survey (HFCS) in April 2013, which provides detailed household-level data on

various aspects of household balance sheets and related economic and demographic variables, including income, voluntary pensions, employment and measures of consumption. Subsequent data collection should aim to increase coverage to all euro area countries and comparability of cross-country data.

- **Sector accounts.**[3] The euro area quarterly institutional sector accounts have further improved, showing euro area non-financial assets by institutional sector, total euro area economy data on produced non-financial assets are available by main asset type as well as household housing wealth and from-whom-to-whom data for loans and deposits, which support the analysis of interconnectedness. At the country level, gaps remain regarding the non-financial assets position of sectors. The ECB is part of a research project led by the IMF Statistics Department on global flow of funds and balance sheet approach matrices. Matrices for the euro area and for the 17 countries of the euro area have been agreed. These provide metadata on data availability of international investment position data broken down geographically.

5. European statistics that support financial stability.

- **Risk dashboard for the European Systemic Risk Board (ESRB).** To provide statistical support to the ESRB, the ECB has developed a risk dashboard released in September 2012. The initial set of 45 indicators will be regularly updated and revised.
- **ESCB Register of Financial Institutions and Affiliates (RIAD).** Further to its function to set up lists of individual financial institutions in the euro area, the RIAD has been recently upgraded to include information on banking groups and conglomerates to support financial stability analysis and the management of collateral in market operations.

6. Prospects for the banking supervision. A new European Parliament and Council Regulation is expected to confer to the ECB the sole responsibility for the prudential supervision of all banks located in the euro area and in those EU member states that voluntarily would adhere to the Single Supervisory Mechanism (SSM) New statistical reporting will be required to enable the ECB to perform its expected duties within the SSM. The ECB will collect supervisory data for the banking groups under ECB's direct supervision, based on the harmonized Implementing Technical Standards (ITS) of the EBA, which has six parts: financial reporting, consolidated reporting, asset encumbrance, large exposures, liquidity ratios, and leverage ratios. Additional ad hoc datasets, including but not limited to those required for stress-testing purposes, may also be requested.

7. Steps to improve Balance of Payments statistics:

- **Transition to *BPM6*.** Both Eurostat and the ECB are engaged with member states to implement the new methodology. The new ECB data requirements related to the BPM6 implementation are due by mid-2014. It is envisaged that members will gradually move their national compilation systems to the new methodology between 2013 and mid-2014.

[3] The sector accounts integrate the flow-of-funds and the non-financial assets, transactions and other flows.

- **Aggregation of EU/EA current account and adjustment of intra-EU/EA trade**. Asymmetries in intra-EU/EA exports and imports persist, but they are relatively stable over time. Methodological differences arise for two main reasons: the partner country allocation and the treatment of goods in transit. Eurostat and the ECB engage with countries in regular "reconciliation rounds" that facilitate the exchange of bilateral data.

8. Data Gaps Initiative (DGI). The ESS and the ESCB are working closely to implement the amended legal acts on European statistics that are aligned to the *ESA 2010* and *BPM6*. The new European statistics also supports the SDDS Plus and G-20 DGI Recommendations. Going forward, European economic and financial statistics will be fit to support the G-20 Mutual Assessment Process and similar global surveillance exercises.

Press Release No. 13/275
FOR IMMEDIATE RELEASE
July 25, 2013

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation on Euro Area Policies

On July 23, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Euro Area.[1]

Background

Substantial collective actions have addressed important tail risks, and extreme market stresses have subsided. The ECB's Outright Monetary Transactions (OMTs) framework has helped address severe market distortions and improved the effectiveness of monetary policy. Initial progress on banking union—the Single Supervisory Mechanism (SSM) agreement, the European Stability Mechanism (ESM) framework for direct bank recapitalization, and the Bank Recovery and Resolution directive (BRRD)—has demonstrated the commitment to improving EMU architecture. Other critical steps to address the crisis have included: the completion of the ESM firewall; the extension of official loan maturities to program countries, and the agreements on Greece and Cyprus. These actions—along with reductions in external imbalances and progress by national governments in restoring the health of public finances—have boosted confidence in the long-term viability of the monetary union.

But the recovery remains elusive. Financial markets are still fragmented along national borders, and the cost of borrowing for the private sector is high in the periphery, particularly for smaller

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

enterprises. Ailing banks continue to hold back the flow of credit. In the face of high private debt and continued uncertainty, households and firms are postponing spending. Needed fiscal consolidation is also weighing on growth. As a consequence, Euro area GDP is expected to contract by 0.6 percent for a second consecutive year in 2013, before expanding modestly by 0.9 percent in 2014. Headline inflation is expected to remain subdued, highlighting risks of underlying deflationary pressures. And with unemployment, especially among the youth—at record levels, there is a risk of long-term damage to potential growth and to political support for reforms, including for further progress on EMU architecture. In turn, lack of reforms would undermine growth and job prospects

Risks to growth remain tilted to the downside. Because policy space is limited, public debt ratios are very high (and still rising), and economic slack is already substantial, further negative shocks—domestic or external shocks—could severely impact growth. The recent turbulence in global markets has tightened financial conditions in the euro area, although the recent introduction of forward guidance by the ECB has had a mitigating effect. Continued turbulence—related, for example, to expectations of earlier-than-anticipated exit from unconventional monetary policy in the U.S.—could aggravate fragmentation and complicate the conduct of monetary policy. Incomplete or stalled policy commitments at the national or euro area level could also reignite financial market stresses. Over the medium-term, there is a high risk of stagnation, especially in the periphery.

Executive Board Assessment

Executive Directors commended euro area authorities for the actions taken at both the regional and national levels, which have stabilized financial markets and reduced tail risks related to a euro break up. They acknowledged, in particular, progress toward building a banking union, enhancing the firewall, and strengthening fiscal governance. Directors noted that these efforts have reinforced the authorities' commitment to preserve the integrity of the monetary union.

Directors observed, however, that despite the policy actions on many fronts, growth remains elusive and high unemployment persists, especially among the youth. At the same time, household and corporate indebtedness remains elevated in a number of countries, holding back domestic demand. Given narrowing policy space and still fragile and fragmented banking sectors, these developments have increased the risks of stagnation, social and political tensions, and spillovers to the global economy.

Against this backdrop, Directors considered it imperative to revive growth and create jobs through a comprehensive strategy aimed at repairing bank balance sheets, making further progress on banking union, and supporting demand, while advancing structural reforms. They stressed that unwavering political backing for institutional reforms remains critical and in the interests of all EMU members.

Directors recognized that the first priority is to restore sound bank balance sheets to revive credit. Immediate steps include full recognition of losses, recapitalization of weak but viable banks, and closure or restructuring of non-viable banks. In this context, Directors supported plans to conduct a comprehensive balance sheet assessment followed by stress tests to assess the potential capital needs of the banking sector, complemented with a clear strategy for addressing capital shortfalls. They pointed to the benefits of involving an independent third party in ensuring the transparency and credibility of the exercise. Directors also emphasized the importance of a credible backstop, including through direct recapitalization by the European Stability Mechanism, and looked forward to early agreement on this matter.

Directors urged further progress toward a fuller banking union to help reduce fragmentation. Stepped-up efforts are needed to adopt the enabling legislation for the Single Supervisory Mechanism, agree on the Bank Recovery and Resolution Directive, and make progress on the Deposit Guarantee Scheme Directive. Directors stressed the importance of establishing a strong, centralized Single Resolution Mechanism, with the independent power to trigger resolution and make decisions on burden sharing.

Directors generally considered that, given weak growth and subdued inflation, further monetary support, including through policy rate cuts by the European Central Bank (ECB), would likely be necessary, especially if conditions worsen substantially. Directors also saw a role for explicit forward guidance in anchoring expectations, while additional unconventional support from the ECB, including that targeted at lending to small- and medium-size enterprises, could help repair monetary transmission, preventing a further credit contraction as measures to restore banking system health are being implemented.

Directors agreed on the need for a flexible, differentiated pace of fiscal adjustment within a credible medium-term framework. In this regard, they welcomed the recent extension for some countries to meet fiscal deficit targets. Directors noted nevertheless that additional flexibility may still be needed in some cases, especially if that available fiscal space is used to implement deeper structural reforms or recapitalize viable banks. In the longer run, it would be desirable to facilitate greater fiscal risk sharing.

Directors urged further structural reforms at all levels, with a view to enhancing the growth potential and further rebalancing demand within the euro area. In particular, a targeted implementation of the Services Directive would remove barriers to protected professions, promote cross-border competition, and raise productivity. Within countries, labor market reforms should continue to remove rigidities, raise participation, and, where necessary, promote more flexible bargaining arrangements.

Euro Area: Main Economic Indicators, 2010-2015

(Percent change)

	2010	2011	2012	Projections 1/ 2013	2014	2015
Demand and Supply						
Real GDP	2.0	1.5	-0.6	-0.6	0.9	1.3
Private consumption	1.0	0.2	-1.3	-0.8	0.4	0.9
Public consumption	0.8	-0.1	-0.4	-0.2	-0.1	-0.1
Gross fixed investment	-0.3	1.4	-4.3	-3.4	1.2	2.0
Final domestic demand	0.7	0.3	-1.7	-1.2	0.5	0.9
Stockbuilding 2/	0.6	0.2	-0.5	-0.1	0.0	0.0
Domestic Demand	1.3	0.5	-2.2	-1.3	0.5	0.9
Foreign balance 2/	0.7	0.9	1.6	0.7	0.4	0.4
Exports 3/	11.2	6.3	2.7	1.5	3.7	3.9
Imports 3/	9.7	4.2	-0.8	-0.1	3.0	3.4
Resource Utilization						
Potential GDP	0.7	0.6	0.4	0.5	0.7	0.8
Output gap	-1.6	-0.8	-1.8	-2.8	-2.5	-2.1
Employment	-0.5	0.3	-0.6	-0.9	0.0	0.4
Unemployment rate 4/	10.1	10.2	11.4	12.3	12.4	12.1
Prices						
GDP deflator	0.8	1.2	1.3	1.2	1.3	1.3
Consumer prices	1.6	2.7	2.5	1.5	1.4	1.4
Public Finance 5/						
General government balance	-6.2	-4.2	-3.7	-3.1	-2.6	-2.1
General government structural balance	-4.6	-3.7	-2.3	-1.4	-1.1	-0.8
General government gross debt	85.7	88.0	92.8	95.9	96.5	95.8
External Sector 5/, 7/						
Current account balance	0.0	0.2	1.2	1.6	1.9	2.1
Interest Rates 4/, 6/						
EURIBOR 3-month offered rate	0.8	1.4	0.2	0.2	...	...
10-year government benchmark bond yield	3.8	4.3	2.3	2.7	...	...
Exchange Rates 6/						
U.S. dollar per euro	1.33	1.39	1.30	1.30	...	...
Nominal effective rate (2000=100)	103.2	104.2	99.7	103.1	...	...
Real effective rate (2000=100) 6/	95.3	95.0	90.3	92.2	...	...

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

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

2/ Contribution to growth.

3/ Includes intra-euro area trade.

4/ In percent.

5/ In percent of GDP.

6/ Latest monthly available data for 2013.

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

Statement by Mr. Snel on Euro Area
Executive Board Meeting
July 23, 2013

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 European Union in their respective fields of competence.

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

The authorities are in broad agreement with staff findings and recommendations. Policy actions over the past year have addressed important tail risks and stabilised financial markets. Concerted policy actions to restore financial sector health and complete the banking union are now essential to tackle the financial fragmentation along national borders and support the recovery.

The authorities are making continued efforts to ensure deeper structural reforms throughout the euro area in order to raise growth potential and create jobs. Policy arrangements under the European Semester guide the countries' structural reforms agenda and put forward appropriate policy plans for correcting external imbalances. The analysis undertaken in the context of the European Semester, the Macroeconomic Imbalances Procedure and the countries´ in-depth reviews, has improved considerably the understanding of the challenges that need to be addressed and has translated into specific policy advice provided to the countries on structural and fiscal policies. The authorities reiterate their commitment to take all necessary actions to preserve the integrity and stability of the euro area and enhance medium-term growth prospects.

Short-term economic outlook

The authorities broadly share staff's view on economic prospects, particularly the assessment of the weakness in economic activity in 2013, with an only gradual return to growth in the course of the year and a more optimistic outlook for 2014. A successful handling of the sovereign-debt crisis and other crisis-related policy challenges remains essential for raising investor and consumer confidence and the return to a recovery path. The Commission services' spring forecast suggests that, for the year 2013 as a whole, GDP is expected to shrink by about 0.4 percent. In 2014, a recovery of economic growth to a rate of around 1¼ percent is forecast, reflecting stronger global growth and moderate growth of private consumption and gross fixed capital formation. However, given subdued output growth, unemployment rates are expected to fall only in 2014 and then only marginally below current levels. The on-going deleveraging and adjustment processes as well as the fragmentation of financial markets are setting the stage for only a modest recovery. Risks to the outlook for European growth are elevated and remain tilted to the downside, which is compatible with staff's views. The predominant risk remains a renewed intensification of the sovereign-debt crisis and the persistence of the monetary policy transmission mechanism impairment. Other downside risks are linked to the external environment, combined with short-term risks related to political and social tensions.

The real economy continues to suffer from the impact of the European sovereign-debt crisis. Since mid-2012, tensions in financial markets have eased in the wake of major policy decisions, in particular the ECB's announcement of the modalities for Outright Monetary Transactions, the finalization of the European Stability Mechanism, and the agreement on the second program for Greece, but developments in the first half of 2013 show that the situation in financial markets remains fragile and that there is no time for complacency. In the first quarter, output fell by 0.3 percent after having already declined by 0.6 percent in the fourth quarter of 2012. Nevertheless, the external and internal adjustments continue to progress and in mid-2013 some early signs of an easing of the downturn were visible, notably in the latest readings of survey indicators (e.g. Economic Sentiment Indicator, euro area PMIs). The assumed further progress on the path of structural reforms and policies to strengthen the framework of EMU is expected to slowly dissipate lingering policy and economic uncertainty and pave the way for a pick-up in activity.

Financial markets and fragmentation

The Staff Report rightly points to continued weak macro-economic growth. This in turn risks reinforcing adverse feedback loops between weak bank balance sheets, tightening lending standards and debt sustainability concerns. Despite some recent signs of improvement, some segments of the euro area financial markets remain fragmented with funding costs still different depending on the geographical location of a bank or its size. More clarity on the quality of bank assets across the euro area's banking sector is necessary since many European banks may be perceived to experience high ratios of non-performing loans and low profitability. Although larger banks in stressed euro area countries have managed to regain access to wholesale funding markets, funding costs remain significantly high for several smaller banks in those countries. In this regard, the asset quality review (AQR) to be carried out before the operationalization of the Single Supervisory Mechanism will be useful to reassure investors.

The on-going deleveraging process of European banks magnifies the challenges faced. As a consequence, the amount of lending to businesses continues to display significant heterogeneity across the euro area. In addition, the cost of borrowing of non-financial corporations (NFCs) located in countries such as Germany and France remains significantly lower than those faced by NFCs operating in Greece, Italy, Portugal or Spain. The overall weak credit growth in the euro area results both from demand and supply constraints. On the demand side, low appetite for investment and high leverage in some Member States has depressed borrowing. The main challenge on the supply side consists in further repairing the monetary transmission channel and bank balance sheets of vulnerable banks. Improving market confidence in the quality of banks' balance sheets should help weaker banks regain market access and would also improve investor confidence and banks' willingness to lend to corporates, SMEs and households.

Further progress to repair lending in the euro area was made at the European Council of June. To boost investment and improve access to credit, the European Council called for the mobilisation of European resources including that of the EIB, and launched a new "Investment Plan" to support SMEs and boost the financing of the economy. The Staff Report rightly points out that restoring banking sector health is essential to address fragmentation and lower costs. While the issues raised by deleveraging by banks is problematic in some cases, it cannot be ignored that part of this painful process is also unavoidable and that along with other measures it is a necessary ingredient in the restoration of bank balance sheets. The authorities acknowledge that the high bank lending rates prevailing in some Member States may partly reflect banks' efforts to boost margins and offset high provisions. However, there could be other important factors behind high rates that need to be emphasised. First, banks’ cost of private (unsecured) funding in some Member States remains high. Second, the bank funding structure needs to change. In the pre-crisis period, bank funding relied very much on cheap short term funding for financing long positions. Changes in the banks’ funding model may require further adjustments in bank balance sheets and lead to more conservative lending policies. Moreover, a re-pricing of risk after a burst in a credit bubble during the downturn might be seen as a rational behaviour.

In order to lift confidence in the euro area banking system, the authorities would like to also highlight that following the forthcoming assessment of banks' asset quality, which will identify banks' vulnerabilities in a comprehensive manner, the new EU-wide stress tests planned by EBA in 2014, in coordination with the ECB for banks covered by the SSM, will provide an opportunity to strengthen banks' balance sheets, reducing uncertainty surrounding banks' capacity to withstand a further deterioration of the economy.

The Report rightly emphasises that the recent agreement at the EU level on the main features of an operational framework for the ESM's direct bank recapitalisation instrument is an important element addressing the adverse sovereign–banking link and - together with the general approach in the Council on the Bank Recovery and Resolution Directive (BRRD) - represents an important step forward in improving financial market conditions. In this context, the authorities agree with the staff's view that clear rules on the role of bail-ins are needed to reduce uncertainty for private investors. As agreed by the Eurogroup, when applying ESM direct bank recapitalisation an appropriate level of write-down or conversion of debt will have to take place in line with EU State aid rules, and applying the principles of the forthcoming BRRD as of the start of the supervision of the ECB/SSM.

Overall, the most important pillar of EMU's new architecture and the key policy priority is to complete the Banking Union in line with the European Council conclusions of December 2012 and March 2013. This is essential to ensure financial stability, break the vicious circle between banks and sovereigns, reduce financial fragmentation and restore normal lending to the economy. The legislative package on the new Single Supervisory Mechanism (SSM) is expected to be adopted and enter into force by September 2013 allowing for the SSM to become fully operational by September 2014. A fully effective SSM requires a Single Resolution Mechanism (SRM) for the banks covered by the SSM. The Commission therefore presented a proposal for establishing an SRM with a view to reaching agreement in the Council by the end of the year so that it can be adopted before the end of the current parliamentary term.

Monetary policy and the outlook for price stability

Early May, the ECB decided to lower two of its key interest rates. As a result, its main policy rate (MRO rate) now stands at 0.50 percent, the marginal lending facility rate stands at 1.00 percent, while the deposit rate remains unchanged at 0.0 percent. These policy decisions took account of subdued underlying inflationary pressures over the medium term. Moreover, the ECB announced in July that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation was based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.

Euro area annual inflation was 1.6 percent in June 2013 (Eurostat flash estimate), up from 1.4 percent in May. Annual inflation rates are expected to be subject to some volatility throughout the year owing particularly to base effects. However, underlying price pressures are expected to remain subdued over the medium term, reflecting the broad-based weakness in aggregate demand and a modest pace of recovery. Medium-term inflation expectations remain firmly anchored in line with price stability. Risks to the outlook for inflation are still broadly balanced over the medium term: on the downside they relate to weaker than expected euro area growth; on the upside risks could stem from further increases in administrative prices, indirect taxes and higher commodity prices. Information from the monetary analysis confirms the picture of price developments remaining in line with price stability over the medium term. On-going weak loan growth largely reflects the current cyclical situation, heightened credit risk, and balance sheet adjustments in the financial and the non-financial sectors.

As regards non-standard monetary policy measures, the ECB decided in May that all ECB refinancing operations will continue to be conducted as fixed-rate tender procedures with full allotment, at least until mid-July 2014, ensuring that funding constraints will not be an impediment to banks' lending decisions. Moreover, the OMT-announcement has proven to be an efficient backstop against unfounded fears of a euro break-up.

Fiscal policy

The authorities share the general view reflected in the staff's assessment of the fiscal situation of the euro area, especially as far as the need for a differentiated pace of the fiscal adjustment is concerned. The recently submitted Stability and Convergence Programmes reveal that fiscal efforts are larger for countries with a lower fiscal space. While it is true that across EMU the pattern of adjustment remains pro-cyclical, the pro-cyclicality of the fiscal stance is expected to be reduced in 2014, when the output gap begins to close and the structural adjustment decelerates thanks also to progress already made. The authorities would also like to stress that adhering to sound medium term deficit reduction plans is key to preserve hardwon fiscal credibility and low interest rates. The growth impact of consolidation presented in the staff document of more than 1 percentage point in the aggregate euro area seems on the high side in the authorities' view, especially taking into account that the largest euro area economy will have a neutral stance in 2013.

While in staff's view some of the current EDP targets could prove too ambitious, the authorities would like to stress that the assessment of effective action in the context of the EDP is made on the basis of the effort implied by the adjusted changes in the structural balances. Such adjustment accounts for revenue windfalls/shortfalls, forecast errors in output gaps. Ultimately, if a country has taken effective action and unexpected adverse economic events with major unfavourable consequences for public finances occur the Stability and Growth Pact provides for the possibility to extend deadlines. In the authorities' view, the EU framework is flexible enough and responds to the characteristics proposed in the Staff Report. It focuses on both structural and (headline) nominal balances. Moreover, Member States for which the EDP is abrogated need to pursue fiscal consolidation towards the 'benchmark' 0.5 percent annual structural improvement envisaged by the 'preventive' arm of the SGP with no further consolidation being required of countries having reached the Medium Term Objective.

The authorities agree on the need of ensuring strong implementation of the new governance framework and of delivering credible medium-term fiscal anchors. Fiscal frameworks, both at EU level and domestic, have a clear role to play. The surveillance framework of the EU is characterized by the existence of Medium Term Budgetary Frameworks (MTBFs) as also evidenced by the medium-term budgetary strategies outlined in Stability and Convergence Programmes. The 2011 “Six Pack” legislation also contains a Directive on budgetary frameworks introducing minimum requirements of the MTBFs and their relation with annual budgets. The implementation of this Directive has been followed up by a peer review, discussing the design of such frameworks, which has asked in many cases for the introduction of binding changes. Moreover, the "Two Pack", which entered into force in May 2013, integrates the annual national budgetary process within the EU framework, by requiring that euro area Member States submit their draft budgetary plans to the Commission for an opinion before the Member State budgets are adopted or fixed upon. This allows a better appraisal and a deeper discussion of the implications of the EU framework for fiscal policy at the national level.

Structural Reforms and External Imbalances

The authorities would like to emphasise that after having a roughly balanced current account position since the launch of the euro, the current account balance of the euro area shifted into a mild surplus of around 1.2 percent of GDP in 2012. According to the Commission Spring Forecast, the surplus may still increase by around 0.8 percent of GDP over the forecast horizon (2012-14). While this is not a negligible amount, it is still in line with the structural characteristics of the euro area, which suggest that it should have a moderate surplus. Most of the strengthening in the current account is the result of significant adjustment in the vulnerable countries, which previously recorded high deficits. These countries are actually expected to reach a collective surplus of around 0.5 percent in 2013. The IMF staff analysis ascribes a large part of this adjustment to cyclical developments. While the authorities agree that much of the adjustment is driven by suppressed internal demand, they also find that the strong export performance of many crisis-stricken countries contributes considerably to the adjustment. Therefore, the authorities consider that the adjustment is largely non-cyclical in nature in most of the vulnerable countries. The reasons are permanent contractions in domestic demand and imports induced by reductions in overblown housing-construction investments, corrections in future income expectations and increases in structural unemployment. Moreover, the dynamism of a number of countries' exports is encouraging and adds to the permanent nature of the adjustment. In the case of Greece, the authorities concur that the adjustment in the current account appears to be more cyclical. These results are sensitive to the correct estimation of output gaps and therefore some uncertainty remains regarding their exact values.

The external adjustment has mainly been due to developments in deficit countries. In deficit countries, structural improvements in exports are required to resume potential growth and reduce the social cost of rebalancing. To achieve this, reallocation of resources towards the tradable sectors, supported by appropriate changes in relative costs and prices as well as better integration into euro area value chains, is warranted. Surplus countries can contribute to the rebalancing of external position of deficit countries by increased domestic demand through addressing market failures and structural reforms, and wages growing in line with productivity growth.

The euro is broadly at its equilibrium value. Estimates based on different methodologies point to a slight but insignificant overvaluation of the euro. While the euro exchange rate is not therefore expected to contribute to rebalancing, further adjustments in relative prices within the euro area are still needed. Recent improvements in unit labour costs and nonprice/cost competitiveness as well suppressed domestic demand, have given incentives to firms in the vulnerable economies to turn to export markets. They have managed, as a result, to regain a large part of the competitiveness lost prior to the crisis. Labour costs adjustments are expected to continue in order to close the large unemployment gaps. At the same time firms' operating margins have increased as wage declines have not fed fully into prices. This is expected to attract more firms into the sectors in the future and hence help increase the share of tradables. Developments in this direction will be an important issue to monitor. Full implementation of flexibility enhancing structural reforms will be key in facilitating the resource reallocation towards tradable sectors.

Policy arrangements under the European Semester have included country-specific policy recommendations in the structural domain for each Member State plus the euro area as a whole. The authorities are committed to follow the country-specific policy recommendations as endorsed in June under the European Semester. In the area of product market and labour market reform, many country-specific recommendations refer to the implementation phase of the reforms, as several of the structural reform plans put forward in the Staff Report have already been adopted. Furthermore, financing from EU Budget through the EU structural funds is providing additional support for the implementation of a much broader structural agenda than presented in the Staff Report. The reform agenda includes product and labour market reforms, but also measures to improve framework conditions such as the functioning of the judicial systems, and strengthening of independent sectoral regulators.