



EURO AREA POLICIES

July 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 21, 2017 consideration of the staff report that concluded the Article IV consultation with member countries.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 21, 2017, following discussions that ended on May 19, 2017, with the officials at EU institutions on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 6, 2017.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Germany, on behalf of the euro area Member States and the European community.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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July 25, 2017

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IMF Executive Board Concludes 2017 Article IV Consultation on Euro Area Policies

On July 21, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Euro Area.

The cyclical recovery is firming and becoming broad based. Lower energy prices, supportive policies, stronger labor markets and a recovery in credit growth have boosted domestic demand, especially private consumption. The near-term outlook is favorable, with growth of 1.9 percent expected in 2017 and 1.7 percent in 2018. While headline inflation picked up in the first half of 2017 due to higher energy prices, core inflation has remained persistently low. As the base effect of higher energy prices dissipates, headline inflation is anticipated to slow from 1.6 percent this year to 1.5 percent in 2018, well below the ECB's medium-term price stability objective.

The improving near-term outlook is clouded by significant downside risks, especially in the medium and long term, amidst thin policy buffers. Some high-debt countries could experience rising borrowing costs in the face of tighter global financial conditions or reduced monetary accommodation. Structural weaknesses in the European banking system in the form of weak profitability and pockets of high non-performing loans could trigger financial distress. Moreover, political support for further European integration may be eroded by persistent external imbalances and lack of real income convergence.

On current trends, the output gap is forecast to close by 2019. Over the medium term, growth is expected to stay around 1.5 percent per annum. This reflects a variety of factors including insufficient structural reforms aimed at boosting productivity, the remaining crisis legacies of impaired balance sheets and high unemployment, and demographic headwinds.

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.

Executive Board Assessment²

Executive Directors welcomed the broad-based recovery and decline in unemployment, driven by higher domestic demand and supported by continued accommodative monetary policy. Directors cautioned, however, that underlying inflation and wage growth remain subdued, while medium-term risks are tilted to the downside. Countries with high public debt levels have limited buffers and are vulnerable to a rise in borrowing costs. An external slowdown, due to a rise in global protectionism, for example, could weigh on the recovery, while the uncertainty related to Brexit negotiations could dampen investment and consumption in some countries. Directors concurred that the more favorable political and economic context provides an opportune moment to accelerate reforms at both the national and central levels and complete the euro area architecture.

Directors noted that stagnant productivity growth has impeded the adjustment process in the euro area and contributed to stalling income convergence among countries. They urged countries to press ahead with structural reforms to improve productivity. Such reforms can have a larger impact in countries with lower productivity levels, thereby promoting income convergence and reducing competitiveness gaps. Directors reiterated their call for stricter enforcement of the Macroeconomic Imbalances Procedure combined with incentives for structural reforms, such as targeted support from central funds and outcome based benchmarks.

Directors recognized the uneven distribution of fiscal space across countries, and the need for tailored fiscal strategies. They encouraged countries with fiscal space to use it to support public investment and structural reforms that boost potential growth, while countries without fiscal space should consolidate to put debt ratios on a downward path. All countries, regardless of fiscal space, should make fiscal policy more growth friendly. Directors stressed that countries need to respect the Stability and Growth Pact, which is crucial to ensure the credibility of the fiscal framework and also important to build support for a central fiscal capacity. Developing such a capacity could go hand in hand with reforms to simplify the fiscal framework and make enforcement more automatic.

Directors concurred that monetary policy should remain firmly accommodative until there is a sustained rise in the inflation path toward the ECB's price stability objective. The ECB's forward guidance should remain unchanged until justified by actual inflation or by substantial evidence that the inflation outlook has improved. Directors considered that countries with closed output gaps will need to tolerate inflation above the ECB's objective for a prolonged period to achieve higher area wide average inflation.

Directors urged further efforts to address nonperforming loans and low bank profitability, which, in part, requires countries to continue reforming their insolvency frameworks. They encouraged the European Commission to provide a blueprint for national asset management companies and clarity on State Aid requirements, which could help develop markets for distressed debt. Restructuring and consolidation in the banking sector should be incentivized by a firm approach

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

to closing failing banks. Directors noted that the upcoming review of the Bank Recovery and Resolution Directive presents an opportunity to address any impediments to bank resolution.

Directors considered completing the banking union—with common deposit insurance and a common fiscal backstop—as an essential complement to risk reduction in the banking sector. They also noted that ring fencing of capital and liquidity within countries runs counter to the concept of a banking union. Directors agreed that Brexit gives greater urgency to building a capital markets union and that supervisory capacity needs to be correspondingly upgraded.

Euro Area: Main Economic Indicators, 2014–22

	Projections 1/								
	2014	2015	2016	2017	2018	2019	2020	2021	2022
Demand and Supply									
Real GDP	1.2	2.0	1.8	1.9	1.7	1.6	1.6	1.5	1.5
Private consumption	0.8	1.8	2.1	1.6	1.5	1.5	1.5	1.5	1.4
Public consumption	0.7	1.3	1.8	1.2	0.9	0.6	0.7	0.7	0.7
Gross fixed investment	1.6	3.2	3.7	3.1	2.9	2.7	2.5	2.4	2.3
Final domestic demand	0.9	2.0	2.4	1.8	1.7	1.6	1.6	1.5	1.5
Stockbuilding 2/	0.4	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand	1.3	1.9	2.2	1.9	1.7	1.6	1.6	1.5	1.5
Foreign balance 2/	0.0	0.2	-0.3	0.1	0.1	0.1	0.1	0.1	0.0
Exports 3/	4.4	6.2	3.0	4.1	4.0	4.0	3.9	3.8	3.8
Imports 3/	4.9	6.3	4.1	4.3	4.2	4.2	4.1	4.0	4.0
Resource Utilization									
Potential GDP	0.9	1.4	1.1	1.2	1.3	1.3	1.4	1.4	1.4
Output gap	-2.5	-2.0	-1.3	-0.7	-0.2	0.0	0.2	0.3	0.4
Employment	0.5	1.0	1.4	1.3	0.9	0.6	0.6	0.5	0.4
Unemployment rate 4/	11.6	10.9	10.0	9.2	8.8	8.5	8.2	8.0	7.8
Prices									
GDP deflator	0.9	1.2	0.8	1.0	1.3	1.5	1.6	1.6	1.7
Consumer prices	0.4	0.0	0.2	1.6	1.5	1.7	1.8	1.9	1.9
Public Finance 5/									
General government balance	-2.6	-2.1	-1.5	-1.4	-1.1	-0.6	-0.4	-0.2	-0.1
General government structural balance	-1.1	-0.9	-0.8	-1.0	-0.9	-0.6	-0.5	-0.4	-0.3
General government gross debt	94.4	92.5	91.4	90.0	88.5	86.4	84.0	81.7	79.3
External Sector 5/, 6/									
Current account balance	2.5	3.2	3.3	2.9	2.9	2.8	2.8	2.7	2.7
Interest Rates (end of period) 4/, 7/									
EURIBOR 3-month offered rate	0.1	-0.1	-0.3	-0.3	...	...	...	...	...
10-year government benchmark bond yield	1.5	1.2	1.3	1.2	...	...	...	...	...
Exchange Rates (end of period) 7/									
U.S. dollar per euro	1.23	1.09	1.05	1.1	...	...	...	...	...
Nominal effective rate (2005=100)	105.4	101.2	102.0	104.2	...	...	...	...	...
Real effective rate (2005=100, ULC based)	100.8	91.6	91.5	91.3	...	...	...	...	...

Sources: IMF, *World Economic Outlook*, Global Data Source; Reuters Group; 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/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

7/ Latest monthly available data for 2017.



EURO AREA POLICIES

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES

July 6, 2017

KEY ISSUES

Context. The steady recovery and political developments provide an opportune moment for advancing much-needed reforms to strengthen the architecture of the Economic and Monetary Union. Pro-EU political parties have gained momentum, while strong private consumption and supportive policies have boosted growth. Unemployment is falling amid solid job creation, although it remains elevated in some countries. Productivity growth has been lagging in some countries, leading convergence across countries to stall and competitiveness gaps to persist. While the recovery has been resilient to shocks so far, risks remain and continued monetary policy support is required.

Policies. Decisive actions are needed at both the central and national levels to set the stage for sustained growth and to replenish policy buffers.

- ***Raising productivity growth to reduce imbalances and restart convergence.*** Countries should take advantage of the recovery to push forward with reforms, focusing on those that can lift potential growth, close competitiveness gaps, and enhance their resilience to shocks.
- ***Replenishing fiscal buffers and building a central fiscal capacity.*** High-debt countries should take advantage of the recovery and the remaining window of accommodative monetary policy to rebuild buffers and reduce vulnerabilities. Countries with fiscal space should use it for initiatives that boost potential growth, which would also help external rebalancing. All countries should respect the common fiscal rules and pursue growth-friendly fiscal rebalancing. A central fiscal capacity would help offset shocks and relieve fiscal space constraints at the country level, but will require building trust.
- ***Maintaining an accommodative monetary stance.*** Subdued underlying inflation underscores the imperative for policy to remain accommodative for an extended period. To help achieve a sustained recovery of euro area inflation, countries with closed output gaps could encourage robust wage and price growth in their public communication.
- ***Repairing bank balance sheets and completing the financial architecture.*** A comprehensive approach to reducing non-performing loans is required, including through strict supervision, modernizing insolvency and foreclosure frameworks, and further developing distressed debt markets. Expediently completing the banking union and advancing the capital markets union remain essential.

Approved By
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Discussions took place during May 8–19, 2017. Mission members included M. Pradhan (head), S. Aiyar, A. Bhatia, A. Banerji, J. Bluedorn, S. Mitra, N. Arnold, C. Ebeke, H. Lin (all EUR), A. Al-Eyd (MCM), T. Poghosyan (FAD), and J. Franks, B. Barkbu and H. Schölermann (EUO). Executive Director S. Meyer and his Advisor B. Parkanyi, ECB Observer at the IMF R. Ruffer and his advisor L. Guttenberg, and Head of Economic and Financial Affairs at the EU Delegation to the U.S. V. Rouxel-Laxton participated in some meetings. Support was provided from headquarters by C. Casabianca, C. Rubio, X. Shao, J. Siminitz, and R. Vega and from Brussels by L. Hobbs (EUO).¹

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¹ The mission would like to thank the authorities, in particular—in alphabetical order—Deputy Director General J. Berrigan (European Commission), Director General M. Buti (European Commission), Vice-President V. Constâncio (European Central Bank), President J. Dijsselbloem (Eurogroup), Chairperson A. Enria (European Banking Authority), Director General K. Ibel (ECB Banking Supervision), Chair E. König (Single Resolution Board), Deputy Director General G.J. Koopman (European Commission), Head of the Secretariat F. Mazzaferro (European Systemic Risk Board), Vice-President A. McDowell (European Investment Bank), Management Board Member R. Strauch (European Stability Mechanism), Chairman N. Thygesen (European Fiscal Board), and President T. Wieser (Economic and Financial Committee of the European Union and Eurogroup Working Group), as well as their staff for their time, support, and accessibility. The mission has also benefited from the Fund's bilateral Article IV consultations with euro area countries and from discussions with national authorities during meetings of the Eurogroup and the Eurogroup Working Group.

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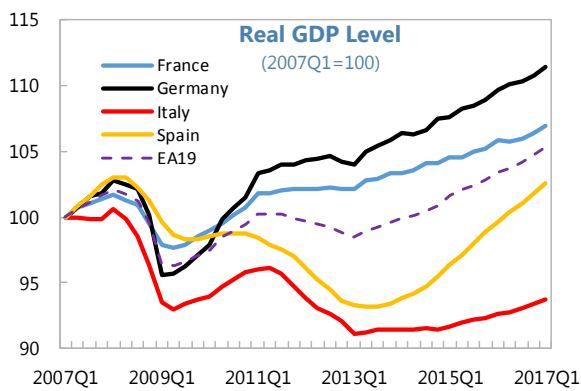
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KEY MESSAGES

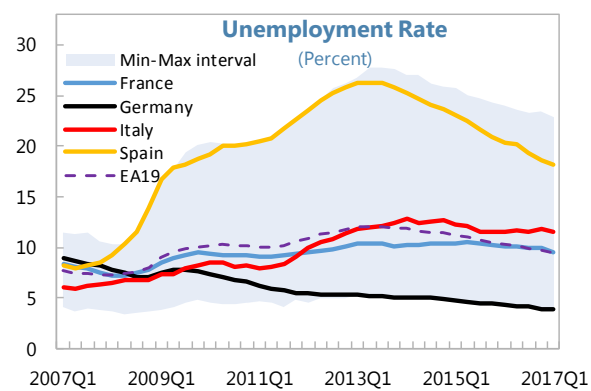
The recovery is firming, with growth and job creation returning in many countries that went through severe downturns. Accommodative policies have played an essential role in securing the recovery. High-debt countries should take advantage of the recovery and the remaining window of monetary accommodation to reduce vulnerabilities and rebuild buffers. Euro area countries should grasp the opportunity provided by the recovery and the political momentum to push for deeper integration and complete the architecture of the Economic and Monetary Union (EMU). At the same time, persistent competitiveness gaps and a lack of income convergence across countries could challenge the cohesion of the monetary union, and need to be addressed by decisive actions at the national level. Structural reforms to boost productivity in lagging countries should be accompanied by measures to support external rebalancing through higher wage inflation and domestic demand in net external creditor countries.

CONTEXT: THE RECOVERY IS FIRMING

1. The recovery has strengthened, supported by domestic demand. Growth reached 1.8 percent in 2016, despite a challenging external environment marked by depressed global trade and elevated uncertainty triggered by the U.K. vote to leave the European Union (EU) (Brexit) (Table 1). In line with divergent post-crisis trends, robust growth in Germany and Spain contrasted with weaker growth in Italy (text figure). Domestic demand, especially private consumption, accelerated in several countries supported by monetary stimulus, a mildly expansionary fiscal stance, lower energy prices, and stronger labor markets. The euro area unemployment rate has fallen to 9.3 percent in May from its 2013 peak of 12 percent, but with large variations across countries (text figure).



Sources: Eurostat; and Haver Analytics.



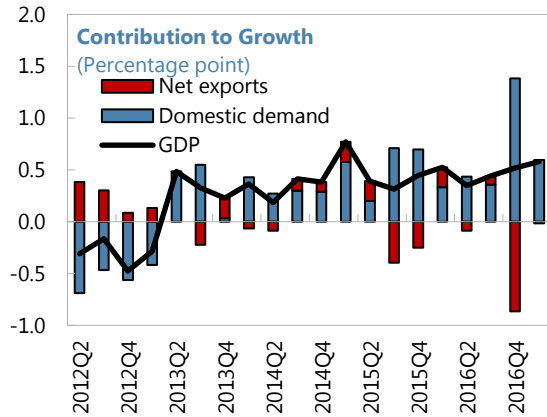
Sources: Eurostat; and Haver

2. Recent data point to steady and broad-based growth (Figure 1). Growth held firm in the first quarter of 2017 at 1.9 percent year-on-year, benefiting from both a robust domestic demand and improved net exports. PMIs and business surveys strengthened in early 2017, suggesting that firms are benefiting from the recovery in global manufacturing and trade. Euro area manufacturing

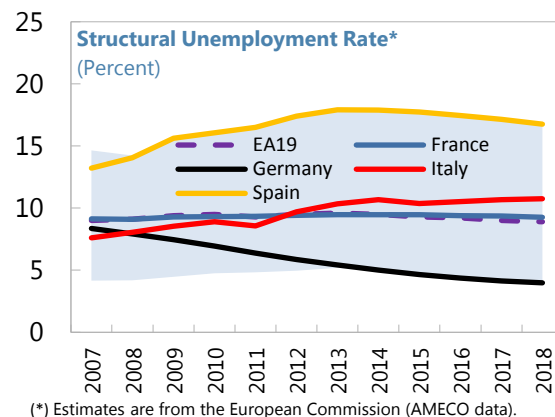
export growth rose to 4.5 percent in the past six months compared to a year ago. Consumer confidence remains above its long-term average.

Figure 1. Euro Area: High Frequency and Real Economy Developments

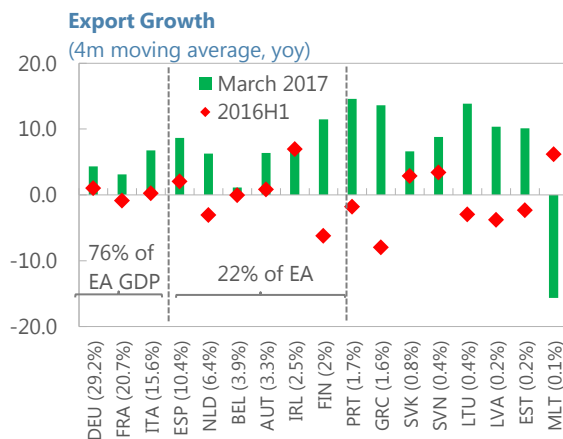
A domestic demand-led recovery is firming....



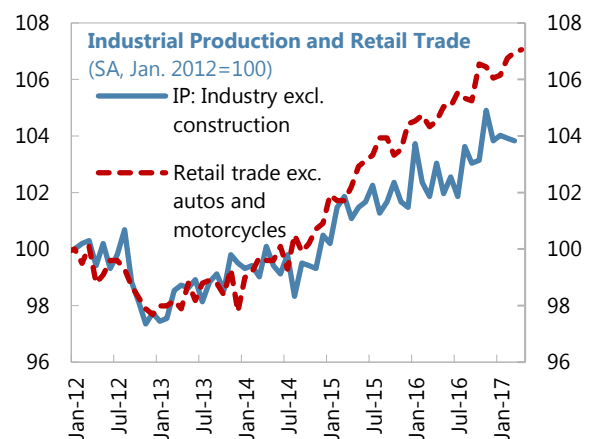
...but structural challenges remain significant.



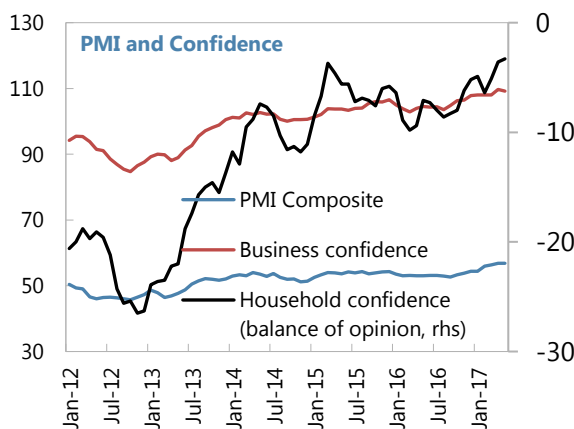
Trade has resumed in line with the global cycle....



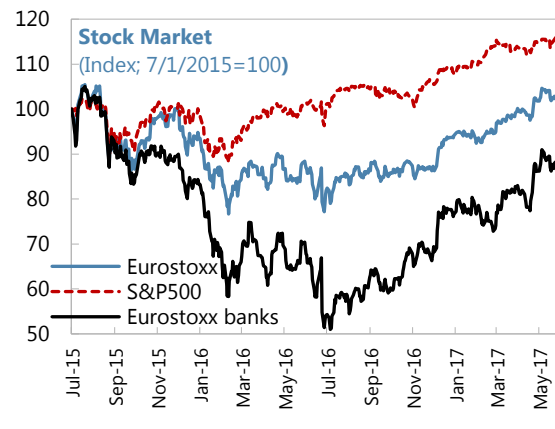
...which is benefiting industrial production.



Private sector confidence is strong....

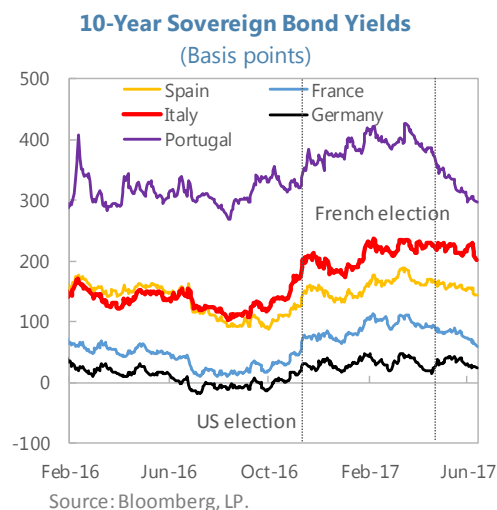


...amid a gradual recovery of bank and non-bank shares.

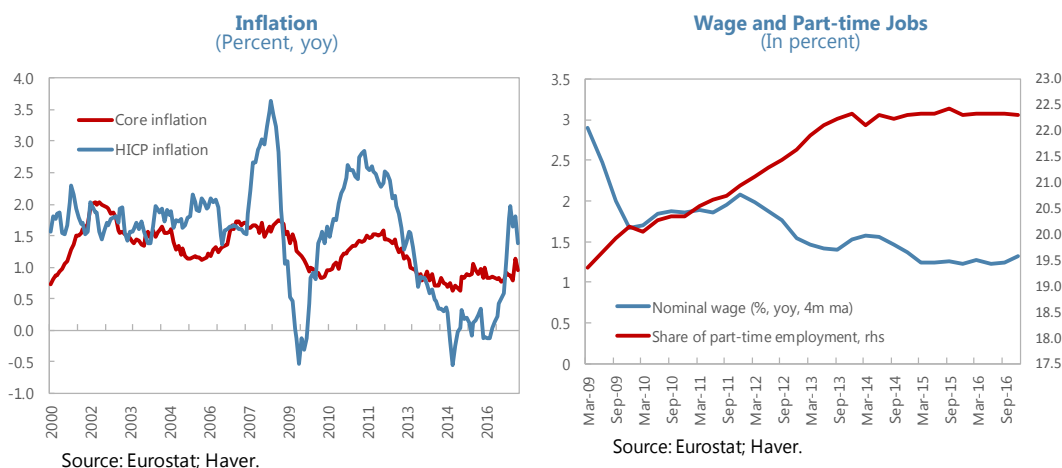


Sources: AMECO; Bloomberg Financial LP; Haver Analytics; and Eurostat.

3. Financial conditions in most countries remain strongly accommodative, though long-term interest rates have risen. The strengthening of the global economic outlook, stronger inflation data, and expected further reduction in monetary stimulus in the U.S. have pushed core yields up. Furthermore, sovereign spreads widened in several countries with high public debt in early 2017, possibly due to concerns about political developments, though yields have stabilized after the French elections (text figure).



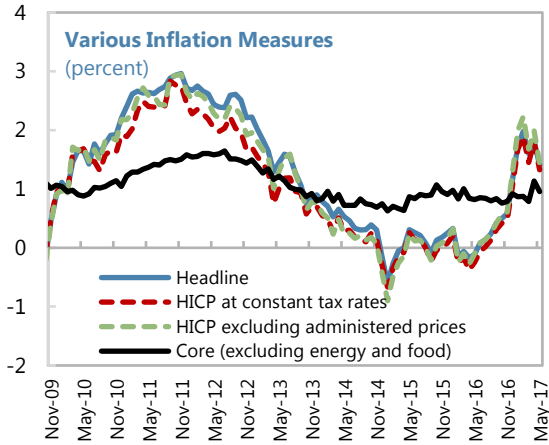
4. Headline inflation has picked up, but core inflation remains stubbornly low (Figure 2). Average annual inflation reached 1.6 percent in the first six months of 2017, reflecting a rise in energy prices and stronger readings in Germany and Spain. Base effects in energy will likely subside further in the coming months, pushing inflation down to more subdued levels by the end of the year. Inflation expectations for the most part have increased slightly. Meanwhile, underlying inflation averaged 1.0 percent between January and June, reflecting subdued nominal wage growth, weighed down by anemic productivity growth, still elevated unemployment in some countries, and a high prevalence of part-time employment (text figure).



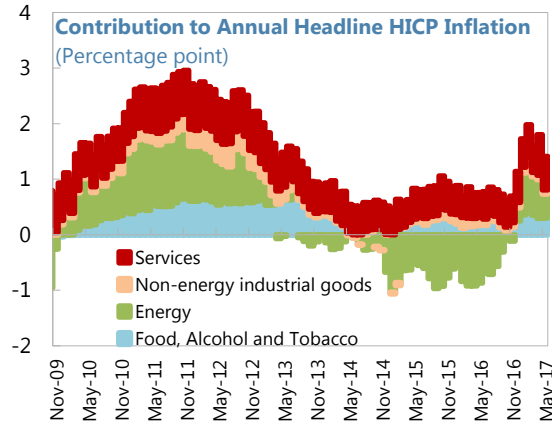
5. The euro area's external position is in line with medium-term fundamentals. The region's current account surplus rose to about 3.3 percent of GDP in 2016 (Figure 3). The CPI-based real effective exchange rate (REER) appreciated by about 1.1 percent over the same period, consistent with the gradual strengthening of the euro area recovery. As of May 2017, the REER has depreciated compared to its average level in 2016 by around 1 percent. Overall, the euro area's external position in 2016 remained broadly in line with the level implied by medium-term fundamentals and desirable policies (Table 2).

Figure 2. Euro Area: Inflation Developments

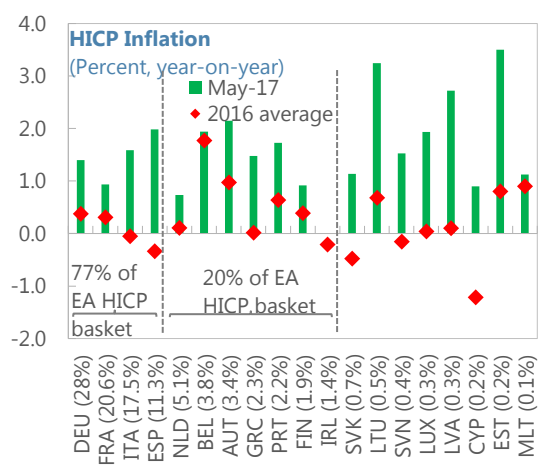
Headline inflation picked up...



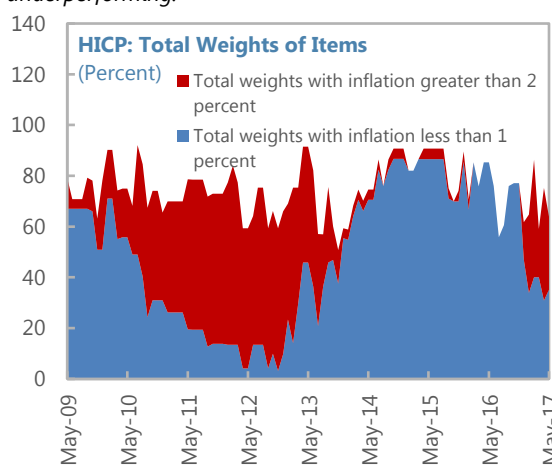
...reflecting increases in energy prices.



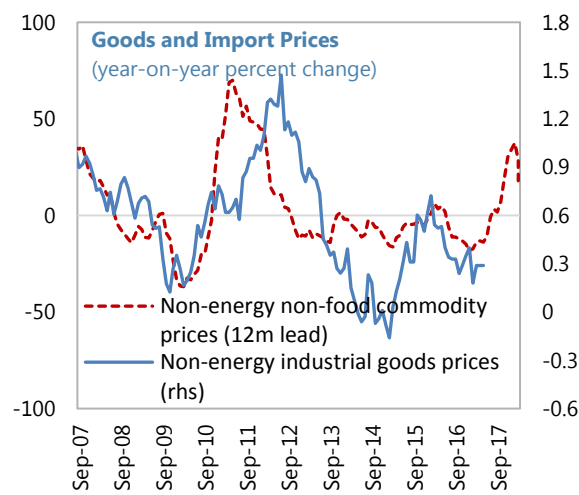
The pick-up is broad-based across countries...



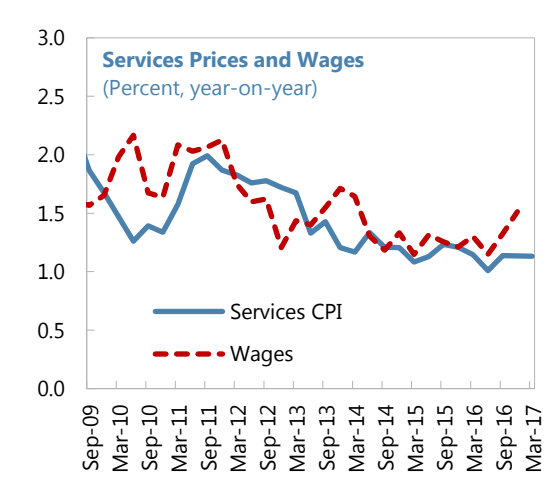
...though a large share of the HICP basket is underperforming.



Non-energy industrial goods inflation remains low...



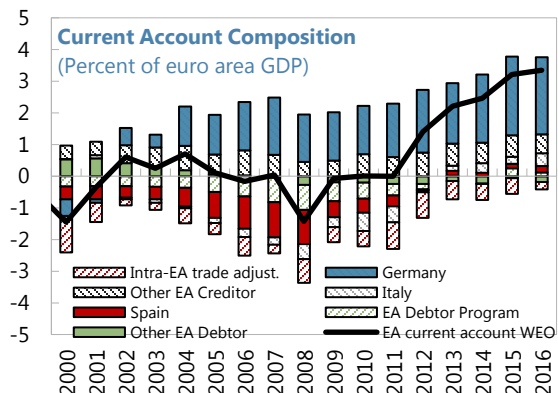
... and services prices remain depressed by subdued nominal wage growth.



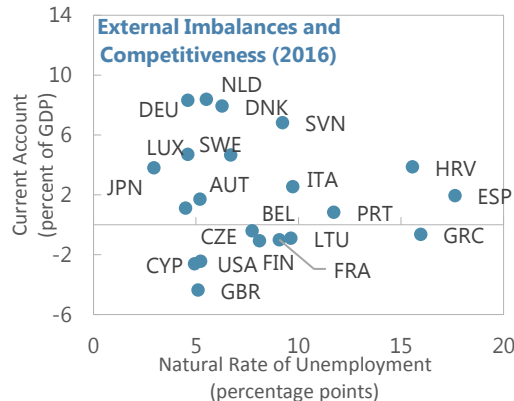
Sources: ECB; Eurostat; Haver Analytics; and Fund staff calculations.

Figure 3. Euro Area: External Sector Developments

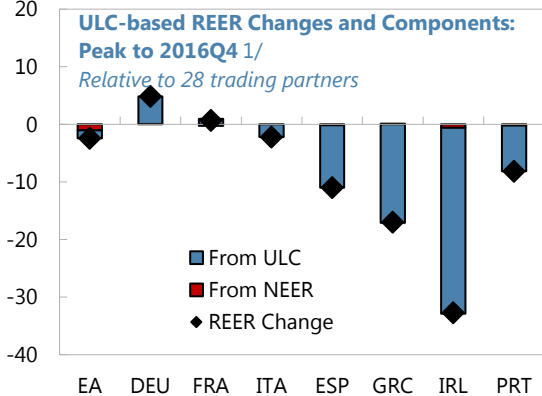
Current accounts have continued to strengthen...



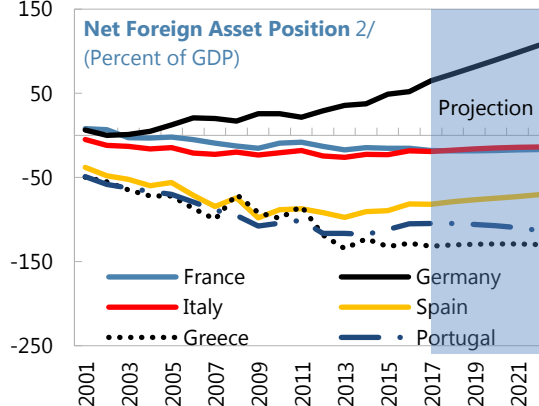
...and appear higher where the natural rate of unemployment is lower.



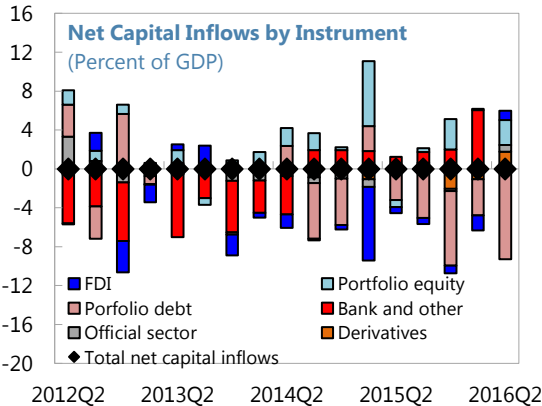
REER adjustment is still largely a net debtor country phenomenon...



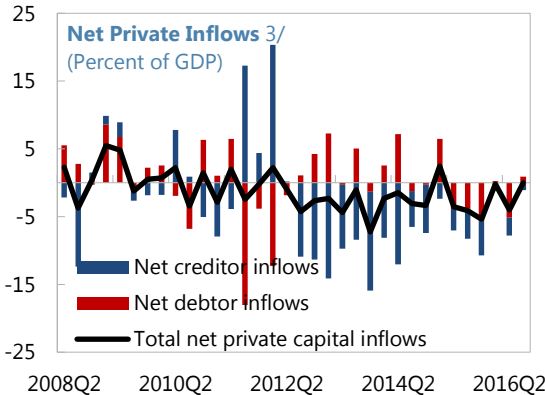
...and net external positions are expected to stabilize, except for large and persistent creditor countries.



Portfolio debt has dominated capital outflows...



...which are coming from both net creditor and net debtor countries.



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

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

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

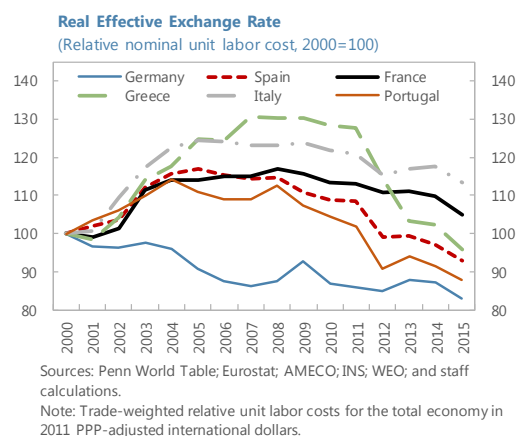
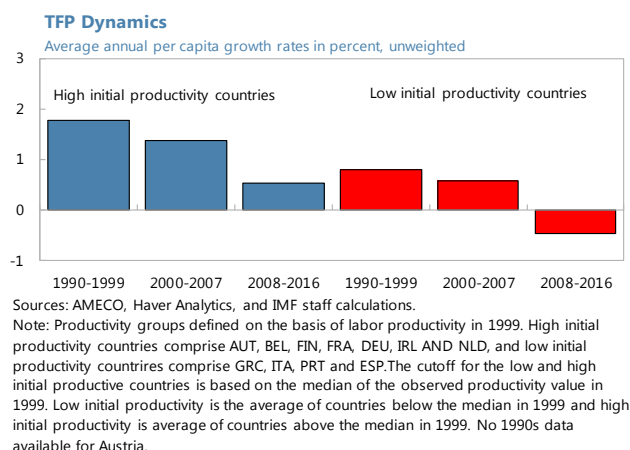
3/ Net private inflows, comprising debt and equity inflows, exclude inflows to the official sector. Debt inflows are the sum of portfolio debt, bank and other, and derivatives, while equity inflows are the sum of FDI and portfolio equity. Creditor countries include DEU, NLD, AUT, BEL, FIN, LUX, and MLT.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

6. But imbalances at the national level remain sizeable, as adjustments have mainly taken place in countries with large net external liabilities. Net external debtor countries, which earlier had persistent current account deficits, such as Portugal and Spain, have maintained surpluses over the past four years, leading to a small improvement in their net foreign asset positions (Figure 3). The persistent surpluses of large net external creditor countries, such as Germany and the Netherlands, have not shrunk significantly or have even grown larger, diverging from the levels consistent with medium-term fundamentals, due to high national saving and comparatively weak domestic investment. Absent adjustment, the net international investment positions of persistent surplus countries look set to grow markedly over the medium term.

UNDERLYING WEAKNESSES: SLUGGISH AND DIVERGENT PRODUCTIVITY GROWTH

7. Income convergence across euro area countries has stalled (Box 1). Euro area countries experienced steady convergence of real GDP per capita in the decades leading up to euro introduction, but convergence stalled thereafter. Since the outset of the crisis, income has tended to diverge. While countries such as Germany are now well above their pre-crisis GDP levels, for other countries, such as Italy, the effect of the crisis has been more persistent, and GDP is only expected to return to its pre-crisis level in the mid-2020s. Convergence of real income levels is not a prerequisite for a functioning monetary union, but is considered a key objective of the economic integration process. It is important for the cohesion of the monetary union, by helping to ensure that the gains from integration are shared, especially in a low-growth environment where distributional issues are more pressing.

8. This lack of convergence in part reflects that productivity growth fell behind in countries with lower per capita income. Gaps in labor productivity across countries have been persistent, partly reflecting that total factor productivity (TFP) growth slowed more in countries with low initial levels of productivity (text figure). At the same time, wage growth outpaced productivity growth, contributing to a build-up of competitiveness gaps, as shown by divergence in relative unit labor costs (ULC) between Germany, on one hand, and Portugal, Spain, Italy and Greece, on the other (text figure).



Box 1. Real Income Convergence ^{1/}

Economic and Monetary Union (EMU) was expected to foster greater macroeconomic stability and income convergence. The single currency would stabilize exchange rates and lower interest rates for

countries in the union. Policymakers also assumed that by eliminating exchange rate uncertainty and reducing cross-border transaction costs, the single currency would increase capital mobility and intra-regional trade, thereby boosting growth and helping income convergence between countries (Aglietta and Brand, 2013). Without recourse to devaluation, the discipline imposed by monetary union would increase incentives for policy reforms to boost productivity growth (European Council, 1989). While EMU succeeded in establishing a credible monetary policy framework and deepened financial integration, many national governments failed to exercise sufficient fiscal discipline or to undertake needed structural reforms.

Real convergence has disappointed. Contrary to expectations, the catching-up process of EA-12 countries with lower GDP per capita has stalled. In the decades before EMU was founded, euro area countries with lower GDP per capita grew faster than richer ones (β -convergence). However, regressions show a lack of β -convergence in GDP per capita from 1993 to 2015. Time-series plots of cross-country dispersion of GDP per capita (σ -convergence) reveal a gradual slowdown in convergence leading up to euro adoption, and divergence since the crisis, reversing the initial narrowing in income dispersion.

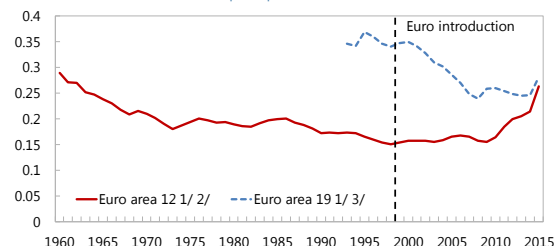
New euro area members converged rapidly in the run-up to their accession. Income levels of countries that joined the euro area in 2007 or later continued to converge up to their accession, though their convergence has also slowed since the crisis. Nevertheless, convergence has been higher among the EA-19 than within the European Union, suggesting that the common currency *per se* is not the reason for the slowdown in convergence.

The lack of convergence reflects a lack of productivity catch-up. A decomposition of annual GDP per capita growth across countries with high and low initial productivity levels shows that both groups of countries experienced a slowdown in total factor productivity (TFP) growth. However, the countries with low initial productivity had consistently lower TFP growth and a more pronounced slowdown.

Policies that raise productivity growth would help foster convergence. Labor and product market reforms tend to boost productivity more in countries with low productivity levels, and can therefore help these countries to catch up, reducing the disparities with higher-income countries. ^{2/}

σ -Convergence Across EA Countries, 1960-2015

Coefficient of variation, PPP GDP per capita



Sources: WEO database and IMF staff calculations.

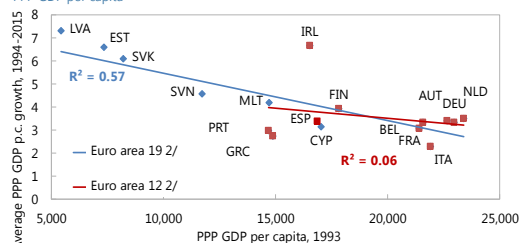
1/ Excludes Luxembourg.

2/ Includes Ireland from 1970 and the Netherlands from 1980 onwards.

3/ Includes Lithuania from 1995 onwards.

β -Convergence Across EA Countries, 1993-2015¹

PPP GDP per capita



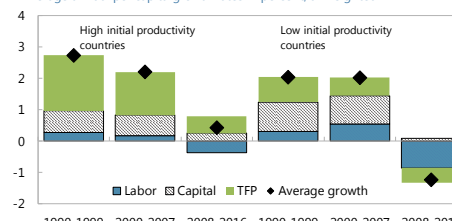
Sources: WEO database and IMF staff calculations.

1/ As GDP not logged, R² values shown differ from results in Table 6.

2/ Excludes Luxembourg, and in the case of euro area 19 Lithuania due to missing data.

Growth Decomposition

Average annual per capita growth rates in percent, unweighted



Note: Productivity groups defined on the basis of labor productivity. Countries with high initial productivity include Austria, Belgium, Finland, France, Germany, Ireland, and the Netherlands. Countries with low initial productivity include Greece, Italy, Portugal and Spain. No 1990s data available for Austria.

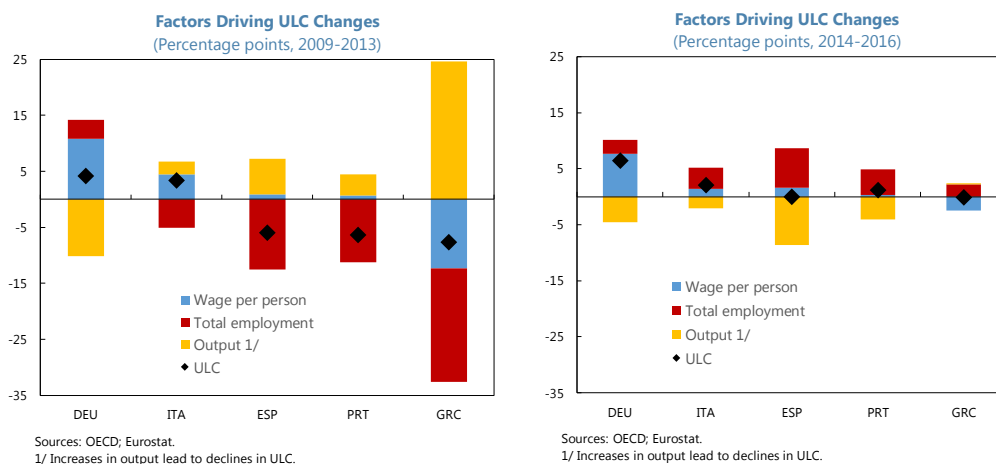
Sources: AMECO, Haver Analytics, and IMF staff calculations.

^{1/} See Selected Issues Paper on "Real Income Convergence in the Euro Area."

^{2/} See Selected Issues Paper on "Can Structural Reforms Foster Real Convergence in the Euro Area?"

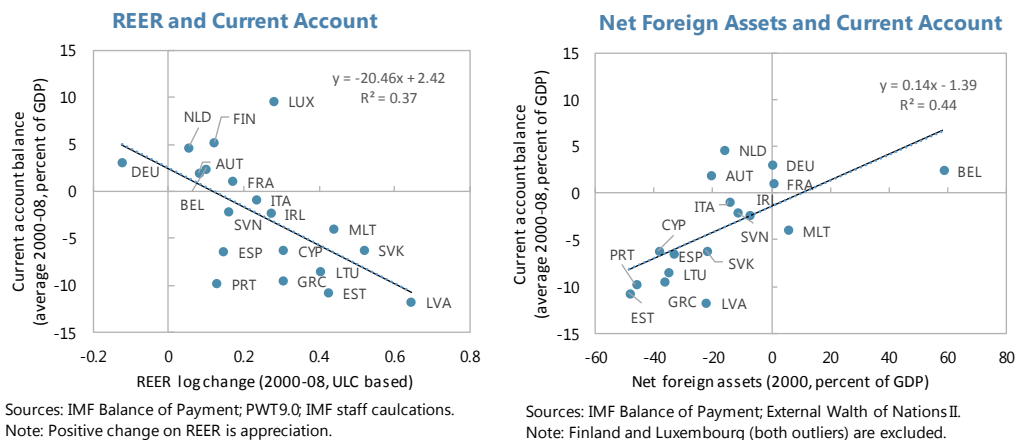
9. Since the crisis, the disparities in competitiveness have been reduced, but gaps remain.

Nominal wage growth in Germany has averaged about 2½ percent annually since 2009, outpacing the rise in labor productivity. Despite the rise in own ULCs, Germany continued to gain competitiveness relative to its trading partners—with its nominal ULC-based REER depreciating by around 7 percent over the same period. In Greece, Portugal and Spain, the ULC reduction occurred mostly during 2009–13 and was to a large extent driven by labor shedding, accompanied by wage declines in the case of Greece. In Italy, despite job cuts, wage growth outpaced labor productivity growth, leading to a rise in ULCs. Since 2014, Spain’s ULCs have been stable, with wage growth in line with labor productivity (supported by job creation), though ULCs in Italy have continued to rise (text figures). Additional job and wage cuts would have high social costs, implying that further adjustment should focus on raising TFP.



10. Competitiveness gaps were associated with persistent external imbalances across the euro area.

Rises in ULC-based REER prior to the global financial crisis were associated with lower average current account balances over the period. Over the same period, poorer current account performance was also associated with lower pre-existing net international investment positions immediately after the euro adoption (text figures). As noted above, some net external debtors have made large price adjustments, bringing down their ULCs (also relative to trading partners) since the crisis. Further narrowing of competitiveness gaps would help reduce external imbalances.



OUTLOOK AND RISKS: A CONTINUED RECOVERY, CLOUDED BY UNCERTAINTY AND THIN BUFFERS

11. The cyclical upturn is likely to continue in the near term. Growth is expected to reach 1.9 percent this year and slow modestly to 1.7 percent in 2018. Germany and Spain will remain the main growth engines, whereas Italy and France will benefit to varying degrees from the recovery. European Central Bank (ECB) policies are expected to remain accommodative and the aggregate fiscal stance to be mildly expansionary. A pick-up in exports, mirroring the strengthening in global trade, should benefit business investment, which has so far been subdued. After surging in early 2017, headline inflation is anticipated to slow in 2018 to 1.5 percent, as base effects from higher energy prices dissipate.

12. With growth modestly above potential, the output gap is expected to close by 2019. While there is uncertainty surrounding estimates of output gaps, this assessment is supported by a range of indicators that suggest aggregate economic slack is limited. Capacity utilization, employers' perception of labor shortages, and optimism about demand growth are all near pre-crisis levels. Subdued wage growth could signal underutilized resources in the labor market, but it could also reflect that anemic productivity growth is holding back the scope for wage increases, including in countries with closed unemployment gaps (e.g., where observed unemployment is lower or equal to structural unemployment). While there is considerable variation in output gaps across countries, the dispersion is at its lowest level since the crisis. The countries with the most economic slack are now generally reducing their output gaps faster than others, but will still take several years to fully close these gaps.

13. Unresolved legacy problems are holding back a stronger medium-term outlook. The post-crisis recovery has been slow in many countries, reflecting the still ongoing repair of impaired public and private balance sheets. At the same time, potential growth remains weak, in part linked to insufficient structural reform efforts and adverse demographics. The jobless rate will return close to its pre-crisis level of 8 percent only by 2021. It will remain around double-digit levels in a group of countries accounting for more than one third of the euro area population. Inflation is expected to move slowly toward the ECB's medium-term objective, settling at 1.9 percent in 2021.

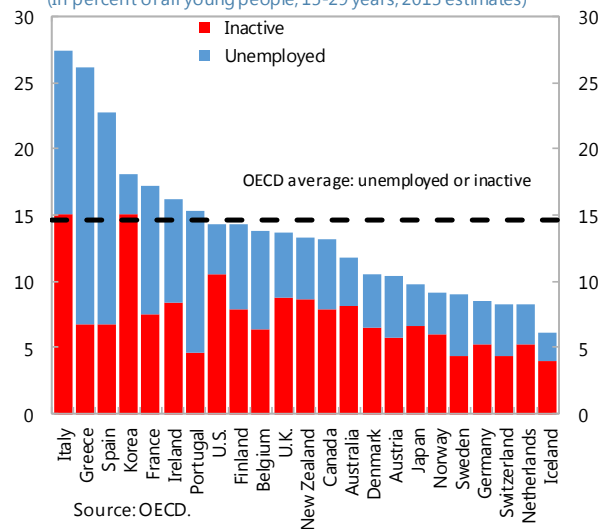
14. Against this backdrop, risks are large and policy buffers remain thin (Table 3). Public debt-to-GDP ratios in high-debt countries have barely declined. By failing to rebuild buffers over the last few years, highly indebted countries could face difficulty coping with higher borrowing costs when monetary accommodation is reduced, exacerbating economic divergences. Their policy space to respond to the next shock will be limited. Furthermore, European bank distress, exacerbated by a structurally weak profitability outlook and still high non-performing loans (NPL) ratios, could have knock-on effects on the broader financial sector and real economy, and on sovereign yields in vulnerable economies.

15. With persistent structural problems—such as low productivity growth, and high unemployment and income inequality—the threat of inward-looking policies remains present.

Externally, rising protectionism and uncertainty emanating from Brexit negotiations or from new U.S. policies could weigh on the global economy and on the euro area through trade, financial, and investment channels. Inside the euro area, concerns about populist undercurrents and possible policy shifts toward euro skepticism remain extant. Doubts about the merits of integration in some camps, as well as concerns about high youth unemployment and increasing inequality, could be exacerbated by low growth and profound societal changes. The challenges of reducing inequality of opportunity in several countries have also become more acute (Box 2). A renewed surge in refugee or migrant inflows could trigger border controls, curtailing the free movement of people and goods within the EU. Any disruption of economic activity within the euro area would have important negative spillover effects on the global economy.

Young People Not in Employment, Education, or Training (NEET)

(In percent of all young people; 15-29 years; 2015 estimates)



16. On the upside, a stronger-than-anticipated global recovery could facilitate countries' reform efforts. Recent gains in business sentiment and a sharper-than-expected recovery in global trade flows could underpin stronger momentum in investment and exports. If countries take advantage of the ensuing stronger cyclical upswing and favorable financial conditions to reduce debt and implement reforms, confidence could increase and the momentum could become entrenched, sustaining the pickup in activity.

Authorities' views

17. The authorities expect growth to continue at a steady pace. With a supportive policy mix, reduced political uncertainty, and improved global economic cycle, the authorities' forecasts are in line with the Fund staff's forecast in 2018. The European Commission (EC) viewed risks as more balanced than before, but still tilted to the downside, reflecting a shift from domestic political risks towards external risks. The ECB also saw downside risks, predominantly from global factors, but considered risks to be balanced, as the current positive cyclical momentum has increased the chances of a stronger-than-expected economic upswing. They both remained concerned about the vulnerability of high-debt countries to a sudden repricing in bond markets, and noted that the window of opportunity to deliver on reforms is shrinking. On the external side, they flagged risks related to the uncertainty from U.S. policies and geopolitics.

18. An acceleration in underlying inflation is conditional on stronger wage growth. The authorities noted that while headline inflation is gathering momentum, driven by higher energy prices, underlying inflation remains anemic. The ECB expects a slight moderation in inflation in 2018,

followed by a gradual move toward the medium-term price stability objective, broadly in line with Fund staff’s forecast. Subdued wage growth is weighing on underlying inflation despite the robust decline in the jobless rate, which seems to suggest that a considerable degree of underutilization (e.g., in terms of hours worked) still characterizes the labor market.

Box 2. Inequality of Income, Inequality of Opportunity, and Growth ^{1/}

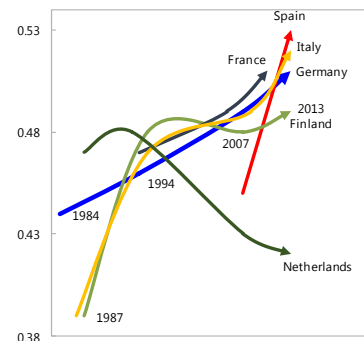
Income inequality has increased in several euro area countries over the last few decades. The rise in and persistence of market income inequality is often cited as an important contributor to rising populism, societal stress and demands for protection (Alesina et al., 2017).² For these and many other reasons income inequality is undesirable. But its effect on growth is ambiguous and disputed in the literature.

Pinning down the impact of inequality on growth is a challenge. Theoretically, the effect can go either way. An increase in income inequality arising, say, from substantial rewards to risky entrepreneurship and innovation, could boost economic growth. By contrast, higher inequality could impair growth if low-income households are persistently less productive because of slower human capital accumulation and greater financial exclusion.

We explore whether the relationship between income inequality and growth depends on equality of opportunity. Inequality of opportunity is measured using data on various indices of intergenerational mobility, such as the elasticity of son’s income to father’s income. Our hypothesis is that in economies characterized by low equality of opportunity, income inequality acts as a drag on growth. An increase in income inequality becomes entrenched across generations due to various market failures connected with social stratification. This retards growth, by holding back human capital development or causing talent misallocation. On the other hand, in countries with high equality of opportunity, an increase in income inequality is easily reversed precisely because low-income people have access to the same opportunities as others. In such societies, an increase in income inequality is less harmful to growth.

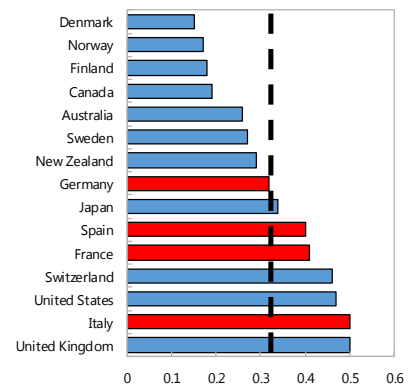
Econometric results show a negative effect of widening income disparities on growth in the presence of high inequality of opportunity. Most euro area countries fall into this category. The implication is that reducing income inequality can accelerate growth in the euro area. There is no trade-off between efficiency and equity. Over the long run, addressing the root causes of inequality of opportunity can make growth less sensitive to shifts in income distribution. International experience suggests that leveling the playing field requires reforms that touch on human capital investment and job creation, and those promoting innovation, including by lowering barriers to labor and product markets.

Market Income Gini, 1984-2013
(In Units)



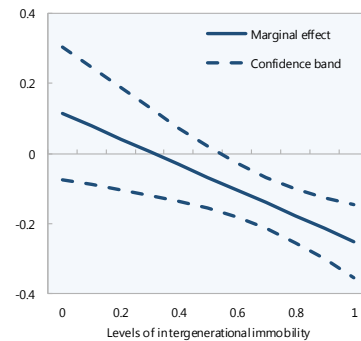
Source: OECD statistics.

Intergenerational Income Elasticity
(Higher value indicate lower intergenerational mobility)



Source: Corak (2015).

Marginal Effect of Income Inequality on Growth
(In percentage points)



Sources: IMF staff estimates.

^{1/} See Selected Issues Paper on “Inequality of Opportunity, Inequality of Income, and Long-Term Growth.”

^{2/} Alesina, A., Stantcheva, S., and Teso, E., 2017. Intergenerational Mobility and Preferences for Redistribution, NBER Working Papers, No. 23027, January 2017.

19. Although concurring with the Fund’s view on the real exchange rate, the authorities differed in their assessment of the overall current account. The EC and the ECB both saw the 2016 real exchange rate as roughly aligned with medium-term fundamentals, possibly skewed slightly towards undervaluation. Similar to the Fund, the ECB saw the 2016 current account as being in line with fundamentals, but the EC considered it to be stronger than implied by fundamentals. Differences in analytical methodologies between the EC and IMF, mainly related to the treatment of demographics, explain much of the discrepancy.

20. The authorities concurred that an improved medium-term outlook hinges on delivering on reforms that strengthen resilience and increase productivity. The EC shared staff concerns about low productivity acting as a drag on potential growth, and the lack of convergence. They argued that EU-level initiatives were important to seed the ground for convergence through higher productivity, and warned that a lack of further EU coordination would exacerbate the effects of poor policies at the national level. The ECB noted that part of the post-crisis reduction in competitiveness gaps had been achieved through wage containment, not only labor shedding, but agreed that reforms were needed to close remaining gaps.

POLICIES TO REBUILD BUFFERS, FOSTER CONVERGENCE, AND REDUCE IMBALANCES

21. Actions at the central and national level are needed to address the euro area’s major risks and challenges. The euro area should grasp the current political momentum to push forward much-needed collective actions to strengthen the EMU. At the same time, a further widening of income gaps between countries could threaten the ability of policymakers to build support for common solutions. Decisive actions at the member-state level are essential to address the challenges: restart convergence, reduce imbalances, and address vulnerabilities. The desired policy mix covers actions on several fronts: (i) promoting structural reforms to boost potential growth; (ii) using fiscal space where available, while consolidating in high-debt countries; (iii) continuing monetary accommodation; (iv) repairing bank balance sheets; and (v) enhancing fiscal integration through a central fiscal capacity, completing the banking union, and advancing the capital markets union, as laid out in the [EC’s recent Reflection Paper on the Deepening of the EMU](#).

A. Structural Reforms to Raise Productivity and Restart Convergence

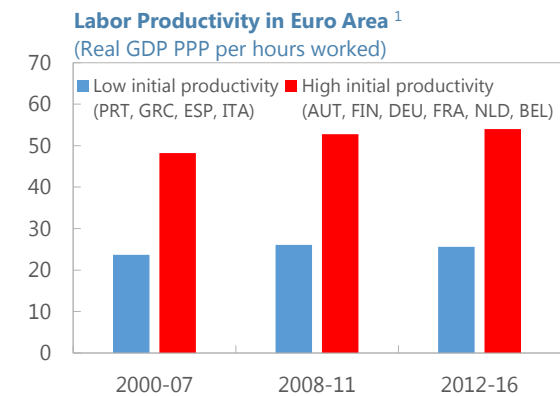
22. Faster progress on structural reforms would raise productivity growth, thereby helping to revive income convergence and narrow competitiveness gaps. Labor and product market reforms tend to boost productivity more in countries with low productivity levels and can therefore help reduce productivity gaps, contributing to income convergence (see Figure 4).² At the same time, reforms can help rebalancing across euro area countries. For net external debtors, reforms that raise productivity growth above the pace of wage increases will lower ULC, thereby reversing competitiveness gaps. For large net external creditors, measures to encourage higher domestic

² See Selected Issues Paper on “Can Structural Reforms Foster Real Convergence in the Euro Area?”

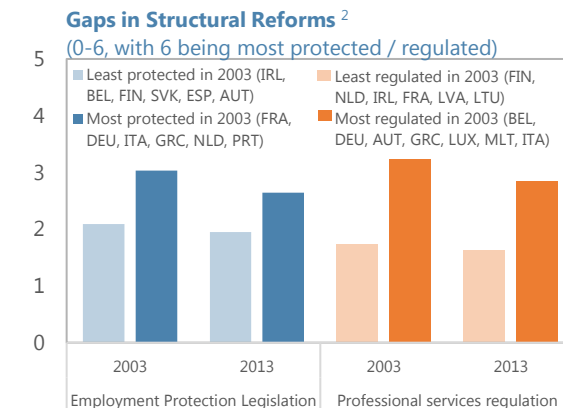
investment and lower unduly high saving rates can reduce excessive current account surpluses, while at the same time improving their capital stocks and lifting potential growth.

Figure 4. Euro Area: Structural Reforms Reduce Productivity Gaps

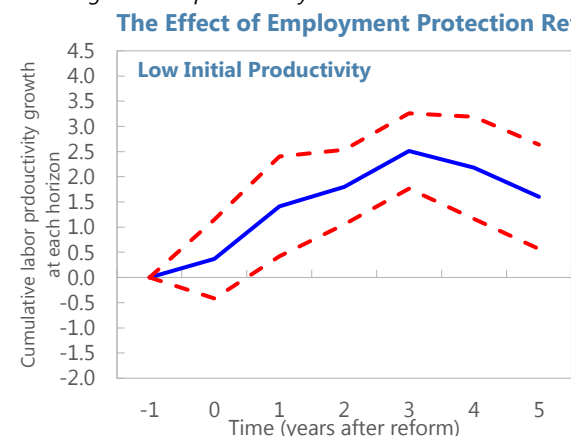
Productivity gaps are large and persistent...



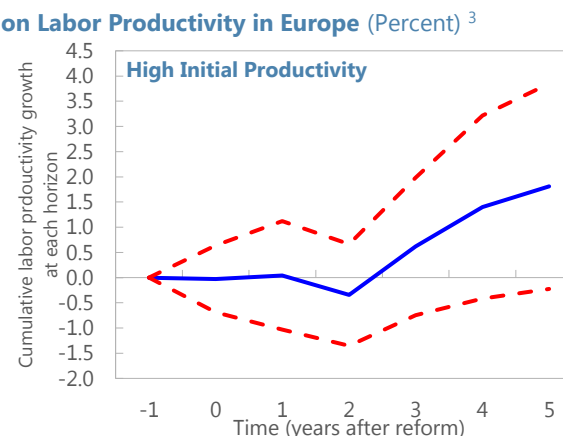
...and reform efforts have been incomplete.



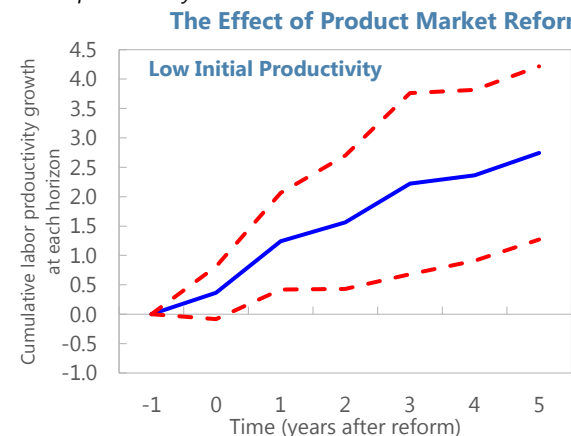
The positive effect of labor market reforms is estimated to be stronger in low-productivity countries...



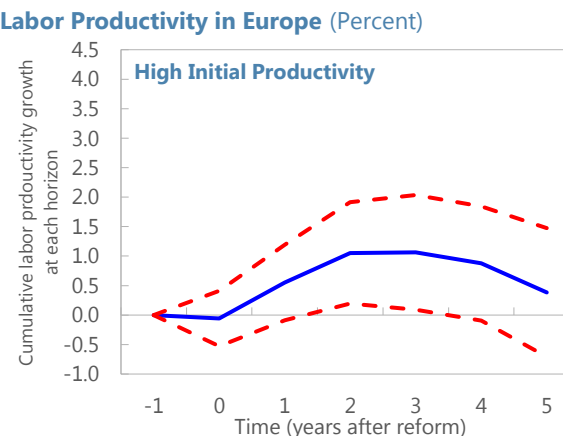
...and lower in high-productivity countries



Similarly, product market reforms deliver stronger effects in low-productivity countries...



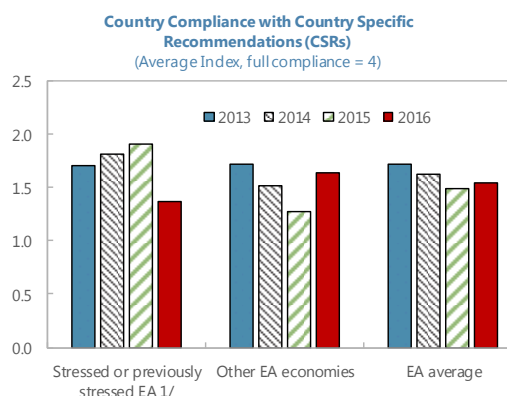
...but less so in high-productivity economies.



Source: OECD, IDB Employment Protection Database, Product Market Regulation Database; and IMF staff estimates.
¹ Productivity groups are based on average productivity above and below the median labor productivity level in 1999. ² The most and least regulated countries are based on the median value in 2000 and 2003 respectively of the OECD's employment protection legislation indicator for employees on regular contracts and the professional services regulation indicator. ³ Reforms occur at t = 0. The estimation method is the local projection method (Jorda, 2005) controlling for lagged log of productivity level, past crisis dummies, country and timer fixed effects. The reform dummy enters additively, and in interaction with lagged log level of productivity. The dashed lines denote 90 percent confidence bands.

23. Progress on structural reforms has been sluggish both at the national and central level.

- Compliance with the Country-Specific Recommendations (CSR) under the European semester remained weak in 2016, notwithstanding efforts to streamline the number of recommendations (text chart).



Source: European Commission.

Note: The EC assesses progress on CSR on the scale: none (0), limited (1), some (2), substantial (3), full (4). The stressed and previously stressed countries are Ireland, Greece, Spain, Italy, Portugal, Cyprus, and Slovenia. 1/ IRL and PRT data are for 2014 since these countries fell outside the Macro Imbalance Procedure framework in 2013.

- At the EU level, the EC is implementing the 2015 Single Market Strategy, but progress has been mixed. While some initiatives, such as legislation to remove geographical discrimination in e-commerce within the Single Market (geo-blocking), are quite advanced, others such as the European Services e-card and minimum standards for corporate debt restructuring and insolvency, could face protracted negotiations among member states.³ Overcoming national opposition, the Comprehensive Economic and Trade Agreement (CETA)—the first comprehensive trade agreement between the EU and an advanced economy (Canada)—was signed in 2016, but prospects for the Transatlantic Trade and Investment Partnership (TTIP) agreement with the U.S. remain uncertain.⁴ The EU is making progress in negotiating ambitious free trade agreements (FTAs) with Japan, Mexico, and Mercosur.

24. The cyclical recovery and supportive financial conditions present an opportune time to push ahead with reforms.

Partly reflecting country-specific reform agendas (Table 4), the main priorities for structural reform are:

- *Product market reforms.* Countries should improve the business climate, public administrations and insolvency regimes (e.g., Italy and Portugal) and reduce cross-border entry barriers in the professional and retail sectors (e.g., Greece). Progress in completing the single market in services, energy, digital commerce, and transport would increase competition and allow firms to reap cross-border economies of scale. So would ambitious trade agreements, accompanied by policies to support adjustment to trade and to ensure that the gains from trade are evenly and

³ The e-card is a simplified electronic procedure for business providers to complete the administrative formalities required for providing business services in other EU countries.

⁴ The recent European Court of Justice ruling on the Singapore FTA has provided greater legal clarity on the EU's role in trade negotiations, thereby reducing scope for national hurdles in ratifying FTAs. The ruling specifies areas where the EU has exclusive competence to negotiate aspects of the FTA, as well as areas where the EU shares competency with its member states (such as portfolio investments and dispute settlement regime for investments).

widely distributed. This could provide a significant boost to potential output across the euro area.⁵

- *Labor market reforms.* To lower structural unemployment and increase labor force participation, policies should focus on reducing the labor tax wedge (e.g., Germany), improving active labor market policies (e.g., Italy and Spain), and reforming distortive unemployment benefits (e.g., France) and excessive job protection for permanent contracts (e.g., Portugal and Spain). The latter needs to be designed carefully in countries with weak growth to minimize short-term costs.

25. Strong and credible reforms could be incentivized through, and their impact amplified by, the judicious use of fiscal policy.⁶ Countries with fiscal space could accompany structural reforms with some upfront fiscal stimulus focused on shifting spending toward high-return investments and reducing the adjustment cost of reforms (e.g., Germany’s fiscal easing would also boost the effect of its recommended structural reforms). Countries without fiscal space should sequence reforms carefully, within a credible medium-term framework, prioritizing product market reforms as they entail few short-term costs (e.g., Italy, Spain and Portugal). The short-term economic effects of employment protection and unemployment benefit reforms could be minimized through budget-neutral fiscal support as part of a broader reform package (such as combining job protection reforms with measures to facilitate the setting up of small businesses). In any event, reforms with permanent fiscal costs—such as labor tax cuts and higher spending on active labor market policies—should be implemented in a budget-neutral manner in all countries to avoid compromising fiscal sustainability.

26. Instruments at the EU level should be used more effectively to incentivize reforms. The weak implementation of CSRs in most countries, including by those six countries identified with excessive imbalances under the Macroeconomic Imbalance Procedure, suggests that the EU instruments are currently not being used effectively. To build credibility, stronger enforcement of the governance framework is needed.⁷ This could be complemented by incentives, in the form of targeted support from European Structural and Investment (ESI) funds, flexibility under the fiscal rules to reward strong reforms, and outcome-based structural reform benchmarks.⁸ Finally,

⁵ For example, EC estimates suggest that a Single Market in services could boost EU GDP by an estimated 0.8–1.8 percent over 5–10 years, a Digital Single Market could add €415 billion to the EU economy every year, and the European Union could lead to household savings of about €1,000 per household per year by 2020.

⁶ See “[Labor and Product Market Reforms in Advanced Economies: Fiscal Costs, Gains, and Support](#),” IMF Staff Discussion Note 17/03, March 2017.

⁷ While considering progress toward correcting excessive external imbalances in February 2017, the EC has again used its discretionary powers not to open the excessive imbalances procedure in six cases, despite these countries having made only ‘limited’ or ‘some’ progress in implementing CSRs.

⁸ The 2016 Article IV consultation recommended six priority benchmarks in key reform areas: (i) OECD indices on regulatory barriers in professional services sectors; (ii) the licenses needed to engage in retail trade; (iii) employment protection in regular work contracts; (iv) the labor tax wedge; (v) the number of days to enforce a contract; and (vi) measures of public sector value added per employee.

independent national productivity boards can help build greater national consensus and ownership for reforms.

Authorities' views

27. The authorities agreed that structural reforms are critical to reverse the declines in productivity growth. There has been progress in some areas such as financial services, labor taxation, and active labor market policies. Moreover, considering a multi-annual rather than annual horizon, the large majority of CSRs have seen progress, reflecting that some reforms take time to implement. Nevertheless, measures to reduce labor market duality and improve the business climate have lagged due to resistance from vested interests in a fragile political environment. Countries, especially those without fiscal space should prioritize product market reforms to improve the investment climate and create more effective insolvency regimes and public administrations, as they have few short-term economic costs and significant medium-term gains. The authorities noted that they were indeed pursuing ambitious “new generation” FTAs and that Single Market reforms remain a priority.

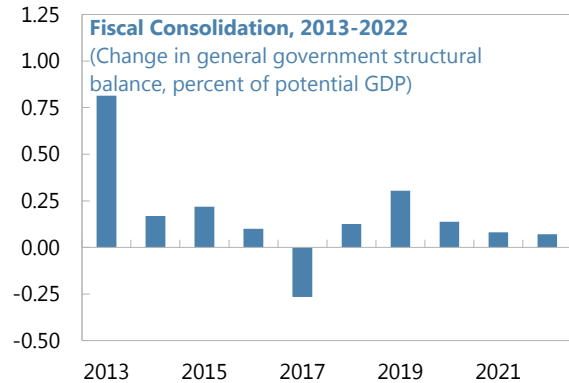
28. Efforts are underway to further incentivize and build ownership of reforms. Reform agendas laid out in CSRs are being supported by technical assistance through the Structural Reform Support Service; flexibility under the Stability and Growth Pact (SGP) for structural reforms (recently for Finland and Lithuania); and, going forward, by establishing tighter links between CSRs and ESI funds. The benchmark set by the Eurogroup on the labor tax wedge appears to have helped implementation, and a second benchmark—on pensions—was adopted by the Eurogroup in March 2017. Additional benchmarks, such as on insolvency practices, are being developed. In countries with excessive imbalances, the EC intends to continue to enforce the Macroeconomic Imbalance Procedure by “specific monitoring,” which is helping to provide peer pressure for reforms, in lieu of opening an Excessive Imbalance Procedure, given the need to further foster ownership and improve traction. The ECB, on the other hand, calls for a full implementation of the Macroeconomic Imbalance Procedure. Going forward, national productivity boards will need to play a vital role in building consensus for reforms. Finally, to address protectionism, trade negotiations will henceforth be conducted in a more transparent manner, with greater public consultation with member states, civil society, and other stakeholders.

B. Rebuilding Fiscal Buffers and Promoting Growth

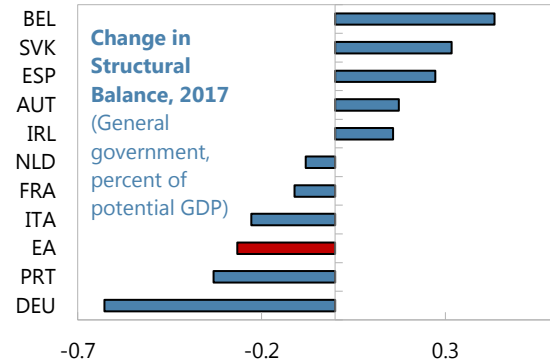
29. The aggregate fiscal stance of the euro area is expected to be mildly expansionary in 2017. The structural fiscal balance is expected to ease by 0.3 percentage points of potential GDP (Figure 5). The fiscal easing comes primarily from Germany, and, to a lesser extent, from Italy, France, Finland, and Portugal (Table 5).

Figure 5. Euro Area: Fiscal Developments and Policies

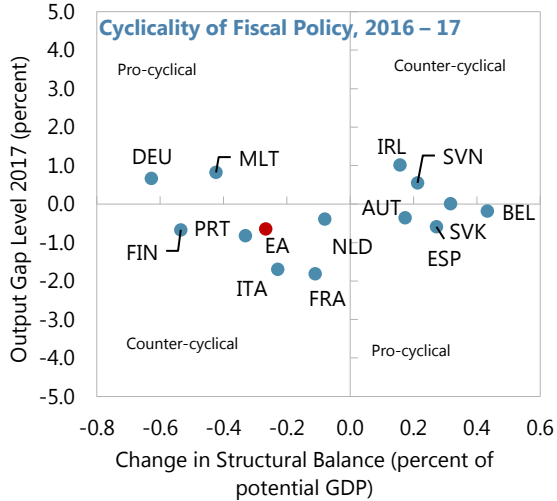
The fiscal stance turned expansionary in 2017...



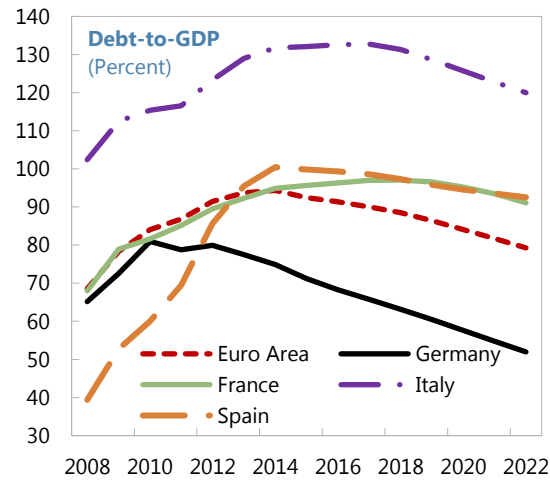
...with most large countries easing.



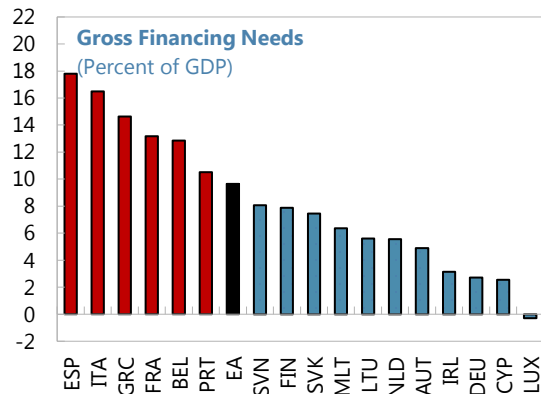
Fiscal policy is mixed, but counter-cyclical with respect to the level of the output gap for many countries...



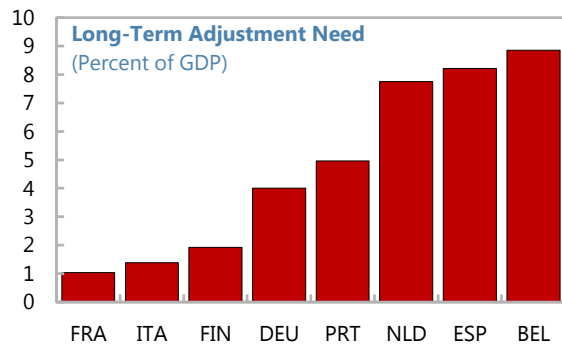
Scope for additional fiscal support is limited due to high public debt levels in many countries...



...and already sizable gross financing needs.



Moreover, LTANs stemming from aging related spending are significant even in some countries with fiscal space.



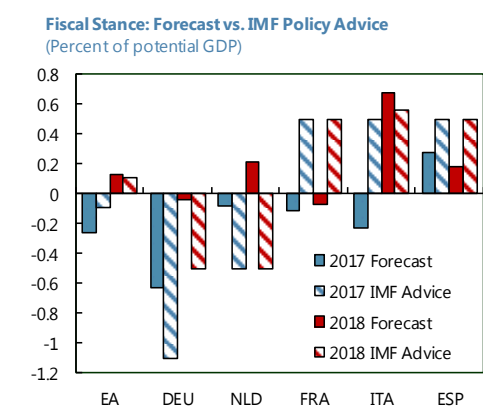
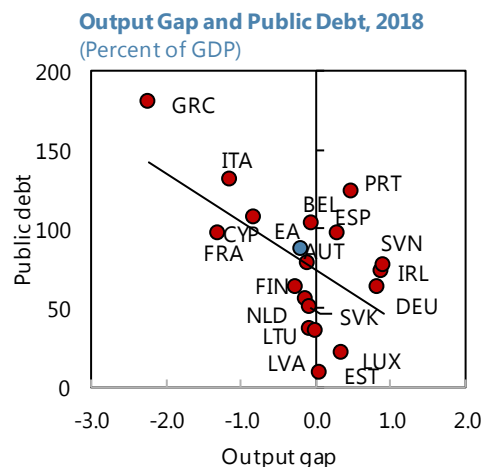
Note: The indicator shows long-run adjustment needed to stabilize debt in the very long-run taking into account projected aging related spending increases. For high debt countries, more adjustment would be needed to actually reduce debt.

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

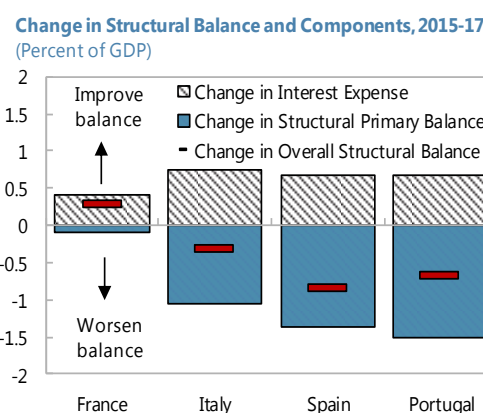
30. For 2018 and beyond, with a closing output gap, the rationale for additional fiscal cyclical support at the euro area level is waning. The output gap is projected to shrink to -0.2 percent of GDP in 2018, and to close in 2019, suggesting that further fiscal easing may not be needed for the euro area as a whole. At the same time, output gaps vary considerably across countries, ranging from below -1 percent of GDP in France and Italy, to +0.8 percent of GDP in Germany, though fiscal space in countries with large output gaps is constrained by high debt levels (text figure).

31. While the overall euro area fiscal stance is broadly consistent with staff advice, the composition is not. The structural primary balance is expected to ease slightly in 2017 and remain stable in 2018, broadly in line with the sum of staff's advice to euro area members.⁹ However, the heterogenous distribution of fiscal space at the member-state level calls for differentiated fiscal strategies (text figure):

- *Countries with fiscal space should use it now, to boost public investment and promote structural reforms, helping to increase potential growth over the medium term.*¹⁰ It would also boost domestic demand and inflation in the near term and reduce sizeable external surpluses. Furthermore, positive cross-border growth spillovers, while likely modest, could support the efforts of other countries to rebuild fiscal buffers and implement reforms. Germany's projected fiscal easing goes in this direction, but remains well below staff's recommendations. The Netherlands fiscal stance is expected to be tighter than staff advise.
- *High-debt countries with relatively less fiscal space need to adjust now to rebuild buffers and reduce vulnerabilities.* Most high-debt countries have so far not saved the windfall interest reductions from



Notes: Fiscal stance at t is the change in the structural fiscal balance from $t-1$ to t . Euro area "advice" is the sum of IMF advice to individual euro area countries. IMF advice for 2017 from most recently published Article IV.



⁹ While the structural *primary* balance is stable, the change in the structural balance is slightly contractionary (see text figure) because the interest expense is declining between 2017 and 2018.

¹⁰ In recent bilateral Article IV consultations, Germany and the Netherlands were considered to have substantial fiscal space, while Italy, Portugal, and Spain were considered to have limited fiscal space.

monetary accommodation (text figure). It is important to make decisive progress on fiscal adjustment before monetary accommodation is reduced. Otherwise, countries could face dangerous debt dynamics as interest rates rise—running the risk that self-fulfilling expectations could emerge if markets begin to doubt fiscal sustainability. Delaying consolidation would imply larger and faster adjustment measures,

which would be more damaging to growth than a more gradual approach. Contrary to staff's advice, however, most of the more highly indebted countries are expected to ease in 2017, including France, Italy and Portugal. In 2018, high-debt countries are expected to consolidate, though full details on adjustment measures will not be available until draft budgets are published in October.

- *Flexibility under the SGP can and should be used to incentivize credible structural reforms.* The SGP permits a one-time deviation of up to ½ percent of GDP from the required fiscal adjustment path to encourage major structural reforms. Italy, for example, availed of this flexibility in 2016. In all cases, credibility is central, and is best achieved through concrete upfront actions.
- *All countries should undertake growth-friendly fiscal rebalancing.* On the revenue side, there may be benefits from shifting from personal income taxes to indirect taxes, including emissions taxes, and property taxes, as well as from base broadening while lowering marginal tax rates.¹¹ On the spending side, outlays can be shifted to investment from less productive areas such as poorly targeted transfers.¹²
- *In a downside scenario, countries that are currently constrained by fiscal rules can use the additional latitude provided in the SGP.* In case of country-specific shocks, automatic stabilizers should be allowed to operate. For countries in the Excessive Deficit Procedure (EDP), the

Heatmap of Selected Fiscal Indicators for Key Country Examples

Indicators under the Baseline 1/	ITA	PRT	ESP	FRA	DEU	NLD
Availability of financing						
Have sovereign bond spreads breached benchmarks in the last 3 months? 2/						
Do debt profile indicators breach benchmarks?						
Share of public debt held by non-residents 3/						
Change in share of short-term debt 4/						
External financing requirements (percent of GDP) 5/					n.a.	
State of debt burden indicators						
Does debt level breach the benchmark during projection period? 6/						
Do gross financing needs (GFN) breach the benchmark during projection period? 6/						
In Excessive Deficit Procedure? 7/						
More consolidation needed to meet Medium-Term Objective? 7/						

1/ Heatmap based on latest published debt sustainability analysis (DSA) for each country, except for SGP requirements, which are taken from the European Commission. Benchmarks are indicative and correspond to those used in the MAC-DSA.

2/ Low risk (green) <400 bps; 400 bps <Medium risk (orange) <600 bps; High risk (red) >600 bps. Calculated over the last 3 months before DSA published.

3/ Low risk (green) <30; 30 <Medium risk (orange) <45; High risk (red) >45. The flag color reflects that a larger non-resident investor base can make a country more vulnerable to rollover risk. It does not take into account that a more diversified non-resident investor base could indicate market confidence, nor that a more concentrated investor base could reflect stonger domestic sovereign-bank links, which could represent a vulnerability.

4/ Low risk (green) <1; 1 <Medium risk (orange) <1.5; High risk (red) >1.5.

5/ Low risk (green) <17; 17 <Medium risk (orange) <25; High risk (red) >25.

6/ Debt level and GFN benchmarks are 85 percent and 20 percent of GDP, respectively. 'Green' means debt level (GFN) remains below the benchmark in the last year before the projections and over the projection period, 'red' means the respective benchmark is breached for at least one year in the last year before the projections or over the projection period.

7/ No (green), yes (red). The EDP for Portugal was closed in June 2017.

¹¹ For more on possible benefits of emissions taxes, see Selected Issues Paper "Meeting EU Climate Pledges: Assessing Potential Policy Refinements."

¹² For example, in Italy, rationalizing tax expenditures and broadening the tax base, as well as implementing a modern property tax, would provide scope to reduce the labor tax wedge, thereby increasing labor supply growth over the medium term. Also, reforming transfers and pensions, while allocating some of the savings towards public investment, would help meet the adjustment needs in a more growth-friendly fashion.

deadlines to reduce the headline deficit can be extended. For countries in the preventive arm, the required fiscal effort can be lowered if the output gap falls below 1½ percent of GDP. In a severe, euro area-wide downturn, the escape clause should be invoked to suspend temporarily the fiscal adjustment that would otherwise be required.

32. Expanded EU centrally financed investment can help countries with continued demand shortfalls and raise potential growth.

The plan to expand and extend the European Fund for Strategic Investment (EFSI) by €200 billion, for a total of at least €500 billion by 2020, is welcome. It is envisaged to be accompanied by measures to better ensure “additionality” (i.e., that private sector financing for projects would not be available in lieu of the EFSI financing), an enhanced investment advisory hub for greater

geographic and sectoral diversification, and increasing transparency of EFSI governance. EFSI financing could also prioritize projects of common interest, such as those related to developing the energy union and addressing climate change, especially in countries with negative output gaps and high levels of debt, where the demand impact would be greatest. In line with this, in percent of GDP terms, Spain, Portugal, Italy and Greece, are among the top six recipients of EFSI-related investment.

EFSI Related Investment Shares and Investment-to-GDP

(Percent, through end-2016)

Country	Investment Share	Country	Investment/GDP
Italy	17.5	Estonia	3.0
Spain	14.0	Bulgaria	2.1
UK	13.2	Spain	2.1
France	13.0	Portugal	1.8
Multi-country	11.1	Italy	1.7
Germany	9.3	Greece	1.7

Source: European Investment Bank, IMF WEO, and Fund staff calculations.

Note: Total financing for EFSI related investment approved through end-2016 was euro 163.9 billion, though actual investments will only take place over a number of years.

33. Compliance with and enforcement of the SGP have been weak, undermining its credibility and impeding further fiscal integration. While the fiscal framework needs to be reformed, credibility requires that the rules be respected. If they are not, the time consistency of fiscal policy will remain in question. Enforcement has suffered from weak political will, as exemplified by the decision not to sanction Portugal and Spain for failing to take effective action to meet their EDP targets in 2016. Moreover, while well-defined flexibility in the SGP—such as for structural reforms—is useful, the recent absence of quantitative fiscal targets in the CSRs for 2018, which imply greater discretion for the EC in assessing compliance with the rules, weakens the SGP’s credibility. Steps need to be taken to restore SGP credibility.

- *An independent European Fiscal Board.* The new European Fiscal Board, charged with assessing the aggregate fiscal stance and even-handedness in the application of the SGP, is now operational and will need to demonstrate its independence through its actions.
- *A simpler and more transparent fiscal framework.* Over the medium term, the rules should be amended to (i) focus on a single fiscal anchor and a single operational target with well-considered escape clauses; (ii) make enforcement more automatic; and (iii) create better incentives for compliance with the rules.

34. A common stabilization function would permit a more accommodative fiscal stance in a downturn, while supporting fiscal discipline in good times. Such a central fiscal capacity (CFC)

could also help incentivize compliance with fiscal rules, as access to it should be conditional on member states' compliance with the rules. As discussed in the 2016 Article IV consultation, there are several possibilities for the design of a CFC.¹³ In particular, a modest tax-transfer scheme with a "rainy day fund" built up in good times could provide meaningful macroeconomic stabilization to countries hit by shocks, while a borrowing-lending scheme could help finance public investment. A CFC would be essential to completing the EMU architecture, highlighting the importance of utilizing the favorable political momentum, together with better SGP compliance to build political support for further fiscal integration.

35. Looking ahead, Brexit will require politically difficult decisions on the EU budget. The annual gross contribution of the UK to the EU budget has averaged about 13 percent of the total over 2013–15, with an annual net contribution of about €11 billion. Maintaining (non-UK) spending at the current level would require higher contributions from richer EU members or a new source of revenue. Cutting spending would imply lower agricultural and structural funds (about 75 percent of EU spending). Priority should be given to preserving structural funds, which are a major income source for many Central and Eastern European countries and help promote convergence.

Authorities' views

36. The authorities consider that a broadly neutral fiscal stance remains appropriate for the euro area in 2018, given the remaining trade-off between sustainability and stabilization needs. Fiscal indicators have improved considerably, with a headline deficit of 1.5 percent of GDP in 2016. Only two euro area countries had deficits above 3 percent and eight have reached their Medium-Term Objectives for the structural balance. While the economic recovery is steady, with a closing output gap, labor market slack suggests that there is still scope for higher growth without triggering inflationary pressures. At the same time, focusing on the overall euro area fiscal stance hides the issue that debt sustainability is mainly relevant from a country-specific perspective, with several countries facing elevated sustainability risks in the medium term.

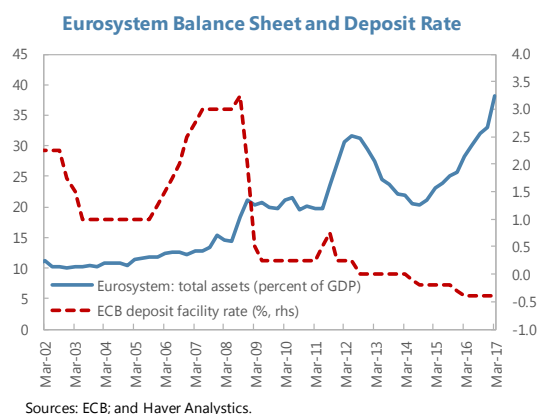
37. The authorities see scope for a better differentiation of the fiscal stance across countries than planned in the Stability Programs. As recommended in the recent CSRs, countries with fiscal space should make use of it, including in Germany, where the fiscal stance could be more expansionary to support future growth. Countries without fiscal space should take advantage of the current negative interest rate-growth differential to reduce excessive levels of debt and rebuild buffers. However, in some cases, such as Italy, the EC highlighted the need to consider the impact of budgetary adjustment on the recovery and employment when assessing compliance with the rules, suggesting that it would use its margins of appreciation. The ECB argued that the window of opportunity for high-debt countries to act is shrinking fast, and that complying with the rules would be the best way to establish credibility.

¹³ See "[Options for a Central Fiscal Capacity in the Euro Area](#)," Euro Area Policies, Selected Issues, IMF Country Report No. 16/220, July 2016.

38. Political determination is needed to strengthen the EMU. A common stabilization function would complement national budget stabilizers and allow smoother aggregate fiscal policy for the euro area. To have the necessary political support, it should not lead to permanent transfers, though a borrowing capacity would be needed to allow sufficient stabilization. The establishment of a CFC could be combined with other EMU deepening measures, such as the creation of safe assets. With a CFC to support stabilization needs, national fiscal rules could focus on sustainability.

C. Maintaining an Accommodative Monetary Stance

39. Monetary policy is appropriately accommodative (text figure). The ECB's decision last December to extend the asset purchase program (APP) through end-2017, while reducing the monthly purchase amount, signals its strong commitment to maintain accommodation until there is a sustained upward shift in the path of inflation. Even with the purchase reduction, the planned purchases this year remain significant relative to the net issuance of medium- to long-term sovereign bonds. The decision to relax the constraint against buying bonds whose yield is below the deposit rate has significantly expanded the pool of eligible assets for purchase.



40. Monetary easing has improved financial and credit conditions through various channels (Figure 6).

- *Asset purchases have supported portfolio rebalancing and compressed risk premia.* Net portfolio investment outflows likely indicate investors rebalancing towards non-euro area debt securities due primarily to negative interest rate differentials *vis-à-vis* other advanced economies. In the two years following President Draghi's Jackson Hole speech in August 2014, where he indicated that the ECB would begin sovereign bond purchases, the euro area average term spread fell by around 80 basis points. The 10-year bond yield spread (to German bunds) narrowed by around 40 basis points for both Italy and Spain. However, since last summer, the average term spread has risen to slightly above the level in August 2014 (Figure 6). This is partly due to rising inflation expectations amid good economic indicators, but may also reflect higher credit risk in some countries as the prospect of reduced monetary accommodation moves closer. In recent months, sovereign spreads and CDS spreads have also increased in some high-debt countries.

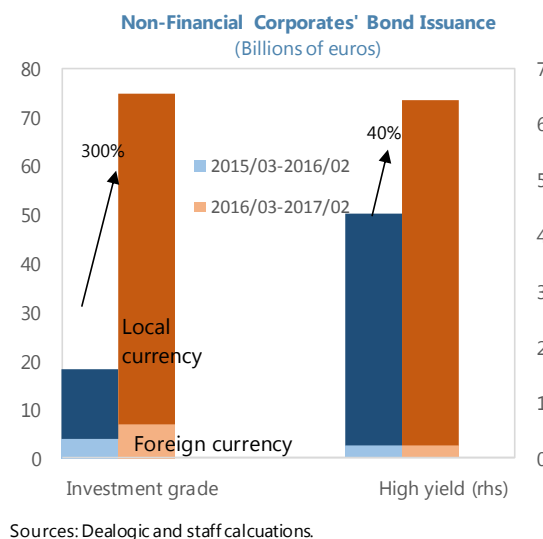
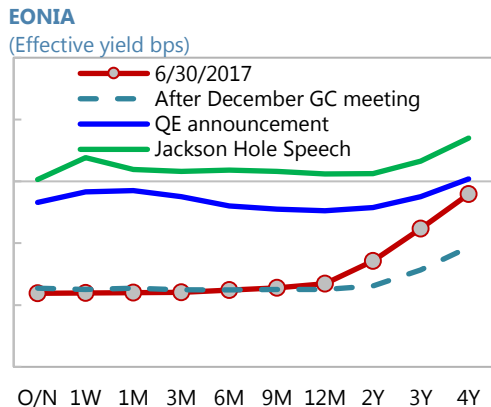
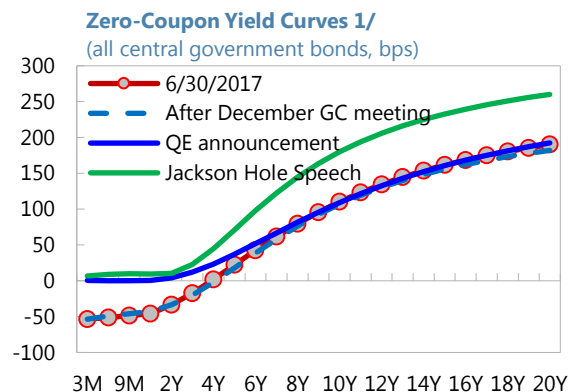


Figure 6. Euro Area: Monetary Policy Channels

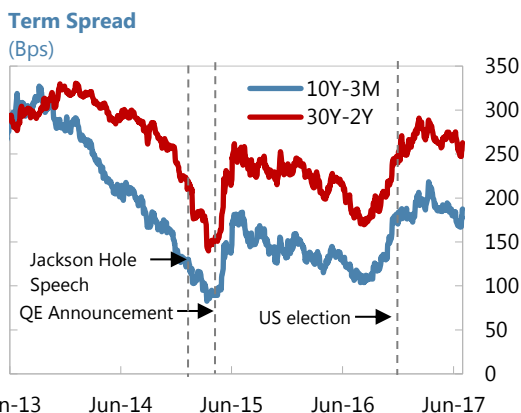
Since last December, the money market rate curve has steepened, pricing in expected future rate rises...



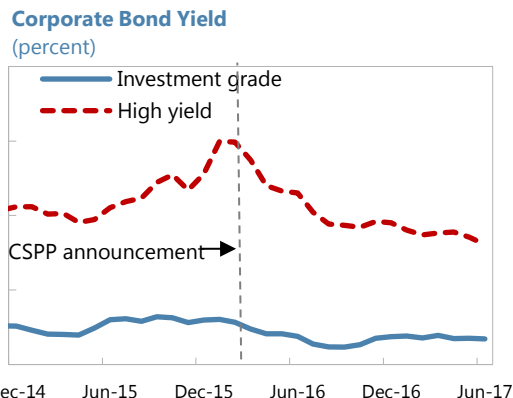
...while euro area sovereign bond yield curves remained broadly unchanged.



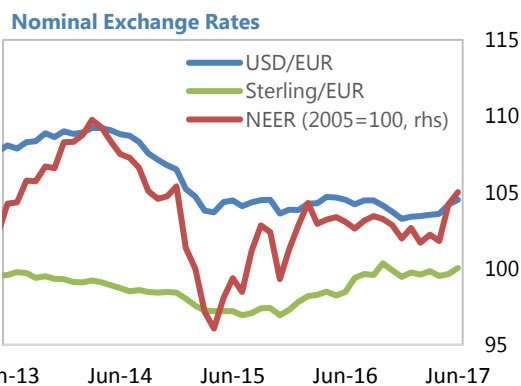
Term spreads have been climbing since last August.



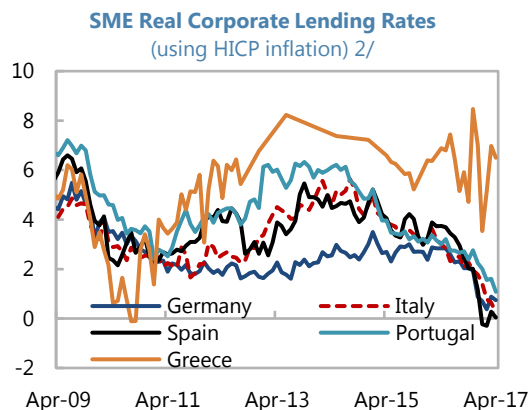
Yields are at historical lows, down significantly since the CSPP announcement.



The euro is now nearly 2 percent above the 2016 average in nominal effective terms, driven by appreciation against the pound, yen, and, to a lesser extent, the USD.



Corporate lending conditions have improved.



Sources: ECB; Bloomberg Financial LP; Haver Analytics; and Eurostat.

1/ A zero-coupon yield curve represents the yield to maturity of hypothetical zero-coupon bonds.

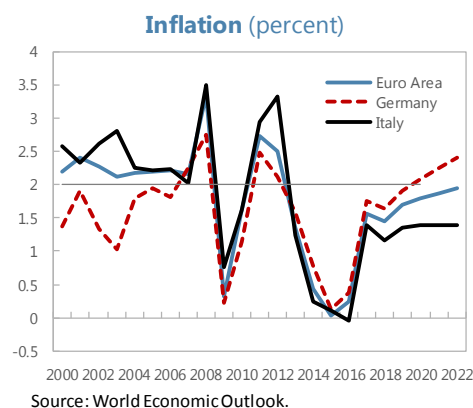
2/ MFI (new business) lending to corporations, under €1 million with maturity 1–5 years. Ex-post real rates using HICP.

- *Corporate bond issuance has picked up.* After the announcement of the corporate sector purchase program (CSPP) in March 2016, corporate issuance—in particular, among firms with investment grade—increased significantly (text figure). Yields, especially for high-yield corporates, have also declined markedly since then, albeit amid other compounding factors.
- *Bank lending volumes have improved and lending rates declined, with limited side-effects on bank profitability.* Bank Lending Surveys indicate that targeted longer-term refinancing operations (TLTROs) enabled participating banks to replace more costly sources of funding and extend the maturity of liabilities. While the full impact of the TLTROs is still unfolding, ECB studies suggest that they have supported higher lending volumes in less vulnerable countries and a slowdown of the contraction in bank lending in vulnerable countries. The *Survey on the Access to Finance of Enterprises (SAFE)* suggests that improvements in financing conditions were widespread across firm sizes and countries, including in SMEs. Bank profitability remains stable in the low interest rate environment as increasing lending volumes, lower wholesale funding costs, and revaluation gains on securities holdings offset compressed lending margins.

41. Subdued underlying inflation points to the need for monetary policy to remain strongly accommodative for an extended period.

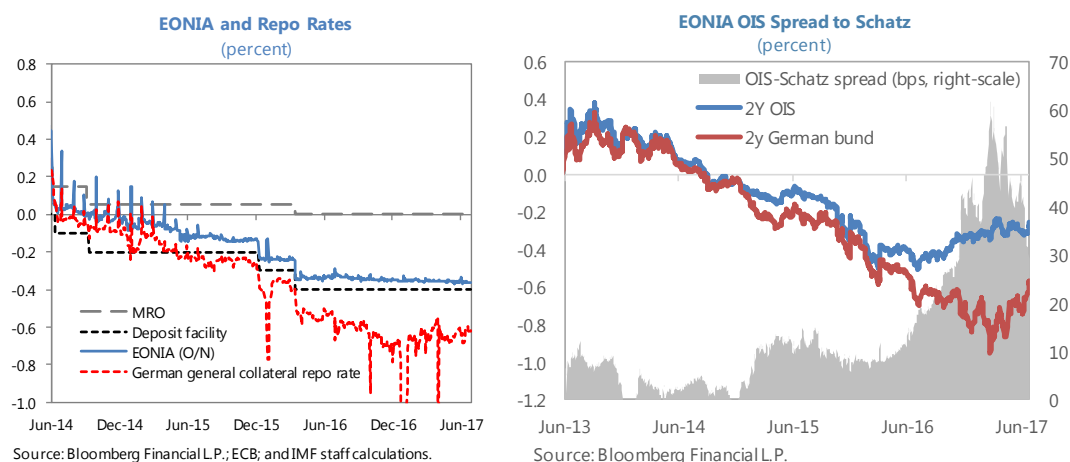
The costs of a long period of inflation undershooting continue to exceed those of a temporary overshoot. The calls from some quarters for an exit from monetary accommodation are therefore premature. Consistent with its public pronouncements, the ECB should look through transitory episodes of above-target inflation, focusing on its area-wide medium-term objective. The recent removal of the easing bias in the ECB's forward guidance on policy rates was warranted by the disappearance of deflation risk. However, any further

change in the forward guidance or policies should be underpinned by a clear shift in the path of actual inflation or a much stronger assessment of the inflation outlook. For a sustained recovery of euro area inflation, some countries must accept inflation above the ECB's "below, but close to, 2 percent" objective (text figure). In particular, in countries where the output gap is closed and wage growth is subdued, authorities could encourage faster wage and price growth in their public communication. As U.S. monetary policy continues to normalize, it will also be important to guard against unwarranted tightening of financial conditions in the euro area.



42. The Eurosystem should continue to address collateral scarcity. The gap between unsecured money market rates and German repo rates remains very wide, despite some recent narrowing, likely helped by the introduction of a cash collateral facility in December (text figure). Moreover, the two-year German bond (Schatz) yields have recently reached new lows, diverging from the Overnight Index Swap (OIS) rates (text figure). This could reflect several factors such as regulatory policies that made it more attractive to hold safe and liquid securities and the declining

issuance of German bonds, but was likely exacerbated by the ECB's removal of the deposit rate floor for the APP in December. Developing a common securities lending framework for national central banks—including by allowing for non-sovereign collateral, using standardized legal agreements, and harmonizing features like costs, maturity, haircuts, and roll-over capacity—would facilitate access to high-quality collateral and improve market functioning, thereby enhancing the effectiveness of asset purchases and monetary transmission.



Authorities' views

43. The ECB stressed its commitment to continued monetary accommodation. Viewing the current monetary stimulus as highly effective in supporting financial conditions and the recovery, it explained that asset purchases acted on the full yield curve while the negative deposit rate was especially potent in the short to medium segment. The latter segment was critical as a pricing benchmark for loans to non-financial corporations (NFCs). The mix of negative rates and asset purchases thus reduced borrowing costs for both NFCs and households, compressed risk premia across a wide range of asset classes, and encouraged portfolio rebalancing as illustrated by higher equity prices as well as lower bond yields. The compressing effect on bank profitability has so far been mitigated by valuation gains, improved asset quality, and higher lending volumes, yet could become more evident going forward.

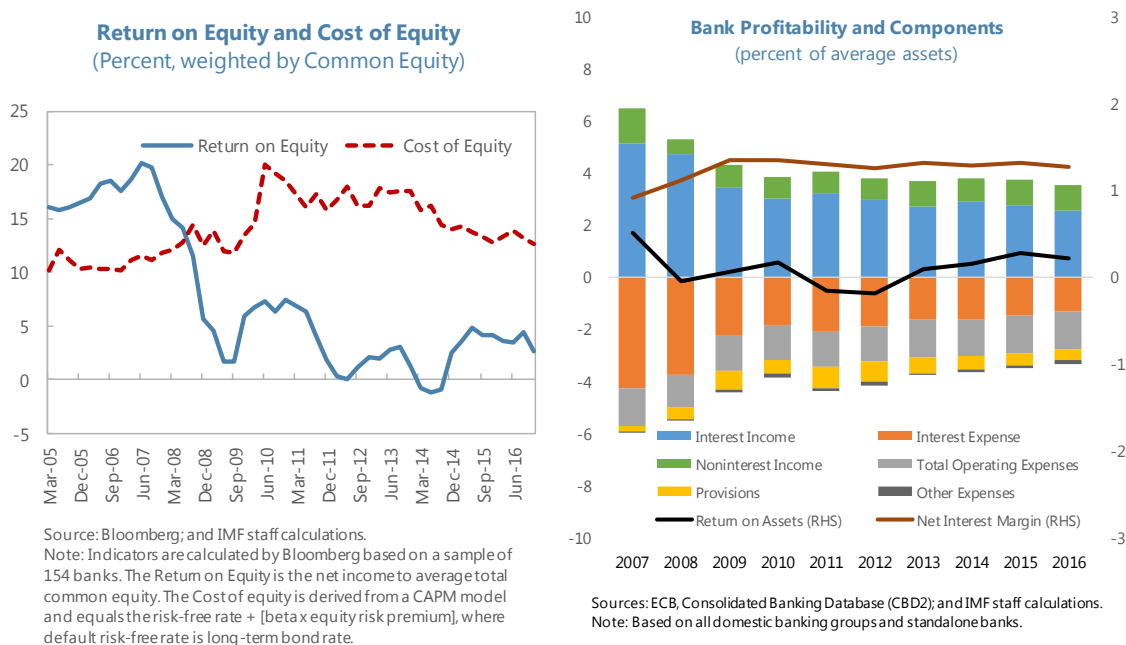
44. The ECB agreed on the need to maintain strongly monetary accommodation until there is a sustained adjustment in the path of inflation towards levels below but close to 2 percent. Its commitment to keep policy rates low for an extended period, well past the horizon of net asset purchases, is guided by inflation prospects, which, in turn, are influenced by the recovery in output. Wage growth has been subdued, likely reflecting the large remaining slack in the labor market.

45. The ECB concurred on the importance of an effective securities lending program across the Eurosystem to avoid collateral scarcity and ensure effective transmission. The cash collateral scheme introduced in December was well received by markets and has been used more extensively where collateral scarcity is most binding (such as in Germany). The ECB noted, however,

that securities lending programs are subject to the risk-management concerns of individual national central banks, as only part of the public sector purchase program (PSPP) is risk-shared.

D. Repairing Banks' Balance Sheets and Completing the Financial Architecture

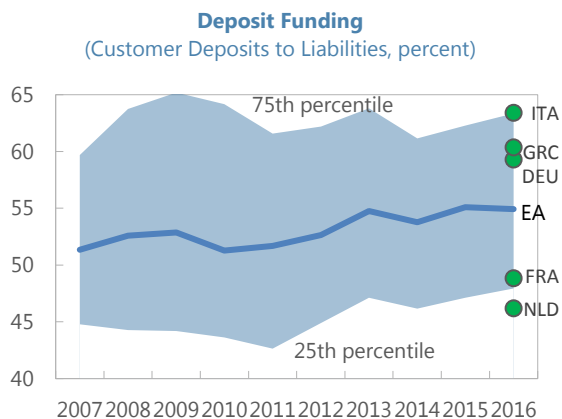
46. Bank funding conditions have improved, but profitability remains lackluster (Figure 7). Although revenues have fallen, they have been partly offset recently by lower funding costs, leaving net interest margin broadly flat. The sector's aggregate return-on-assets (ROA) remains above 2010 levels, bolstered by higher asset valuations and the ongoing recovery. However, costs-to-assets ratios remain stubbornly high. Medium-sized banks, in particular, still struggle to improve their ROAs. The overall low euro area ROA and a return on equity well below the cost of equity raise doubts about the sustainability of banks' business models and their ability to adapt to a stricter regulatory and supervisory environment alongside growing challenges posed by Fintech. Partly due to tougher regulatory limits on leverage, the economic recovery may not be enough to boost returns to meet investor expectations. Large banks reliant on market funding are incentivized to drop unprofitable business lines, reduce costs, and consolidate.¹⁴ By contrast, for banks supervised by the Single Supervisory Mechanism (SSM), almost half of their assets have ownership and governance structures with little exposure to market pressures and may require greater supervisory efforts to adapt and consolidate.



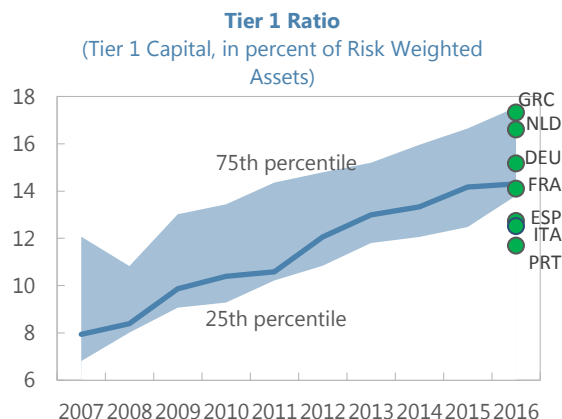
¹⁴ See Chapter 1, [April 2017 Global Financial Stability Report](#), for some related analysis.

Figure 7. Euro Area: Banking Sector Developments

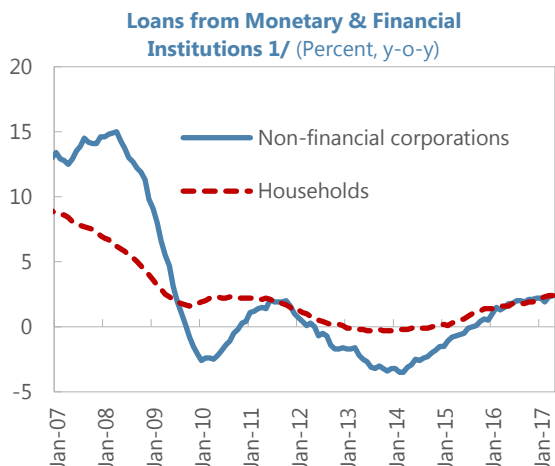
Banks gradually increased their dependence on more stable deposit funding...



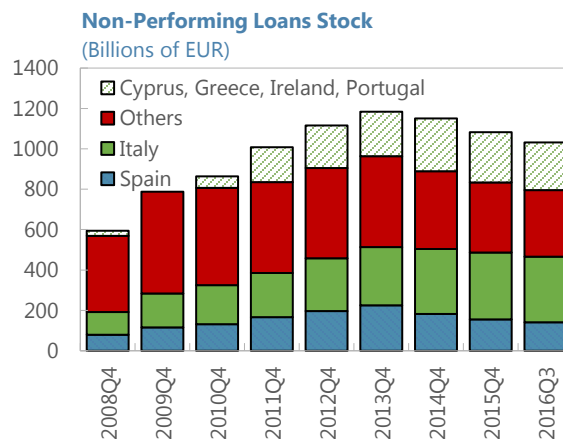
...while raising their capital buffers.



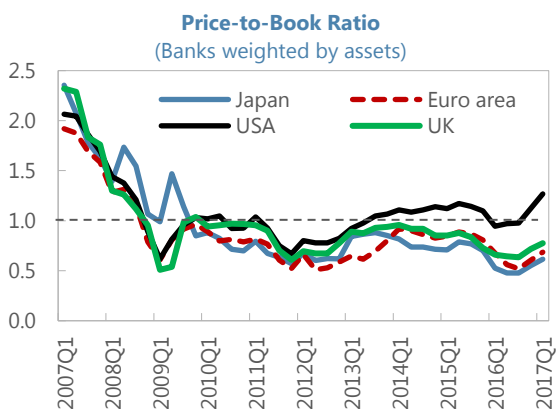
Banks' credit to the private sector is picking up...



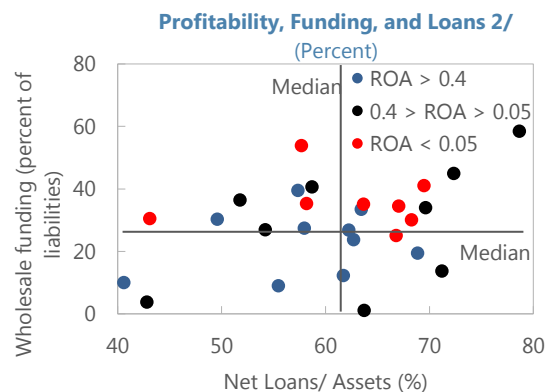
...but NPLs declined only slowly, remaining concentrated in a few countries.



Investors' concern about profitability have pushed banks' equity prices below their book values.



Profitability problems show little systematic relationship with banks' reliance on wholesale funding or business mix.



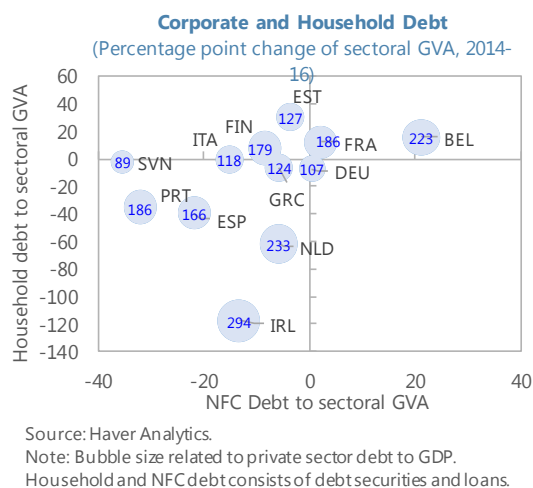
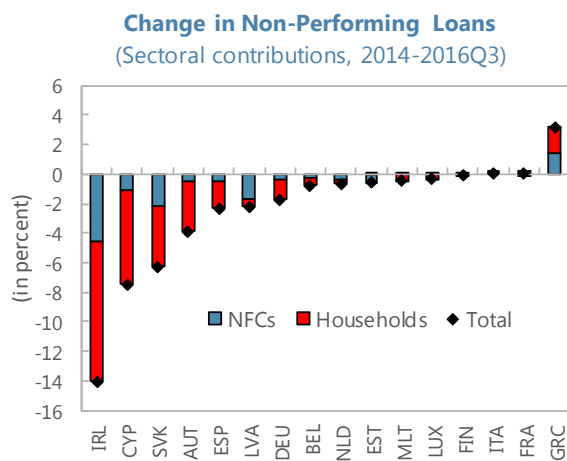
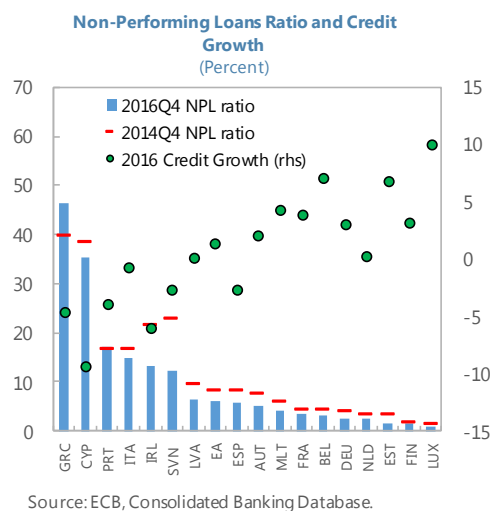
Sources: Bloomberg, LP; SNL; ECB, Consolidated Banking Data (CBD2); S&P Global Market Intelligence; and IMF staff calculations.

1/ Monetary financial institutions are: central banks, credit institutions, other deposit-taking corporations, and money market funds.

2/ Based on 28 banks.

47. High NPL stocks in some countries hinder adjustment and monetary transmission. Over

the last two years, NPLs in the euro area have been reduced by about €160 billion, but the stock remains high at about €1 trillion. More than 90 percent of the reduction in NPLs is accounted for by larger banks, and over 60 percent has occurred in Spain and Ireland. In Italy, which has the largest stock of NPLs, progress has been too slow, with NPLs falling by only about 5 percent relative to the 2015 peak level of €324 billion. Household debt has been the predominant component of NPL reductions, partly reflected in falling household indebtedness in some countries, although causality is hard to establish. Corporate debt accounts for a small share of the reduction, implying that corporate NPL stocks remain stubbornly high. Earlier staff analysis suggests that high corporate debt can lower the sensitivity of firms' investment to demand improvements.¹⁵



48. The ECB's new guidance on NPL management is a good step forward, but needs strong follow-up.

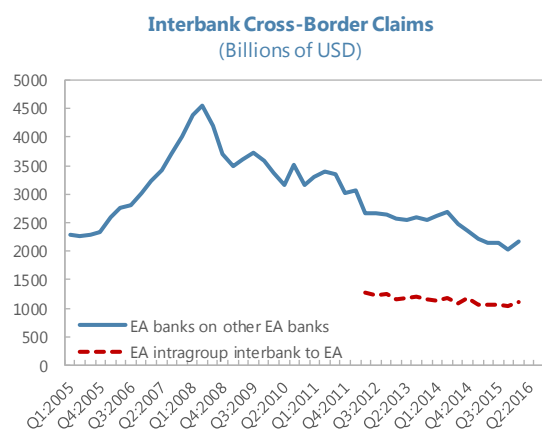
Ambitious reduction targets should be agreed, with vigorous supervisory follow-up. Moreover, member states should apply the framework, with due proportionality, to smaller banks that are not covered by the ECB guidance. Measures to modernize and harmonize foreclosure and corporate insolvency frameworks across member countries would help lift NPL values, by improving the efficiency of judicial processes and providing more certainty in defaults. The Mortgage Credit Directive and the proposals in the draft business insolvency directive are steps in the right direction.

¹⁵ See "Investment, Firm Size, and the Corporate Debt Burden: A Firm-Level Analysis of the Euro Area," Euro Area Policies, Selected Issues, IMF Country Report No. 16/220, July 2016.

Tackling NPLs efficaciously would also ameliorate the private sector debt overhang, which contributed to holding back the recovery in some countries.

49. In parallel, further development of secondary distressed debt markets would help avoid fire-sales, giving banks better chances to recover more value in disposals. An EU-wide NPL clearinghouse to facilitate information dissemination would be a useful initial step. International experience suggests that in several countries a publicly-supported asset management company (AMC) has helped develop the secondary market.¹⁶ In Europe however, such an AMC must be compliant with the state-aid framework and the Bank Recovery and Resolution Directive (BRRD). The European Banking Authority (EBA) has recently proposed a model for a pan-European AMC that it argues would be consistent with the institutional framework, providing a much-needed spur to the debate. The European institutions should now clarify which features of the proposal comply with EU rules and which need modification. Given heterogeneity in insolvency regimes and in distressed asset classes across countries, AMCs at the national level—guided by a “blueprint” established by the EC—are likely to be more useful than a pan-European AMC.

50. The banking union remains incomplete. Even as the important work of resolving problem assets and other crisis legacies presses forward, so too must the architecture. Despite the existence of a single bank supervisor, cross-border liquidity has been falling, not rising, within the euro area (text figure). Moreover, ring-fencing of intragroup bank capital and liquidity remains pervasive, contrary to the spirit of the banking union. Completing the banking union, by establishing a common deposit insurance scheme with a common fiscal backstop, would foster the free flow of liquidity and provide reassurance to supervisors that the bank-sovereign link is severed. To encourage a more uniform treatment of risks by banks, the authorities should push to finalize international standards ensuring the integrity of risk weights. Further integration would also be helped by corporate insolvency and foreclosure framework harmonization and a speedier implementation of the BRRD’s minimum requirement for own funds and eligible liabilities (MREL) and related resolution planning. It would also be useful to consider easing the preconditions for using the European Stability Mechanism’s Direct Recapitalization Instrument for systemically important banks under stress. Although it is not vested with AML/CFT powers, the ECB should continue cooperative efforts to ensure effective AML/CFT oversight, including regional harmonization of supervisory frameworks in line with international standards and possible memoranda of understanding with designated national authorities.



Source: BIS, Locational Banking Statistics; IMF staff calculations.

¹⁶ See “[A Strategy for Resolving Europe’s Problem Loans](#),” IMF Staff Discussion Notes 15/19, September 2015.

51. Systemic risks from insurance and pensions are low, but life insurers in some countries need to change their business models and consolidate to reduce vulnerabilities. The confluence of guaranteed products and interest rate duration mismatches on assets and liabilities create challenges in the low interest rate environment (Figure 8). While the shortfall in own funds to cover capital requirements appear manageable at the euro area level (at about a quarter percentage point of GDP, Figure 8), these are higher for some countries with high public debt. Moreover, the shortfall does not account for possible adverse feedback loops due to insurers' exposures to domestic banks and sovereigns in some countries.¹⁷ Insurers need to diversify and consolidate further to withstand an environment of persistently low interest rates.

52. Faster progress on the capital markets union (CMU) action plan would foster greater international private risk sharing, helping better insure against adverse country-specific shocks. Greater harmonization of financial regulatory and supervisory regimes, and improved access to non-bank financing sources such as venture capital, would provide greater investor certainty and diversify firms' funding options, boosting investment. There has been some forward momentum on the CMU, with the EU's adoption of simple, transparent, and standardized (STS) securitization to bolster banks' ability to provide credit, political agreement on a venture capital fund and regulation, and a revised prospectus regime to facilitate access to capital markets. However, improvements in other areas, such as securities ownership rules, and corporate insolvency proceedings, are pending. New action items added in light of the recent mid-term review of the CMU action plan, such as stronger supervisory powers for the European Securities and Markets Authority (ESMA), potential revisions to the prudential treatment of investment firms, and measures to encourage FinTech and sustainable finance, should further enhance the functioning of the Single Market. Completing the CMU action plan would improve the EU's resilience to shocks and facilitate the efficient allocation of capital.

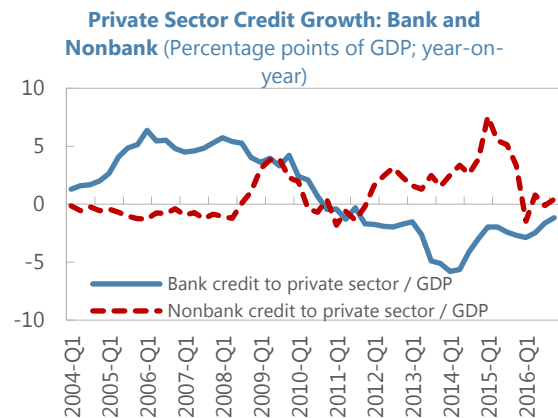
53. Brexit is likely to transform the financial landscape, with some market activity migrating to EU-27. With substantive discussions on the withdrawal agreement to start in June 2017, it is too early to evaluate the impact of Brexit. However, financial market institutions are likely to start adjusting well ahead of the actual separation. To the extent that a range of activities such as clearing and securities transactions migrates to the EU-27, transaction costs may rise during the transition, although the impact is likely to be modest. The EU will need to work on strengthening oversight and regulation to handle a greater volume of financial transactions and mitigate risks.

54. Credit and house price growth are moderate, but pockets of risks suggest that countries need greater flexibility in activating macroprudential tools in a timely manner. Although credit growth has picked up, credit gaps are negative in many countries. At the same time, overvalued residential and commercial real estate prices in a few countries suggest a potential need for the nimble application of macroprudential instruments (Figure 8). To ensure timely actions, the authorities should reduce the onerous process of notifications for increasing banks' risks weights on mortgages to curb housing-related macroprudential risks, which currently could go all the way to the European Council. For SSM countries, the notification and the decision-making process for ECB's top-up powers over capital-based tools, in general, require simplification.

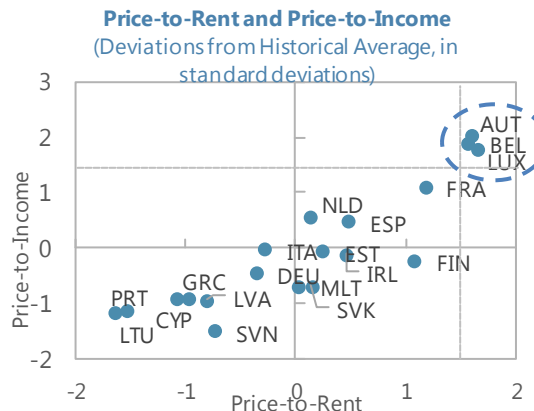
¹⁷ See Selected Issues Paper on "Financial Stability Risks from Euro Area Insurance and Pensions Sector."

Figure 8. Euro Area: Financial Stability

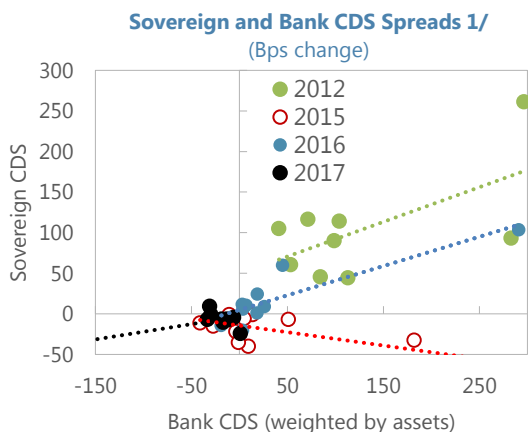
Overall credit is growing slower than GDP...



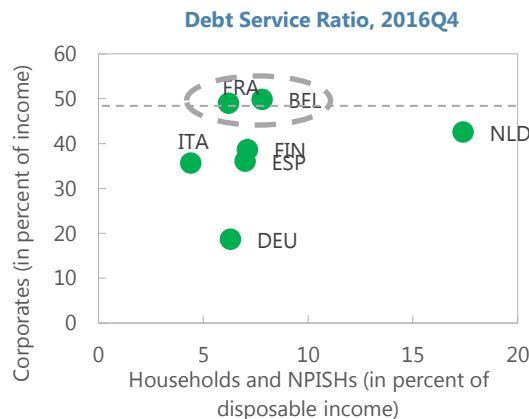
...and housing markets are overheating in only a few countries.



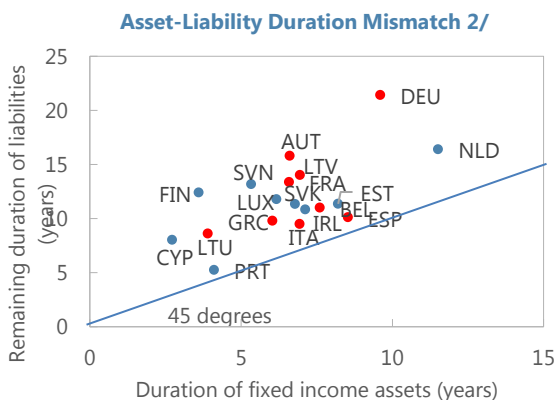
But sovereign-bank risk correlations are high again...



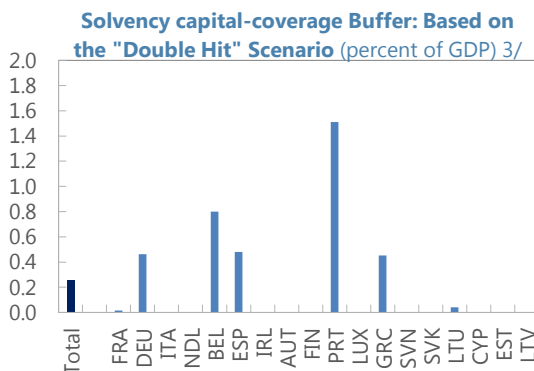
...and corporate debt service appears elevated in a couple of countries.



Although some large insurance sectors have substantial maturity mismatches amid the prevalence of guaranteed products...



...EIOPA's stress tests show that the buffer shortfall in the overall euro area insurance sector is small.



Sources: Bloomberg; Haver Analytics; Eurostat; ECB; EIOPA; IMF, October 2016 GFSR; OECD; and IMF staff calculations.

1/ The slope for 2017 is positive because PRT bank CDS declined 369 percent and sovereign CDS declined 75 percent.

2/ Red dots are related to the prevalence of guaranteed products.

3/ Countries shown in descending order of insurance sector size. This scenario combined rise in risk premia, low interest rates, and declines in equity and house prices.

Authorities' views

55. The authorities agreed that persistently low bank profitability is a pressing challenge, but noted that consolidation must be led by the private sector. Merger activity in the banking sector has been subdued in recent years, with almost no cross-border deals. The lack of activity is due to many factors, including the low-growth environment and problems with NPL valuations. More generally, the authorities indicated that differences in areas of national competence, such as taxation, labor laws, and mergers and approval processes, may provide some disincentives to consolidation. Recent EC proposals to codify loss-absorbing capacity and provide greater flexibility for intragroup waivers of capital and liquidity requirements within the banking union should resolve some of the regulatory uncertainty and encourage the treatment of the banking union as a unified jurisdiction. The EC proposal for a common consolidated corporate tax base should also help. However, the authorities acknowledged that it may be some time before the architecture of the banking union is complete. On the issue of NPLs specifically, the authorities remarked that a forthcoming report by the EU Council's Financial Services Committee (FSC) will provide some clarity on State Aid interactions and lay out several options to facilitate speedier NPL resolution.

56. Authorities are preparing for a substantial relocation of banking, asset management and clearing activities for EU-27 clients from the UK. Assuming a hard Brexit, London-based financial institutions are in touch with EU, euro area, and national authorities regarding licensing and locational choices. The provision of financial services to the EU-27 is probably not expected to shrink, but costs associated with activities hitherto conducted in the UK might increase moderately, including perhaps higher capital and margin requirements for banking and euro clearing activities, respectively. The SSM has clarified that all licensing decisions for banks in the euro area rest with them. The EC is also considering more centralized supervision for investment funds and clearing activities.

57. The authorities agreed that more flexibility was needed in activating macroprudential tools, even though country-specific systemic risks appeared moderate. Rapid growth in commercial real estate prices posed risks in a few countries but risk monitoring is hampered by lack of data. Moreover, the use of borrower-level tools such as limits on loan-to-value (LTV) ratios is based on national laws with varying activation procedures. The authorities also recognized the cumbersome rules on activating capital-based tools and suggested that the European Systemic Risk Board could be a single point of notification to ease confusion. For the insurance sector stress tests, shortfalls in own funds relative to capital requirements do not necessarily reflect solvency problems, but are mainly used by supervisors to assess business models. However, they agreed that the insurers could seek more diversity in their business models.

STAFF APPRAISAL

58. The increasingly broad-based euro area recovery presents an opportune backdrop to deepen integration. The dispersion of growth rates across countries is now at its lowest since euro introduction despite serious shocks such as Brexit, and pro-European political formations have been

ascendant. This confluence of a firming recovery and favorable political conditions should be used to renew a push to complete the architecture of the monetary union.

59. Risks to the forecast have become more balanced in the near term, yet remain tilted to the downside over a longer horizon, leaving no room for complacency. High-debt countries have few policy buffers against adverse shocks and are vulnerable to a rise in borrowing costs. An external slowdown, arising from higher global protectionism or a deceleration in growth elsewhere, could weigh on the recovery. Uncertainty surrounding the outcome of the Brexit negotiations and elections in some countries over the next several months could dampen consumption and investment.

60. Moreover, stagnant productivity is holding back medium-term growth prospects, and complicating the much-needed adjustment process within the monetary union. Countries with lower per capita GDP have experienced lower or stagnant productivity growth, inhibiting income convergence across euro area countries. At the same time, weak productivity growth relative to nominal wage growth in lagging countries has prevented sufficient adjustment in ULC. This has created disparities in competitiveness that have been reduced but not eliminated after the crisis.

61. The overall external position remains broadly in line with medium-term fundamentals, masking significant misalignments at the national level. The euro area current account surplus grew further despite a small real appreciation in 2016. In coming years, the current account is projected to come down, while remaining in surplus. Most net external debtor countries have had current account improvements. By contrast, some large net external creditor countries have failed to curb their large and persistent current account surpluses.

62. Countries should use the window provided by the cyclical recovery to undertake ambitious structural reforms that boost productivity. Reforms boost productivity more in countries with initial low productivity levels and can therefore help reduce productivity gaps and foster convergence. Faster productivity growth in lagging countries will also tend to reduce their ULC, narrowing competitiveness gaps. Ambitious structural reforms covering both labor and product markets are needed at the national level. At the EU-level, stricter enforcement of the Macroeconomic Imbalance Procedure could be combined with incentives for structural reforms in the form of targeted support from central funds and outcome-based benchmarks.

63. Fiscal policies should be tailored to country-specific circumstances. Fiscal space is unevenly distributed across countries, with the countries with larger output gaps constrained by high debt levels. Countries with fiscal space, such as Germany and the Netherlands, should use it to boost potential growth, while also encouraging healthier external rebalancing. High-debt countries with relatively less fiscal space, like Italy, France and Portugal, should consolidate to put debt firmly on a downward path and to rebuild buffers, taking advantage of the recovery and current accommodative monetary stance. All countries should continue to strive for a more growth-friendly mix of taxes and spending. The sum of staff's country-specific fiscal advice amounts to a broadly neutral euro area aggregate fiscal stance in 2018, which is appropriate in light of the ongoing recovery.

64. All countries must respect the SGP, even as the euro area should grasp the current political momentum to advance proposals for a common stabilization fund. Better compliance with the rules is essential to ensuring the credibility of the fiscal framework. Moreover, better adherence to the fiscal rules would build the political support and trust required to establish a CFC. A CFC, in turn, would then permit a more accommodative overall fiscal stance in a downturn, while supporting fiscal discipline in good times. Consideration should also be given to simplifying the fiscal framework and making enforcement more automatic.

65. Monetary policy should remain accommodative until there is a sustained upward adjustment of euro area-wide inflation. Subdued wage growth and low underlying inflation point to the need for monetary policy to remain accommodative for an extended period. No change to the ECB's forward guidance or policies should be made unless it is strongly backed by the performance of actual inflation or a firm assessment that the inflation outlook has improved. Countries with closed output gaps will need to accept inflation above the ECB's "below but close to 2 percent" objective for a prolonged period, to support the upward adjustment of area-wide average inflation. It will also help the real exchange rate adjustment needed to address competitiveness gaps within the euro area.

66. Further action is needed to address high NPL stocks in some countries as well as widespread low bank profitability. Profitability has improved as the recovery has taken hold, but it remains low, particularly in many medium- and small-sized banks. Banks need to restructure and consolidate, incentivized in part by an uncompromising approach to bank closure where necessary. The upcoming review of the BRRD should seek to iron out any impediments to bank resolution and liquidation. Regarding legacy assets, reforms of national insolvency frameworks must continue. At the same time, the EC could promulgate blueprints for national, public AMCs, which could stimulate distressed debt markets and speed up NPL disposals, while also providing some clarity on State Aid requirements.

67. Completing the banking union is necessary to build a unified banking system. While this important work presses forward, the resolution of problem assets and other crisis legacies must be seen through to completion—risk reduction and risk sharing advancing together. The ECB and national authorities should work to reduce ring-fencing of intragroup capital and liquidity, which runs counter to the spirit of the banking union. Combined with a common deposit insurance scheme and a common fiscal backstop, this would facilitate greater cross-border activity, and represent significant progress towards a true banking union.

68. The Brexit process is strengthening the imperative to build a capital markets union. With Europe's largest financial market leaving the single market, numerous activities could be transferring to the EU-27. Oversight and regulatory capacities should be strengthened concordantly.

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

Table 1. Euro Area: Main Economic Indicators, 2014–22

	2014	2015	2016	Projections 1/					
				2017	2018	2019	2020	2021	2022
Demand and Supply									
Real GDP	1.2	2.0	1.8	1.9	1.7	1.6	1.6	1.5	1.5
Private consumption	0.8	1.8	2.1	1.6	1.5	1.5	1.5	1.5	1.4
Public consumption	0.7	1.3	1.8	1.2	0.9	0.6	0.7	0.7	0.7
Gross fixed investment	1.6	3.2	3.7	3.1	2.9	2.7	2.5	2.4	2.3
Final domestic demand	0.9	2.0	2.4	1.8	1.7	1.6	1.6	1.5	1.5
Stockbuilding 2/	0.4	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0	0.0
Domestic Demand	1.3	1.9	2.2	1.9	1.7	1.6	1.6	1.5	1.5
Foreign balance 2/	0.0	0.2	-0.3	0.1	0.1	0.1	0.1	0.1	0.0
Exports 3/	4.4	6.2	3.0	4.1	4.0	4.0	3.9	3.8	3.8
Imports 3/	4.9	6.3	4.1	4.3	4.2	4.2	4.1	4.0	4.0
Resource Utilization									
Potential GDP	0.9	1.4	1.1	1.2	1.3	1.3	1.4	1.4	1.4
Output gap	-2.5	-2.0	-1.3	-0.7	-0.2	0.0	0.2	0.3	0.4
Employment	0.5	1.0	1.4	1.3	0.9	0.6	0.6	0.5	0.4
Unemployment rate 4/	11.6	10.9	10.0	9.2	8.8	8.5	8.2	8.0	7.8
Prices									
GDP deflator	0.9	1.2	0.8	1.0	1.3	1.5	1.6	1.6	1.7
Consumer prices	0.4	0.0	0.2	1.6	1.5	1.7	1.8	1.9	1.9
Public Finance 5/									
General government balance	-2.6	-2.1	-1.5	-1.4	-1.1	-0.6	-0.4	-0.2	-0.1
General government structural balance	-1.1	-0.9	-0.8	-1.0	-0.9	-0.6	-0.5	-0.4	-0.3
General government gross debt	94.4	92.5	91.4	90.0	88.5	86.4	84.0	81.7	79.3
External Sector 5/, 6/									
Current account balance	2.5	3.2	3.3	2.9	2.9	2.8	2.8	2.7	2.7
Interest Rates (end of period) 4/, 7/									
EURIBOR 3-month offered rate	0.1	-0.1	-0.3	-0.3	...	...	...	...	...
10-year government benchmark bond yield	1.5	1.2	1.3	1.2	...	...	...	...	...
Exchange Rates (end of period) 7/									
U.S. dollar per euro	1.23	1.09	1.05	1.1	...	...	...	...	...
Nominal effective rate (2005=100)	105.4	101.2	102.0	104.2	...	...	...	...	...
Real effective rate (2005=100, ULC based)	100.8	91.6	91.5	91.3	...	...	...	...	...

Sources: IMF, *World Economic Outlook*, Global Data Source; Reuters Group; 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/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.

7/ Latest monthly available data for 2017.

Table 2. Euro Area: External Sector Assessment

	Euro Area	Overall Assessment
Foreign asset and liability position and trajectory	<p>Background. The net international investment position (NIIP) of the euro area fell to about -18 percent of GDP by the end of 2008, but has since recovered, improving to around -6 percent in 2016. The rise has been driven by stronger current account balances and modest nominal GDP growth. Growth in both gross asset and liability positions remains low, but relatively steady after sharply slowing in 2008, coincident with the broader global slowdown in international financial flows. Gross positions are now about 237 percent of GDP for assets and 243 percent of GDP for liabilities in 2016.</p> <p>Assessment. Projections of continued current account surpluses suggest that the NIIP-to-GDP ratio will continue to improve at a moderate pace, with the euro area expected to become a net external creditor within the next few years, absent large differences in valuation changes on gross external assets versus liabilities. The region's overall NIIP financing vulnerabilities appear low. Despite improved current accounts, large net external debtor countries still bear a greater risk of a sudden stop of gross inflows.</p>	<p>Overall Assessment: <i>The external position of the euro area in 2016 was broadly in line with the level implied by medium-term fundamentals and desirable policies. In 2017, the current account surplus is projected to shrink very slightly as the region's economic recovery continues.</i></p> <p>Imbalances at the national level remain sizeable and progress in reducing them slow (see related pages for individual euro area member countries). Further adjustment is needed by net external creditors to strengthen domestic demand (reducing surpluses) and net external debtors to raise productivity and competitiveness (raising surpluses or lowering deficits). The euro area's external position may be affected by the UK's eventual exit from the EU and possible policy changes in the global policy mix, including in the United States. As their precise nature becomes clearer, these will be assessed in the context of future ESR reports.</p> <p>Potential policy responses: Continued monetary accommodation remains key to increase demand and lift inflation closer to the ECB's medium-term price stability objective, while facilitating relative price adjustments at the national level by enabling greater inflation differentials across monetary union members. Country-level efforts to address imbalances, including policies to strengthen private sector balance sheets, structural reforms to enhance productivity and improve competitiveness, and a more growth-friendly composition of national fiscal policies, must accompany region-wide measures. Countries with fiscal space should expand investment and promote structural reforms to raise their potential and reduce their current accounts, while those without it should continue consolidating to reduce their debt and increase their buffers, while undertaking desirable structural reforms. At the regional level, expanding centralized investment schemes would support such rebalancing. A more balanced policy mix with the implementation of priority institutional and structural reforms at the country level, would better boost domestic demand and rebuild policy buffers, helping to reduce external imbalances, including within the euro area.</p>
Current account	<p>Background. The current account (CA) balance for the euro area was higher at 3.3 percent of GDP (cyclically adjusted 2.9 percent) in 2016. Nearly all euro area countries are now running current account surpluses (apart from Belgium, Cyprus, Finland, France, Greece, and Lithuania). Although the drivers of the improvements differ across countries, lower commodity prices have provided a broad-based boost to euro area current accounts. Import compression in the immediate aftermath of the crisis and external competitiveness gains from price and wage adjustments have strengthened the current accounts of net external debtors, like Spain and Portugal. The continued growth of the surpluses of some large creditor countries, such as Germany and the Netherlands, reflect strong corporate and public saving and weak investment.</p> <p>Assessment. The EBA model estimates a CA gap of -0.2 percent of GDP for 2016, with a cyclically adjusted CA norm of 3.1 percent of GDP. The elevated norm reflects in particular demographics (population aging) and its impact on desirable saving. Underlying heterogeneity in the estimated gaps across countries largely offsets in aggregate, with positive estimated gaps in some countries (e.g., Germany, the Netherlands) roughly equaling total of the negative estimated gaps for other countries (e.g., France, Italy). Taking into account the uncertainties in model-based estimates and consistency with the euro area member country-level assessed CA gaps, staff assesses the euro area CA gap to be in the range of -0.5 to 1.0 percent of GDP for 2016, leaving the underlying CA broadly consistent with the level implied by medium-term fundamentals and desirable policies. 1/ 2/</p>	
Real exchange rate	<p>Background. The CPI-based real effective exchange rate appreciated by about 1.1 percent from 2015 to 2016, reflecting the gradual strengthening of the euro area's recovery. Weaker inflation in the euro area relative to its trading partners accounts for a real appreciation lower than the nominal appreciation of about 3.3 percent. As of May 2017, the REER is down by about 1.0 percent relative to its 2016 average level, essentially unwinding the 2016 appreciation.</p> <p>Assessment. The EBA index REER model points to an overvaluation of about 2.4 percent in 2016, while the level REER model suggests an undervaluation of about 4.5 percent. On balance, staff assesses the euro area 2016 average real exchange rate to have been broadly aligned, between an undervaluation of 5 percent and an overvaluation of 3 percent. As with the CA, the aggregate masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 10-20 percent in Germany to overvaluations of 5-20 percent in a number of small to mid-sized euro area member states. The large differences in REER gaps within the euro area highlight the continuing need for net debtor countries to improve their external competitiveness and for net creditor countries to boost domestic demand.</p>	
Capital and financial accounts: flows and policy measures	<p>Background. Mirroring the 2016 CA surplus, the euro area experienced net capital outflows, largely driven by portfolio debt and FDI outflows. These were somewhat tempered by inflows into portfolio equity and loans and other bank-related instruments. The geography of gross capital inflows shifted with the global financial and sovereign debt crises, with inflows from the core euro area economies into the rest of the euro area diminishing.</p> <p>Assessment. Capital outflows in portfolio debt and inflows into portfolio equity over the past couple years likely arose in large part from the ECB's monetary accommodation through its asset purchase program, which has lowered yields on debt and spurred interest in equity.</p>	
FX intervention and reserves level	<p>Background. The euro has the status of a global reserve currency.</p> <p>Assessment. Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.</p>	
Technical Background Notes	<p>1/ The IMF EBA analysis for the euro area covers 11 euro area members, which are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, and Spain. The assessments of CA and REER gaps for the euro area are derived from GDP-weighted averages of the assessments of the individual countries listed above, as well as from estimates for the euro area as a whole.</p> <p>2/ When applying GDP-weighted aggregation for the euro area, the CA is corrected for reporting discrepancies in intra-area transactions, as the CA of the entire euro area is about ½ percent of GDP less than the sum of the individual 11 countries' CA balances.</p>	

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

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Response
Retreat from cross-border integration.	High Protectionism and economic isolationism could reduce global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment and growth.	High <ul style="list-style-type: none"> Increased investor uncertainty, exacerbating low investment, weak productivity and undermining cyclical recovery. Lower growth due to trade barriers. Rise in euro skepticism, leading to less cooperation and a reversal of integration. 	<ul style="list-style-type: none"> Strong collaboration to ensure smooth and predictable transition to a new economic relationship between the U.K. and the EU. Continued support for trade liberalization and free-trade agreements. Re-double efforts to secure the benefits of economic integration and cooperation across the EU.
Policy and geopolitical uncertainties.	High Global spillovers from difficult-to-predict US policies, uncertainty regarding post-Brexit negotiations and elections in some European countries. Policy divergence with U.S. could lead to rising global imbalances, exacerbating exchange rate and capital flow volatility.		
Intensification of security dislocation could lead to sharp rise in migrant flows into Europe.	High Slow implementation of the modest. EU-level agreements on relocating refugees could deepen political divisions.	High <ul style="list-style-type: none"> Lack of refugee integration could raise unemployment, put pressure on national budgets and put social cohesion at risk. Border controls could restrict movement of goods, services and labor in the single market. 	<ul style="list-style-type: none"> Refugees should be rapidly integrated into host country labor markets. Temporary costs related to refugee expenditures should be accommodated within current fiscal targets on a case-by-case basis. A new system to relocate refugees is needed to reduce the burden on frontline countries.
Significant further strengthening of interest rates.	High Financial conditions could tighten as investors reassess policy fundamentals, term premia decompress, or if there is a more rapid Fed normalization.	High <ul style="list-style-type: none"> Highly indebted countries could face higher borrowing costs when the ECB normalizes monetary policy. Less favorable financial conditions in vulnerable countries when global financial conditions tighten. Loss of market confidence. Negative shocks to growth, worsening an already weak growth outlook. 	<ul style="list-style-type: none"> To build buffers against adverse shocks, structural reforms, balance sheet repair and fiscal consolidation is needed in high-debt countries. The ECB should stay the course on its asset purchase program and look through inflation movements and remain focused on its euro area-wide medium-term price stability objective.
European bank distress.	Medium Strained bank balance sheets amid weak profitability outlook could lead to financial distress in one or more major banks.	Medium Given slow progress in balance sheet repair in some countries and broader profitability concerns, such an event could reverberate through the entire financial sector and widen sovereign yield spreads within the banking union.	<ul style="list-style-type: none"> Supervisors should set ambitious targets for reducing the stock of impaired assets in identified banks. The ECB's new guidance on NPL management should be followed with strict supervisory monitoring of all banks. Insolvency reform, further development of distressed debt markets, cost-cutting, and banking system consolidation would facilitate the sector's adjustment. The Single Resolution Fund (SRF) needs a common fiscal backstop.
Euro area insurance sector stress from low interest rates.	Low Stress on life insurer balance sheets due to investment returns falling below minimum return guarantees.	Low Absent a unified supervisory or resolution regime, the failure of a number of mid-size insurers could be a funding risk for domestic sovereigns in some countries.	<ul style="list-style-type: none"> Restrict use of new guarantee-based products, review rates on existing products, and transition to unit-linked instruments, review business models or consolidate through M&As. Some insurers may need additional capital based on EONIA stress tests. Transition to Solvency II framework requires periodic review and regular system-wide stress testing.
Structurally weak growth in key advanced economies relative to baseline.	High Low productivity growth, a failure to fully address crisis legacies and undertake structural reforms, as well as persistently low inflation undermines medium-term growth.	High <ul style="list-style-type: none"> Lower growth potential and higher output gaps compared to baseline due to weaker investment and persistent long-term unemployment. Further deterioration in public debt sustainability, private balance sheets, intra-euro area rebalancing. 	<ul style="list-style-type: none"> Accelerate structural reforms to spur investment, productivity and competitiveness, advance rebalancing. r bank, corporate, and household balance sheets to enhance monetary transmission. Use fiscal space within SGP framework and fiscal rebalancing to support demand and promote structural reforms. In an adverse scenario, invoke systemic escape clause in SGP to provide near-term demand support while strengthening medium-term fiscal commitments. Continue accommodative monetary policy to raise inflation and support demand.
Significant slowdown in China and other large emerging market economies.	Low-Medium Turning of domestic credit cycle in addition to lower potential growth leads to disruptive deleveraging (Medium). In China, disruptive drying up of interbank liquidity for weak borrowers (Low).	Medium <ul style="list-style-type: none"> Slower export growth, higher output gap. Lower growth and inflation weakens public debt sustainability and private balance sheets. 	

¹ The Risk Assessment Matrix shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. ("Low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more.)

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

	Reform Priorities	Recent Progress	Staff Recommendations
France	<p>Reform government spending to reach medium-term fiscal objective.</p> <p>Improve labor market functioning to reabsorb the unemployed, especially among the young and low skilled.</p> <p>Increase competition in service sectors with high economic impact.</p> <p>Pursue business-friendly policies.</p>	<ul style="list-style-type: none"> • Pension reform in 2014–15 (higher rates, longer contribution period for full pension, supplementary pension); targeted expenditure reviews; social security contributions cuts. • Tax credit (CICE) on firms' payroll on wages below 2.5* minimum wage progressively introduced from 2013–14 and increased in 2017; flexibility on hours and pay for firms in difficulties or under special circumstances; subsidized jobs for young and low skilled; reform of union representation and streamlining mandatory discussions between social partners (Rebsamen law); increased scope for company-level labor agreements and employment protection agreements (El Khomri law). • Reduced judicial uncertainty around individual dismissals through reform of the prud'hommes system (Macron law); liberalization of legal professions, coach transport, retail trade opening hours; expansion of Competition Authority competencies (Macron law). 	<ul style="list-style-type: none"> • Limit general government spending growth to inflation, with burden sharing mechanism. At all levels of government, institutionalize broad spending reviews to improve efficiency and reverse public employment growth. Further raise the effective retirement age and streamline special pension regimes. Tighten caps on local taxes and borrowing, and eliminate "universal competency" clause for municipalities. Improve the targeting of professional training. Alleviate affordable housing supply constraints and improve targeting of benefits. • Improve targeting of social benefits. Tighten eligibility for unemployment benefits and job search requirements for unemployment and welfare benefit recipients. Change the minimum wage formula to limit indexation to inflation. • Further reduce disincentives for SMEs to grow above certain employee thresholds. Enhance effectiveness of Business Simplification process. Align regulated savings rates to market rates and review tax incentives for savings and insurance products.
Germany	<p>Increase labor force participation of women, older workers, and refugees, and facilitate immigration of qualified workers.</p> <p>Increase productivity and competition, especially in the services sector.</p>	<ul style="list-style-type: none"> • Progress in extending child care provision (stepped up federal financial support for municipalities to this end). A 2016 law reduces financial disincentives to work after pensionable age. Several measures taken in 2015–16 to broaden access to training and active employment services to refugees and asylum seekers. • Action plan on professional regulations submitted to the EC in January 2016. Modifications to regulations regarding the practice (not access) of a few professions announced or being considered. • Federal measures to improve the environment for venture capital and startups were adopted in 2015. A December 2016 law allows more corporations to deduct past tax losses following a change in shareholders from taxable income. • The Act to Strengthen Competition in the Railway Sector was passed in August 2016. 	<ul style="list-style-type: none"> • Lower the tax wedge, in particular for the low skilled and women. • Improve the provision of child care. • Increase retirement ages. • Facilitate labor market integration of low-skilled migrants. • Further deregulate professional services. • Strengthen the regulator's powers to stop discrimination against the incumbent operators' competitors in railways and postal services. • Continue policy focus on innovation and the digital economy, and reduce administrative uncertainties surrounding venture capital.
Greece	<p>Preserve and further expand labor market flexibility.</p> <p>Foster competition in service and product markets.</p> <p>Improve the business environment.</p>	<ul style="list-style-type: none"> • The 2011 collective bargaining reform was effectively reversed, raising risks to competitiveness. Reform of the collective dismissal framework, eliminating ex-ante approval of dismissals, was legislated. • Restrictions on dockworkers (stevedores) were removed. Initial steps to remove geographical and other restrictions on the engineering profession have been taken. • Some reforms completed, such as OTC trade of pharmaceuticals and liberalization of Sunday trade. But the Sunday trade reform falls short of OECD recommendations due to Constitutional constraints. Several issues remain pending regarding other reforms (in construction, media, etc.) • Pilot investment notification system in three sectors has been launched, but other aspects of the reform (e.g., regulation of inspections) and the expansion of the system to other sectors remains to be completed by mid-2018. 	<ul style="list-style-type: none"> • Preserve recent labor market reforms, including collective bargaining reforms. Adopt legislative changes to align framework on collective dismissals and industrial actions with EU best practices. • Significantly accelerate the opening up of regulated professions, prioritizing macro-critical professions (e.g., engineers, lawyers, notaries). • Implement pending OECD recommendations to reduce barriers to competition (including Sunday trading over-the-counter trade of pharmaceuticals). • Accelerate the overhaul of the investment licensing system in line with international best practice, moving towards a notification system with ex-post verifications and inspections.

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

	Reform Priorities	Recent Progress	Staff Recommendations
Italy	<p>Increase competition in product and services markets.</p> <p>Raise public sector efficiency.</p> <p>Labor market reform.</p> <p>Civil justice and insolvency reform.</p>	<ul style="list-style-type: none"> • The draft Annual Competition Law (to address regulatory barriers to entry and competition) presented to parliament in 2015, remains under discussion. Some of the draft's provisions have been weakened. • The implementing decrees on public administration reform have been issued, but some critical reforms (e.g., rationalizing local public enterprises, liberalizing local public service provisions, and accountability of senior managers) have been weakened or stalled. • The 2014 Jobs Act overhauled the labor market, reduced duality by introducing a new standard employment contract with protection increasing with tenure, expanded the social safety net and plans to strengthen active labor market policies (ALMPs). Progress is uneven (e.g., delays in ALMPs) and some elements of the reform (e.g., voucher scheme for irregular work) have recently been removed (January 2017). • Recent reforms include: out-of-court mechanisms to enforce secured credit over immovable assets in commercial loans; flexible forms of non-possessory security interests over enterprise assets; and a national registry for insolvency and enforcement procedures. More adequate filters for appeals to the Supreme Court were also introduced (2016). 	<ul style="list-style-type: none"> • Strengthen the annual competition law in line with the recommendations of the competition authority. Ensure annual process of adopting pro-competition laws. Enhance competition including in local public service provision, transport, legal and professional services, and fully implement existing legislation (e.g., retail sector). Enhance the independent role of the competition authority to expedite deregulation. • Bold and comprehensive implementation, as well as constant monitoring of public administration reform to lower the cost of doing business. Improve the public sector skill mix, match positions with skills, align wages with productivity, and reduce high public-private wage premiums. Fully rationalize procurement, consolidate local service enterprises and tackle privileges and employment in public enterprises, including through privatization. • Align wages with productivity at the firm level, thereby also reducing regional disparities in labor outcomes by giving clear primacy to firm-level contracts and introducing a (possibly differentiated) minimum wage across regions. Implement the remaining aspects of the Jobs Act (e.g., ALMPs) and extend the new contract to all open-ended contracts in the private sector. • Promote intensive use of out-of-court debt restructuring. Further improve the efficiency of civil justice: strengthen enterprise courts, translate the specialization afforded by the enterprise courts into more efficient commercial justice (corporate litigation and insolvency). Continue civil procedure reforms to simplify and reduce enforcement time for secured and unsecured claims. Reinforce resources of courts and extend best practices in court management across the country.
Portugal	<p>Alleviate impediments to external competitiveness and potential growth.</p> <p>Continue to improve the functioning of labor and product markets.</p>	<ul style="list-style-type: none"> • Public transport concessions have been halted and the privatization of the national airline TAP to retain a 50 percent stake has been renegotiated. • A one-time levy on GALP, the largest natural gas provider, was imposed and paid in May 2015, lowering gas prices for end users by an estimated 7–12 percent in the next three years. • A new Budgetary Framework Law was adopted in 2015, including measures to reduce budget fragmentation and improve transparency through better fiscal reporting, but implementation is delayed. • The authorities' National Reform Program for 2017–21 focuses on the modernization of the public sector, 	<ul style="list-style-type: none"> • Revisit reforms that have not yielded expected results, fully implement already initiated reforms, and address remaining bottlenecks through fresh reforms. • Preserve recent labor market reforms. Promote managerial skills; more inclusive labor support systems; link minimum wage increases to productivity growth and use alternative policies to fight poverty; reduce duality by making permanent contracts more flexible. • Upgrade the quality of public services and policies, raise effectiveness of public administration at all levels, and increase the payment discipline of public sector entities.

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

	Reform Priorities	Recent Progress	Staff Recommendations
	Improve the efficiency of the judicial sector.	<p>including simplification of administrative and licensing procedures for enterprises. It also seeks to expand programs providing mid-career and managerial training in an effort to improve the comparatively low skill level of the labor force.</p> <ul style="list-style-type: none"> • There is a large discrepancy between official data showing more efficient resolution of enforcement and insolvency cases in recent years, and anecdotal evidence suggesting that frequent delays and low pay-outs remain a persistent problem. 	<ul style="list-style-type: none"> • Continue reducing energy costs and make no new investments in energy infrastructure until energy sector debt is paid off. Strengthen market integration at the European level. • Commission an in-depth survey on the efficiency of the judicial system by an outside firm to develop an accurate assessment of the reality on the ground and propose next steps.
Spain	<p>Address labor market duality. Reduce high structural unemployment (long-term unemployed and unskilled youth).</p> <p>Boost productivity particularly for SMEs.</p> <p>Facilitate further private sector deleveraging and further strengthen SMEs access to finance.</p>	<ul style="list-style-type: none"> • Wage moderation continued. The 2012 labor reform reduced severance payments and eased the use of fair dismissals (though gaps between dismissal costs for permanent and temporary contracts persist), and, facilitated firm-level agreements (though administrative obstacles hamper the use of opt outs). Progress toward raising the effectiveness of Active Labor Market Policies has been slow. • The implementation of the Market Unity Law is ongoing, but regional differences in regulatory norms and practices remain. Several size-dependent tax incentives were eliminated with the 2015 CIT reform, but no actions have been taken to liberalize professional services or reduce non-tax size-related disincentives. • Efforts to increase market-based SME financing are also continuing. • The “fresh start” reform has been implemented but additional efforts are needed to ensure the new system’s efficacy. 	<ul style="list-style-type: none"> • Ensure wage growth in line with productivity and external competitiveness, allowing differentiation across firms and sectors; ensure the use of firm-level wage bargaining and opt outs, particularly by small firms; close the protection gap between temporary and permanent contracts. Reduce legal and administrative uncertainties in collective dismissals and streamline the application of objective criteria for fair dismissals. Enhance the effectiveness of ALMPs. • Foster competition by swiftly implementing the Market Unity Law and liberalizing professional services, identify, assess and eliminate all unwarranted size-related obstacles to growth and support internationalization and innovation. • Further strengthen SMEs access to finance by enhancing market-based financing, accuracy of financial reporting and transparency, by direct financing and guarantees for new firms through ICO, including European efforts. • Ensure a fuller use of the enhanced insolvency regime to further facilitate private-sector deleveraging.

Source: IMF country teams.

Table 5. Euro Area: A Scorecard Approach to the Near-Term Fiscal Stance

	1 - Cyclical Conditions				2 - Sustainability Indicators					3 - Fiscal Stance					
	Output gap	Output gap Change	Unemployment	Real GDP growth	Debt sustainability		10-year bund spreads	Fiscal balances			Change in Overall Structural Balance			Deviation from MTO 8/	Debt rule triggered? 7/
					stock	flow		Overall	Structural	Under EDP?	WEO baseline	IMF advice 5/	EC recom. 6/		
	%	%	%	%	% GDP	% GDP	bp	% GDP	% pot. GDP		% pot. GDP	% pot. GDP	% pot. GDP	2016	2016
2016	2016-17	2016	2016	2016	2016	2016	2016	2016	2016	2016	2016-17	2016-17	2016-17	2016	2016
Euro area	-1.3	0.7	10.0	1.8	91	2.2	...	-1.5	-0.8		-0.3				
Germany	0.3	0.4	4.2	1.8	68	3.3	...	0.8	0.7	No	-0.6	-1.1	...	1.2	No
France	-2.2	0.4	10.0	1.2	96	1.2	31.8	-3.4	-1.9	Yes	-0.1	0.5 3/	0.8	-1.5	No
Italy	-2.7	1.0	11.7	0.9	133	1.9	133.6	-2.4	-1.1	No	-0.2	0.5	0.6	-1.1	No
Spain	-2.3	1.7	19.6	3.2	99	0.2	124.3	-4.5	-3.0	Yes	0.3	0.5 4/	0.5	-3.0	No
Netherlands	-0.9	0.5	5.9	2.2	62	2.8	14.3	0.4	0.7	No	-0.1	-0.5	0.6	1.2	No
Belgium	-0.4	0.3	7.9	1.2	106	1.6	33.4	-2.6	-2.3	No	0.4	0.5	0.6	-2.3	No
Austria	-0.9	0.6	6.0	1.5	85	2.2	22.7	-1.6	-1.0	No	0.2	0.0	0.3	-0.5	No
Finland	-1.5	0.8	8.8	1.5	63	1.5	21.5	-1.9	-0.9	No	-0.5	-0.4	0.6	-0.4	No
Ireland	0.7	0.3	7.9	5.2	76	2.6	53.8	-0.6	-1.1	No	0.2	0.3	0.6	-0.6	No
Portugal	-2.7	1.9	11.1	1.4	130	2.5	305.0	-2.0	-1.1	Yes	-0.3	0.5	0.60	-1.4	No
Luxembourg	0.5	-0.1	6.4	4.2	20	2.3	10.6	1.6	1.2	No	-1.2	-0.5	...	1.7	No
Greece	-5.4	1.4	23.6	0.0	182	...	821.0	0.8	...	...	...	...	...	...	No
Estonia	-1.0	0.5	6.9	1.6	9	1.5	...	0.3	0.9	No	-0.4	-0.4	...	0.9	No
Latvia	-0.5	0.3	9.6	2.0	37	1.7	38.4	-0.4	-0.2	No	-0.5	0.0	...	0.3	No
Lithuania	-0.8	0.3	7.9	2.3	40	1.7	74.8	0.3	0.6	No	-0.7	0.0	...	1.6	No
Cyprus	-3.3	1.5	12.9	2.8	108	4.9	362.3	-0.3	1.2	No	-1.0	-0.2	...	1.2	No
Malta	1.4	-0.5	4.7	5.0	58	3.8	73.6	1.0	0.5	No	-0.4	0.3	0.6	0.5	No
Slovak Republic	-0.2	0.2	9.7	3.3	52	1.6	39.3	-1.7	-1.6	No	0.3	0.0	0.5	-1.1	No
Slovenia	-1.2	1.8	8.0	2.5	80	1.7	99.9	-1.8	-1.3	No	0.2	0.8	0.6	-1.3	No
Memo															
US	-0.4	0.3	4.9	1.6	107	...	169.2	-4.4	-3.8	...	0.1	...	...	...	...
Thresholds 2/															
Strong tighten	Above 3	Above 1	Below 3	Above 3	Above 100	Below -3	Above 100	Below -3	Below -1		Above 1	Above 1	Above 1	Below -1	
Modest tighten	1 to 3	0.5-1	3 to 5	2-3	90-100	-1 to -3	80-100	-1 to -3	-0.5 to -1		0.5-1	0.5-1	0.5-1	-0.5 to -1	
Neutral	+/-1	+/- 0.5	5-7	1-2	80-90	+/-1	40-80	+/-1	+/-0.5		+/- 0.5	+/- 0.5	0-0.5	+/-0.5	
Modest stimulus	-1 to -3	-0.5 to -1	7 to 10	-1 to 1	70-80	1 to 3	20-40	1 to 3	0.5 to 1		-0.5 to -1	-0.5 to -1		0.5 to 1	
Strong stimulus	Below -3	Below -1	Above 10	Below -1	Below 70	Above 3	Below 20	Above 3	Above 1		Below -1	Below -1		Above 1	

Sources: Haver Analytics; WEO.

1/ Primary gap is P-P*, where P is the structural primary balance as % pot. GDP in 2016 and P* is the debt stabilizing primary balance in the medium term defined as (r-g)*d, where d is for 2015 and (r-g) is for 2021.

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

3/ Enough to exit EDP in 2017.

4/ Enough to exit EDP in 2018. Spain's IMF advice is in terms of the change in the structural primary balance.

5/ Source: EUR desks.

6/ Source: EC Spring 2016 Country-Specific Recommendations (CSR) for 2017. "..." indicates no specific value provided for the fiscal adjustment CSR.

7/ The SGP's debt reduction rule requires an annual debt/GDP ratio reduction of at least 1/20 of the difference from the 60 percent target if the debt ratio > 60. For countries with EDPs opened before December 2011, a transitional debt rule applies for 3 years after exiting the EDP.

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

Appendix I. Progress Against IMF Recommendations

Policies	2016 Article IV Policy Advice	Actions since 2016 Article IV
Structural Policies	Accelerate the implementation of structural reforms at the country level, to raise potential growth and narrow imbalances.	Compliance with the 2016 Country-Specific Recommendations (CSR) under the European Semester has been patchy. See Table 4 for country-specific information on reform progress.
	A stronger governance framework, with CSRs linked to outcome-based benchmarks, could better incentivize reforms.	While considering progress toward correcting imbalances identified in the 2016 CSRs, the EC has once again used its discretionary powers to not to open the excessive imbalances procedure in several cases. Some progress on benchmarking.
	At the regional level, further improvements to insolvency regimes; a greater push toward a single market in services, capital, transport, energy, and the digital economy; and ambitious free trade agreements would boost competitiveness and productivity.	Some progress in implementing the 2015 Single Market strategy on services but other initiatives under discussion. Some initiatives, such as legislation to remove geo-blocking, are quite advanced, but other initiatives such as the European Services e-card and minimum standards for corporate debt restructuring and insolvency, could face protracted negotiations. The Comprehensive Economic and Trade Agreement (CETA) was signed in 2016, but prospects for the Transatlantic Trade and Investment Partnership (TTIP) agreement have dimmed.
Fiscal Policies	Countries with fiscal space should use it to promote public investment and structural reforms, while high-debt countries should use interest savings from QE to reduce debt.	Policy actions have been mixed. Some countries with fiscal space are easing their fiscal stance while others tighten. Some high-debt countries have made progress on fiscal adjustment, while others did not.
	Centrally financed investment schemes could provide additional fiscal support. The European Fund for Strategic Investment (EFSI) could be enlarged.	The EC has proposed to expand the EFSI by around €200 billion and extend it to 2020. No progress has been made on developing other centrally financed investment schemes to provide additional fiscal support.
	Stricter adherence to the fiscal rules is critical for rebuilding trust in the fiscal framework and backing more centralized initiatives. This could be supported by simplifying the fiscal rules, making the enforcement more automatic, and establishing an independent European Fiscal Board.	Compliance with the fiscal rules has been weak and enforcement has become increasingly discretionary, as exemplified by the lack of quantitative targets in CSRs. There are currently no proposals to reform the fiscal rules, though the European Fiscal Board has been established and begun operations.
Monetary Policies	If the inflation outlook deteriorates or fails to converge more quickly to the anticipated adjustment path, further easing would be warranted, primarily from expanding asset purchases.	In December 2016, the ECB extended the asset purchase program (APP) to end-2017 (from March 2017), or beyond, if necessary, and in any case until a sustained adjustment in the inflation path is achieved. The monthly net asset purchases between April and December 2017 were set at €60 billion (down from €80 billion).

Policies	2016 Article IV Policy Advice	Actions since 2016 Article IV
		To facilitate a continued smooth implementation, parameters of the APP were adjusted as of January. First, the maturity range of the public sector purchase program (PSPP) was broadened by decreasing the minimum remaining maturity for eligible securities for two years to one year. Second, purchases of securities under the APP with a yield to maturity below the interest rate on the ECB's deposit facility was permitted to the extent necessary.
	Developing a common securities-lending framework for national central banks would facilitate access to high-quality collateral, thereby improving market functioning and enhancing the effectiveness of monetary policy.	In December 2016, the ECB introduced cash collateral in the PSPP securities lending. The overall limit for securities lending against cash collateral was set at €50 billion for the Eurosystem. The cash collateral option will be offered at a rate equal to the lower of the rate of the deposit facility minus 30 basis points and the prevailing market repo rate.
Financial Policies	A comprehensive approach to accelerating NPL resolutions is needed. The SSM should incentivize faster resolution through stricter supervision. Corporate insolvency and foreclosure frameworks should be strengthened and harmonized. Active markets in distressed assets should be promoted, including through AMCs.	The SSM issued new guidance on NPLs, harmonizing and strengthening supervisory oversight of banks with large NPL stocks. The EC advanced a proposal to harmonize some aspects of corporate insolvency and restructuring frameworks across member states. Discussions on ways to further develop distressed debt markets are ongoing, with proposed options including an EU-wide NPL clearinghouse, national AMC blueprints, and a pan-European AMC (put forward by EBA).
	Common deposit insurance and a common fiscal backstop are essential to completing the banking union. Greater risk-sharing should proceed hand-in-hand with measures to reduce banking sector risks.	There has been little progress on the banking union's third pillar and a common fiscal backstop. However, proposals to reduce banking sector risks and further harmonize have advanced, including the adoption of the leverage and net stable funding ratios as binding requirements, a minimum, harmonized requirement for bail-inable liabilities, and a more harmonized bank creditor hierarchy.
	Faster progress on capital markets union (CMU) would spur greater private risk-sharing and non-bank financing alternatives.	The EU has adopted a framework for simple, transparent, and standardized securitization and there is political agreement on a venture capital fund and regulation, and a revised prospectus regime to facilitate access to capital markets. However, improvements in other areas, such as securities ownership rules, and corporate insolvency proceedings, are pending. In the mid-term review of the CMU action plan, the EC presented new initiatives, including to strengthen the supervision of integrated capital markets.

Appendix II. Statistical Issues¹

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

1. **Transition to the new international statistical standards is largely complete and enhancements continue.**³ All member states compile national accounts according to the new European System of National and Regional Accounts (ESA 2010) and external statistics according to the sixth edition of the IMF's *Balance of Payments and International Investment Position Manual (BPM6)*. Eurostat and the ECB continued working closely with all stakeholders on enhancing these statistics and on extending the availability of historical series. Most countries requested derogations in some areas up to 2020. A review of the derogations will take place in 2018.
2. **Eurostat and the ECB continued working in 2016 on the 20 recommendations of the second phase of the G20 Data Gaps Initiative.** Following the conclusion of its first phase, the G20 Finance Ministers and Central Bank Governors endorsed in September 2015 the start of the second phase of this initiative (DGI-2). As members of the Inter-Agency Group on Economic and Financial Statistics, the ECB and Eurostat are working together on the 20 recommendations of the DGI-2.⁴ They maintain the continuity of the first phase but also reflect on the evolving policy needs, place more emphasis on the inter-linkages among the set of recommendations to provide a complete picture of the economic and financial system and set more specific objectives with the intention of compiling and disseminating increasingly consistent datasets across the G20 economies. The development of sectorial accounts, securities statistics, statistics on financial interconnections, both domestic and cross-border, statistics on financial markets and instruments, fiscal data and statistics on property markets are important components of the DGI-2 strategy.

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

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

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

⁴ The IAG members are BIS, ECB, Eurostat, IMF (chair), OECD, United Nations and World Bank.

3. **Eurostat and the ECB jointly support the Special Data Dissemination Standard Plus (SDDS Plus), the third and highest tier of the IMF's Data Standards Initiatives launched in November 2014.** The fact that as of April 2017, seven EA countries (and 11 European Union (EU) member states overall) adhere to the SDDS plus shows the commitment of European countries in this respect.

4. **Eurostat and the ECB continued their efforts to ensure the quality of statistics underlying the Macroeconomic Imbalance Procedure (MIP).** In October 2016, the ESS-ESCB quality assessment report on statistics underlying the Macroeconomic Imbalance Procedure was published (Level 1 report). In November 2016, Eurostat published the indicators for the MIP Scoreboard, together with a set of auxiliary indicators. The MIP Scoreboard provides the statistical basis for the annual Alert Mechanism Report released by the European Commission (EC) at the start of the European Semester. Concerning the availability of historical time series based on the new statistical standards data coverage has substantially improved, with only a few values missing. The ESS and the ESCB continue to work closely to ensure the quality of MIP-relevant statistics, through the established three-level quality framework. On November 7, 2016, Eurostat and Directorate General (DG) Statistics of the ECB signed a Memorandum of Understanding (MoU) on the quality assurance of statistics underlying the MIP.⁵ Within its scope are two statistical datasets where member states may have designated their NCBs for producing the datasets, namely Balance of Payments and international investment position statistics and Financial Accounts. The MoU establishes a mutual recognition of the respective ESS and ESCB quality assurance frameworks, sets out the steps to be taken during the MIP indicator production process, based on a timetable to be agreed annually by Eurostat and the ECB/DG-Statistics, and establishes that, with the support of NSIs and NCBs, Eurostat and the ECB/DG-Statistics may undertake analysis of the output quality and consistency of the datasets with related statistical domains. Eurostat and ECB/DG-Statistics have taken practical steps towards the implementation of the MoU, with a view to applying them in the autumn 2017 exercise and subsequent years.

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

5.1 **Flash quarterly GDP estimates are now published at T+30 days.** On April 29, 2016, Eurostat began publishing preliminary flash estimates of quarterly GDP for the EA and for the EU about 30 days after the end of the quarter (T+30). This earlier publication is an achievement of the ESS, as member states contribute by providing their national estimates to Eurostat two weeks earlier than before. The methodology mainly follows the current methodology for the GDP flash estimates published 45 days after the end of the quarter (T+45). The main difference is the use of more preliminary country estimates. Because of the earlier timing, data for the third month of the quarter often have to be (at least partially) estimated by member states. The published EU/EA flash estimates met the established quality criteria, including on data revisions. Eurostat and the member states are currently working on a feasibility study for early EU/EA employment flash estimates.

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

5.2 A formal process for reporting on the quality of ESA 2010 data transmitted by member states to Eurostat was established with the adoption of the Commission Implementing Regulation (EU) 2016/2304 of December 19, 2016. Eurostat assessment reports will be made public annually with the first one due in 2017. By 2021, the scope of the exercise will gradually enlarge to cover all quality indicators foreseen in the implementing regulation.

5.3 A new basic legal act on the Harmonized Indices of Consumer Prices (HICP) and the House Price Index entered into force. It provides, amongst others, HICP flash estimates for all EA member states by the end of each reference month, and indices at the sub-class level of the classification of individual consumption by purpose (level 5). In May 2016, the owner-occupied housing price index was released for the first time by Eurostat. It is a quarterly index based on the “net acquisition” approach.

5.4 The EuroGroup Register (EGR)—the central European register for multinational enterprise groups managed by Eurostat—is constantly improving in coverage and quality. Based on the microdata sent by NSIs, around 80,000 enterprise groups and over 23 million units with a unique identifier are now part of this register.

5.5 There is an ongoing modernization of intra-EU trade in goods statistics. Following the demand from producers and users to substantially reduce the response burden on enterprises while maintaining a sound level of quality, international trade in goods statistics have been in the spotlight of modernization over recent years in the ESS. Two complementary projects, SIMSTAT and REDESIGN, were recently successfully completed and final reports presented. SIMSTAT proved the technical and statistical feasibility of the micro-data exchange on intra-EU exports as well as the usability of the exchanged data for the compilation of intra-EU imports statistics, while REDESIGN allowed the identification of the costs, the benefits and the risks of the main options for the modernization of intra-EU trade in goods statistics. The strategic orientation provided by EU member states in May 2016 was translated into proposed new legal provisions, containing the key elements of such a modernized intra-EU trade in goods statistics, and preparing its concrete implementation, including the exchange of micro-data. These new legal provisions relating to the modernization of Intrastat have been incorporated in a Framework Regulation on Integrated Business Statistics.

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

5.7 **European-level supply and use tables are being developed.** The FIGARO⁶ project, a cooperative effort by Eurostat and the Joint Research Centre of the EC, aims to establish annual production of EU multi-country input-output tables and a five-yearly production of EU multi-country supply, use, and input-output tables. The tables will support studies on competitiveness, growth, productivity, employment and international trade, and assessment of the position of the EU and the EA in the world. The first deliverables are experimental EU inter-country supply-use and input-output tables (EU-IC-SUIOT) for the year 2010, which will be available by end 2017.

5.8 **Part of the revised and updated versions of the EU KLEMS Productivity and Growth Accounts at the industry level have been published.** The updated Accounts are funded by the EC Directorate General Economic and Financial Affairs and compiled by the Conference Board on the basis of official European statistics. The published database cover 10 EU member states, 34 industries and 8 aggregates, consistent with the ESA 2010 in accordance with the latest industry classification (ISIC Rev. 4/NACE Rev 2). New releases for all 28 EU member states, the United States, possibly Japan, and several aggregates will be available in summer 2017 to the extent possible.

5.9 **Eurostat in collaboration with DG Joint Research Centre has developed new indicators for analyzing the labor and capital productivity components of economic growth: a Quality-Adjusted Labor Input (QALI) index and a set of capital indicators.** The QALI measures labor input to economic production considering the different compositions of the workforce and the volume of hours worked. Such an approach provides a clearer picture of labor inputs to the production process as opposed to traditional measures, which focus only on the quantity of labor input (e.g., employment). A time series for the net fixed capital stock, gross fixed capital formation and the average service life of assets has been estimated to provide researchers and policymakers with a set of comparable indicators at country and industry level.

5.10 **Harmonized insurance corporation (IC) statistics are published by the ECB as of the third quarter of 2016 and replace the non-harmonized EA insurance corporation and pension fund (ICPF) statistics, which are available for the reference periods from the first quarter of 2008 to the second quarter of 2016.** The quarterly data collected under an ECB legal act (and Solvency II) are of higher quality and incorporate new breakdowns by instruments or business categories and will hence provide a better basis for economists and financial stability analysts to monitor this important sector.

5.11 **The indicators measuring systemic risk in the EU financial system were revised in March 2017.** The Risk Dashboard of the European Systemic Risk Board (ESRB) is a quarterly publication, which comprises a set of quantitative and qualitative indicators measuring systemic risk in the EU financial system, covering major risks that could threaten the financial stability of the EU. In compliance with its legal obligation of providing statistical support to the ESRB, the ECB assisted in the revision of the set of indicators in order to include new indicators on insurance corporations (based on the new Solvency II data), new indicators on central counterparties and to discontinue four other indicators. The ECB also provides statistical support to the ESRB through the **Macroprudential Database**, containing reliable and sound data for the identification, assessment

⁶ The acronym FIGARO stands for Full International and Global Accounts for Research in Input-Output Analysis.

and mitigation of systemic risks. A public version of it, released in October 2015, contains around 270 indicators which are reviewed bi-annually to meet continuously evolving user needs.

5.12 Enhanced external statistics for the EA. In September 2016, the ECB started publishing monthly ECB and Eurosystem international reserves and foreign currency liquidity templates with a time lag of 15 days, advancing their publication by 15 calendar days. Moreover, comprehensive quarterly balance of payments and international investment position of the EA have been published since April 2017 for all reference periods back to the first quarter of 1999. In parallel, net external debt data for the EA with detail by sector and original maturity was also disseminated.

5.13 In November 2016, the ECB started to publish a new Supervisory Banking Statistics dataset covering quarterly data on the financial health of significant banks directly supervised by the ECB. The statistics are based on standardized information submitted by significant institutions within the Single Supervisory Mechanism (SSM) pursuant to Commission Implementing Regulation (EU) No. 680/2014 and subsequent amendments. The dataset includes figures on balance sheet items, profitability, capital adequacy, risk exposure composition and asset quality. Supervisory Banking Statistics offer bank analysts and market participants' complementary views on the banks supervised by the ECB. The data are presented by country and along several additional dimensions of interest, such as income sources, geographical diversification, size, sovereign exposures and an overall assessment of the banks' riskiness. Further extensions of the published data e.g., with respect to banks' liquidity are also planned. The publication is completed by the collection of the solvency and leverage ratios as disclosed annually by significant banks in pursuant with Part Eight of Regulation (EU) No 575/2013. By gathering all these relevant figures in one place, the document informs the supervisors and the general public on the status of the compliance of reporting banks with the requirements of the regulation. It also allows the public to easily find the relevant Pillar 3 disclosures of banks as a link is provided.

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

- *Money Market Statistical Reporting (MMSR).* Since July 1, 2016, the ECB receives transaction-by-transaction data from the 52 largest EA Monetary Financial Institutions (MFIs) covering the main market segments (i.e., the secured, unsecured, foreign exchange swap and overnight index swaps transactions denominated in euro (volume and rates)). To ensure standardization, the ECB has developed a common set of reporting instructions, which are fully compliant with the ISO 20022 standards. Some aggregated indicators will be released to the public in late 2017.
- *Securities holdings statistics.* In August 2016, the ECB amended the legal acts concerning statistics on holdings of securities in order to collect additional accounting and credit risk attributes from banking groups. In addition, as of 2018, the list of reporting banking groups will be extended to cover all significant groups directly supervised by the ECB.
- *Analytical credit datasets (AnaCredit Project).* In May 2016, the ECB adopted the new legal act enabling the ESCB to collect granular information on credit granted from banks to financial and non-financial corporations and other legal persons based on a core set of harmonized concepts and definitions. This endeavor aims to support many tasks of the ESCB, in particular monetary

policy analysis and operations, risk management, financial stability surveillance, and macro-prudential policy. The first reporting will take place in mid-November 2018 based on data as of September 2018.

7. **The results of the second wave of the Household Finance and Consumption Survey were published in December 2016.** They covered more than 84,000 households in the EA (except Lithuania) as well as in Hungary and Poland. The survey, a harmonized initiative coordinated by the ECB, showed that between 2010 and 2014 the median net wealth of EA households decreased by 10 percent in real terms, mainly due to lower house prices. At the same time, most inequality indicators, the Gini coefficient among them, only marginally increased. The analysis of the survey's findings will enable a better understanding of how microeconomic heterogeneity can affect macroeconomic outcomes.

8. **Technical work by Eurostat is also ongoing towards modernizing and harmonizing public sector accounting standards in the context of the EPSAS (European Public Sector Accounting Standards).** Four EPSAS Working Group meetings took place since September 2015. The EPSAS Working Group is a permanent forum for EU public sector accounting standard-setters and technical experts, at all levels of government. A two-phase approach is followed: (1) increasing fiscal transparency in the short to medium term, and (2) working towards comparability in the medium to the longer term. The current EPSAS work program comprises: (a) developing of the EPSAS framework (i.e., EPSAS governance, accounting principles and standards) and collection of information for impact considerations, (b) supporting the modernization of public accounting systems in the EU member states, and (c) widening stakeholder engagement. The elements of the EPSAS framework are under construction using, among other inputs, small expert groups ("cells"). The technical work on first-time implementation guidance for accruals accounting and the work of the "cell" on governance principles were concluded recently. Technical work underway covers key public sector accounting issues from the EPSAS perspective, such as taxes, pensions, relief for smaller and less risky entities, heritage, infrastructure and military assets.



EURO AREA POLICIES

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES—SUPPLEMENTARY INFORMATION

July 18, 2017

Prepared by **European Department**

This supplement reports on discussions that straddled the issuance of the staff report. It does not alter the thrust of the staff appraisal.

The euro area has seen a series of bank restructuring, resolution, and liquidation actions. On June 1, agreement in principle was reached on the restructuring of Italy's fourth largest bank, Banca Monte dei Paschi di Siena, with precautionary recapitalization authorized on July 4. On June 6, Spain's sixth largest bank, Banco Popular Español, was resolved with its sale to Spain's largest bank, Santander. On June 23, two mid-sized Italian banks, Banca Popolare di Vicenza and Veneto Banca, were liquidated with the assisted sale of their performing assets, deposits, and senior debt to Italy's second largest bank, Intesa Sanpaolo, leaving nonperforming loans in a run off vehicle where the Italian state is a major claimant and the guarantor of a term loan from Intesa.

These actions are a first major test of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism:

- **For Monte dei Paschi**, the EU-wide stress tests in mid-2016 estimated a significant capital shortfall in an adverse scenario, after which the bank applied for precautionary recapitalization and received substantial liquidity support from the Italian authorities in the form of government guarantees for debt issuance. Next, with the European Central Bank (ECB) reconfirming that the bank met regulatory capital requirements on a point-in-time basis, the Italian authorities requested approval to provide state aid via a precautionary recapitalization under the BRRD while Atlante II, a fund created by Italian financial institutions, committed to purchase most of the equity and mezzanine tranches of the bank's securitized bad loan portfolio. Finally, the European Commission's Directorate General for Competition (DG-COMP) approved up to €5.4 billion of state aid in the context of a restructuring plan intended to ensure the bank's long-term viability.
- **For Banco Popular**, the Eurosystem at the beginning of June 2017 approved substantial emergency liquidity assistance in response to a deposit run, but two working days later the bank proved unable to post sufficient eligible collateral. This prompted the ECB in its supervisory capacity to deem the bank failing or likely to fail on liquidity grounds, on a Tuesday. Next, the Single Resolution Board (SRB) determined that limiting systemic risk at the national and EU levels warranted placing the bank into resolution in the public interest under the BRRD and, with a buyer at hand, was able to resolve the bank using the "sale of business tool."

- **For Vicenza and Veneto**, which had also applied for precautionary recapitalization and benefited in early 2017 from substantial guarantees from the Italian state to support senior bond issuance, the ECB in late June deemed the two banks failing or likely to fail on capital grounds, on a Friday. The SRB determined that the situation did not pose sufficient systemic risk to warrant resolution under the BRRD, and passed the banks to the Italian authorities for liquidation under Italy's national bank insolvency rules. The Italian authorities requested approval to provide state aid in liquidation based on an Article in the Treaty on the Functioning of the European Union (TFEU) that refers to serious economic disturbances. DG-COMP agreed that unassisted, fire sale liquidations would cause a serious disturbance in the economy of the Venetian region, and invoked the liquidation aid provisions of its 2013 Banking Communication to approve up to about €17 billion of state aid to facilitate smooth market exit.

The record of loss sharing is mixed. The action in Spain involves no state aid, with share capital and junior debt alone absorbing losses of €4 billion (equal to 2.7 percent of total liabilities at end-March 2017). The actions in Italy involve state aid—up to €22½ billion or about 1⅓ percent of GDP, excluding previous guarantees on funding—under the 2013 Banking Communication: burden sharing must rise up to junior debt as a precondition for any use of official resources. For Monte dei Paschi, junior debt with a face value of €4.3 billion (2.9 percent of end-March total liabilities) is converted into equity, before the provision of up to €1.5 billion of compensation to retail junior debtholders who were mis-sold. For Vicenza and Veneto, junior debt with a face value of about €1.2 billion (2.1 percent of end-March total liabilities) and share capital are written down to nil and left unfunded in the receiverships and, separately, retail investors holding about €100 million are compensated. Here, however, the counterfactual is important. Had Vicenza and Veneto met the public interest test and been resolved by the SRB, BRRD rules would have applied: any state aid would likely have had to be sourced from the Single Resolution Fund, and any use of the Fund would have been conditional on the bail in of at least 8 percent of total liabilities, with no specific statutory exemption for senior debt. The liquidation of the two Italian banks with state aid thus likely left senior debtholders better off than they would have been in resolution under BRRD rules.

This experience underscores that the review of the BRRD must clear hurdles to timely and efficient bank resolution and liquidation. The goal must be a system that addresses problems effectively and at least cost to taxpayers, the financial system, and the economy. This requires early action and appropriate burden sharing, with state support limited to unambiguously systemic situations, and a robust safety net, including common deposit insurance and a fiscal backstop for the Single Resolution Fund. The recent cases raise a number of issues, many of which touch on the institutional structure and mandates of individual official bodies. These include (i) improving the interaction of emergency liquidity assistance or government guaranteed funding with assessments of whether a bank is “failing or likely to fail” on liquidity grounds; (ii) the need for accurate and timely information sharing on asset quality; (iii) the lengthy procedures for precautionary recapitalization; (iv) conflicting approaches to assessments of financial stability under the BRRD and serious economic disturbance under the TFEU; and (v) aspects of the 2013 Banking Communication, including its less demanding bail-in requirements (not mandatory for senior debt) than those for resolution under the BRRD (with the 8 percent threshold) and its section on state aid in liquidation.

These and other issues will also be covered by the Financial Sector Assessment Program exercise for the euro area which is currently getting underway.

**Statement by Steffen Meyer, Executive Director for Germany
on behalf of the Euro Area Authorities
July 21, 2017**

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

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

The authorities are in broad agreement with the findings and recommendations in the staff report. The strength of the cyclical recovery is indeed a positive development that signals the improved fundamentals among euro area economies. Underlying weaknesses remain nonetheless significant. Future growth depends therefore on addressing those weaknesses—including notably the remaining legacies of the crisis, slow productivity growth and the insufficient structural and nominal convergence. The current favourable economic and political conditions need to be seized as an opportunity to step-up the delivery of the reform efforts—both at national and European level—while strengthening the architecture of the Economic and Monetary Union and preserving responsible fiscal policies.

Euro area economic situation and risks

The authorities largely concur with the IMF staff's assessment that the recovery has further strengthened into broad-based expansion, which the staff expects to continue in 2018. The European Commission forecasts are broadly in line with those of the IMF, amidst a supportive policy mix, reduced uncertainty and an improved global outlook. Risks are more balanced than before. On the internal side, political uncertainty has receded markedly but crisis legacies remain significant in some countries, reducing their ability to withstand future shocks. The risk of negative feedback loops between banks and sovereigns appears well contained. In high public debt countries, fiscal adjustment needs to continue also with a view to increasing countries' resilience once the window of low interest rates starts closing. Conversely, external risks have gained in prominence, notably as regards the uncertain policy stance of key trading partners, the relationship with the United Kingdom once it exits the EU, and broader geopolitical and security developments. On the upside, the positive momentum could lead to higher-than-expected growth.

Economic and confidence indicators have continued to firm up. Improving household balance sheets and falling unemployment are expected to support consumption, while the expansion in investment looks set to continue, supported by the pick-up of construction from a very low level. The optimism that underlies survey results could partly be associated with the brighter economic environment globally, which should impact positively euro area exports, even if it is now partly mitigated by a stronger euro. Domestic confidence factors are

also likely at play, including the improved political climate and raising hopes that Europe will re-energise its process of economic integration.

The authorities concur with the staff's assessment that, while the euro area's external position is broadly in line with medium-term fundamentals, imbalances at the national level remain sizeable. Adjustments have mainly taken place in countries with large net external liabilities. Net external debtor countries, which earlier had persistent current account deficits, have maintained surpluses over the past four years, leading to a small improvement in their net foreign asset positions. The persistent surpluses of large net external creditor countries, have not shrunk significantly or have in some cases even grown larger, due *inter alia* to high national saving and comparatively weak domestic investment. Relative price adjustment at the national level would also contribute to the euro area rebalancing. Absent adjustment, the net international investment positions of persistent surplus countries could grow over the medium term.

As for the medium-term outlook, the authorities agree that delivering on the right reforms is essential—both at the European and national levels—to increase the productivity of the economies, as well as their resilience going forward, and to resume convergence among them. Despite the recovery in consumption, investment remains relatively weak. This reduces the future growth potential and, together with the overall high savings rate stands behind the euro area's current account surplus. Banking sector weaknesses, with large differences among countries, could hamper a stronger recovery in investment as well. At the same time, the situation in the labour market is still far from equilibrium. Unemployment has been falling but remains relatively high in several member states, and hours per worker have not recovered to pre-crisis levels as part-time employment has increased. Despite closing output gaps substantial slack in this regard remains. This, together with slow productivity growth, is seen as preventing wage growth from picking up more strongly. Long-term unemployment remains a concern as well, not only for its impact on potential growth but also on concerned workers.

Monetary policy and inflation outlook

The ECB's monetary policy measures have proven powerful in generating very favourable financing conditions that are supporting the ongoing economic expansion and the return of inflation towards levels below, but close to, 2 percent over the medium term. Despite the strengthened economic expansion in the euro area, inflation developments continue to remain subdued. In particular, underlying inflation pressures remain low and should increase only gradually over the next two years, as the economic expansion has yet to translate into stronger inflation dynamics. Therefore, a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to build up and support headline inflation in the medium term. However, strengthening economic growth in the euro area must be supported by much more decisive actions in other policy areas. Achieving

higher sustainable economic growth requires stepping up the implementation of structural reforms and a more growth-friendly composition of public finances.

Fiscal performance and governance

On the fiscal policy side, the authorities broadly agree with the staff's assessment that, in line with the Stability and Growth Pact, fiscal policies should reflect economic conditions and sustainability risks at Member State level—while ensuring an effective co-ordination of economic policies. After strong consolidation during the crisis, the fiscal policy stance in the euro area turned broadly neutral in 2015–16 and is set to remain so in 2017, with a slight overall contraction due to lower debt servicing costs—according to the Commission 2017 spring forecast. The fiscal stance in 2017 is expected to vary across Member States. Based on the change in the structural primary balance, some countries are expected to have an expansionary stance, while only a limited number are expected to have a contractionary stance.

Challenges in terms of fiscal sustainability remain in a number of countries where public debt is high, which may negatively impact growth in the medium term and is a major source of vulnerability to adverse shocks. The stability programmes submitted in April confirm that most Member States plan to converge to their medium-term budgetary objectives in line with the requirements of the Pact, although some back-load consolidation as from 2018–19.

The authorities concur with the staff's recommendations of a broadly neutral fiscal stance for the euro area in 2018, given the need to ensure sustainability and the need to support investment to strengthen the recovery. They also share most of the staff's assessment of potential output and the output gap in the euro area. The Commission forecasts an earlier closure of the output gap (in 2018 rather than 2019). However, this is mostly due to small differences in the forecasts for actual GDP rather than potential GDP at euro area level. The authorities also agree on the importance of the composition of public finances. Member states that have outperformed their medium-term objectives have been invited to continue to prioritise investments to boost potential growth while preserving the long-term sustainability of public finances whereas other countries should focus on rebuilding buffers and reducing vulnerabilities. There is still a large scope in most euro area countries to reorient public expenditure towards more productive and socially efficient uses, as well as to improve the efficiency and growth friendliness of taxation and reduce the tax wedge on labour.

Concerning the enforcement of the Pact, the Council and the Commission remain fully committed to the fiscal rules and the limited degree of discretion that the rules confer on the Institutions represents an essential element of the governance framework. In effect, the agreed framework should not only be applied mechanistically: some economic judgement will always be necessary. It is also important to recall that consolidation has borne fruits. 23 EU Member States were under the excessive deficit procedure (EDP) in 2009, this

is now down to 4. The aggregate headline deficit in the euro area fell to 1.5 percent of GDP last year while the debt-to-GDP ratio has consistently declined since 2014. In sum, the evidence seems rather to suggest that the EU's fiscal rules are working.

At the same time, the authorities also believe that a predictable, transparent and consistent application of the Pact is crucial to fully enforce commitments, to ensure that all Member States are treated equally and to preserve the credibility of the European fiscal rules.

The consideration of whether a fiscal capacity at euro area level would be appropriate is part of a broader reflection on the future of Europe and the strengthening of the EMU. The simplification of the fiscal rules can be seen as part of this process. The European Commission put forth a number of suggestions in a reflection paper on the deepening of the Economic and Monetary Union published on 31st May 2017.

Balance sheet repair and financial architecture

Financial conditions have overall remained favourable, amid supportive monetary policy and progress achieved towards the Banking Union. While differences still remain among national banking sectors, banks used the additional liquidity related to the ECB's expanded asset purchase programme to grant loans. Lending rates for both euro area households and non-financial corporates remained at record low levels, while credit standards on loans to both sectors eased somewhat further, mostly driven by competitive pressure. Residential mortgage credit growth has remained broadly stable at moderate levels, with heterogeneous developments across countries, while corporate sector credit growth continued to recover. The latest bank lending and firms' access to finance surveys signalled improvements in the availability of external finance, including for SMEs. As the recovery firms up, the authorities expect that these positive developments will continue.

Banking sector profitability remained low. While profitability outturns and expectations have improved, as largely reflected in the rise in banks' equity prices over the last months, and the broad dispersion of profitability among EU banks has somewhat narrowed, challenges to reach adequate levels of profitability remain very much pressing. The authorities agree that reducing overcapacity can be accomplished by banks, either internally or by (cross-border) mergers and acquisitions, resolutions or market exits.

The authorities agree that efforts should continue to accelerate and advance bank balance sheet repair across the euro area. While the overall level of non-performing loans (NPLs) has declined, the dispersion of NPLs among countries remains wide and the pace of NPL resolution remains overall steady but slow. The ECB's Guidance to banks on NPLs, published at the end of March, should be used as an inspiration of best practices for significant banking institutions. The Action Plan to Tackle NPLs in Europe endorsed by the ECOFIN Council in July stressed the importance of a comprehensive approach, combining a mix of complementing policy actions at national and EU level. A particular emphasis is put

on the policy areas of supervision and structural reforms (including insolvency and debt recovery frameworks), as well as on the development of secondary markets for NPLs, and the restructuring of the banking system. The Commission has also launched a public consultation on how to best spur the development of secondary markets for NPLs in order to speed up NPL disposals.

The authorities broadly share staff's views concerning the completion of the Banking Union. In line with the roadmap of June 2016, work should continue to complete the Banking Union with regard to risk reduction and risk sharing, including a European Deposit Insurance Scheme and making the common backstop for the Single Resolution Fund operational at the latest by the end of the Fund's transitional period.

Further progress has been made towards the objective of establishing a Capital Market Union in the EU. The completion of CMU will strengthen the EU's resilience to shocks and facilitate the efficient allocation of capital. So far nearly two thirds of the actions have already been delivered. The July Council adopted conclusions on the Commission's review of the CMU action plan, aimed at securing the building block for a fully-fledged capital markets union by the end of 2019. Greater harmonization of financial regulatory and supervisory regimes, and improved access to non-bank financing sources, will provide greater investor certainty and diversify firms' funding options, boosting investment. Improvements in areas, such as securities ownership rules, and corporate insolvency proceedings, are still pending, while new action items such as the possibility of enhanced supervisory powers for the European Supervisory Authorities (ESA), potential revisions to the prudential treatment of investment firms, and measures to encourage FinTech and sustainable finance, should further enhance the functioning of the Single Market.

Structural reforms at Member State level

The authorities agree that well-designed and sequenced structural reforms—if fully implemented—can have a sizeable positive medium-term impact on potential growth and contribute to enhance the adjustment capacity of the euro area. As noted in the staff report, product market reforms should be prioritised, as they entail few relevant short-term costs, while labour market reforms need to be sequenced with caution and with appropriate support. All countries should prioritize reforms to improve the investment climate, including creating incentives to favour investment, and have effective insolvency regimes and public administrations in place. Strengthening competition, improving price responsiveness and lowering entry barriers would also have a positive impact on investment. Moreover, a coordinated implementation of reforms by Member States can produce higher gains. This should particularly be the case at the current juncture, with persistently very low inflation and interest rates, when multipliers are high and potential spillovers of structural reforms are also expected to be larger.

The EU Institutions continue to promote and monitor structural reforms by means of a range of tools within the European Semester. As regards country-specific recommendations (CSRs), while implementation has been uneven across policy areas and countries, progress has been more notable in the areas of fiscal policy and fiscal governance, active labour market policies, taxation policies, social policies and financial services. Moreover, considering a multi-annual rather than annual horizon, the large majority of CSRs have seen good progress. Long-term structural issues take time to be addressed and tangible results may take time to show. Nevertheless, measures to improve the long-term sustainability of public finances, competition in services and the business environment have lagged behind.

The authorities believe that policy implementation is helped by the use of the Macroeconomic Imbalance Procedure (MIP) and that the MIP should be used to its full potential, with the corrective arm applied where appropriate. MIP surveillance has improved the policy dialogue between the Commission and Member States. It has notably helped raising awareness about reform needs and created the conditions for more effective surveillance, complemented where needed by technical assistance by the Commission, and peer pressure and support. Results have been particularly evident for some countries identified with excessive imbalances at some point in time and in the absence of macro-economic adjustment programmes (such as Spain, Slovenia, and Croatia). A recent survey conducted by the European Court of Auditors indicates that Member States see the MIP as having a positive impact on policy implementation.

The authorities consider that higher economic and social convergence—a key objective of any process of economic integration—can be achieved through structural reforms, higher economic growth and actions to address inequality. The crisis of the years 2007–08 marked the end of the convergence trend and the start of a divergence trend, which is only slowly being corrected. This correction is a positive development but its slow path requires additional policy actions. In any event, convergence has been higher in the euro area than within the EU as a whole, as noted in the staff report.

The introduction of structural reforms can be facilitated by the use of benchmarking, meaning the cross-examination against a particular benchmark of indicators related to economic and social performance and policies in each Member State. This can be a useful tool to identify the need for action at an early stage, monitor progress and effectively communicate results. Most importantly, it can also help to increase the ownership of reforms among Member States and facilitate their implementation. Some first possible benchmarks have already been agreed among Commission and Member States in the areas of tax wedges and pensions. The Commission is currently developing further benchmarks and the exchange of best practices across policy areas with Member States.

The authorities also concur on the importance of deepening the Single Market to unlock the full potential of investment and to bring about higher productivity growth. At EU

level, the Commission has launched a number of initiatives regarding the Single Market, in particular, measures to develop the Capital Markets Union, deepen market integration for both services and products, complete the Energy Union and establish a true Digital Single Market. All these initiatives contain specific measures to remove obstacles to investment, in the context of the third pillar of the European Investment Plan. Single Market policies have high potential as they are decided jointly and apply to the whole of the EU. However, this does not mean that the commitment and agreement of Member States are any less necessary to deliver those reforms. Work is ongoing on concrete proposals linked to the enforcement of single market rules as well as measures in the area of business services, including facilitating their cross-border provision, business restructuring and insolvency, and the creation of a simple, modern and fraud-proof VAT system. A thorough implementation and enforcement of additional key measures in the 2015 Single Market Strategy would be positive for growth. At the same time, the European Union remains committed to open and fair trade, as proved by the recent agreement of July 6th on the principles of an Economic Partnership Agreement between the EU and Japan. This is also the first international trade agreement to include a clear commitment to fight climate change and support the Paris goals.

Deepening of the EMU framework

The authorities agree that a favourable environment like the current one, after several major risks have been averted, should be seized to address shortcomings in the design and functioning of the Economic and Monetary Union (EMU) and step-up the delivery of reform of EMU. A range of ideas, including those suggested by the Commission in its reflection paper, will be explored in the coming months with the ambition of achieving a more complete and resilient architecture, and capable of delivering higher growth and stronger economic and social convergence. Completing the Banking Union and the Capital Markets Union are key priorities, with the measures indicated above. Furthering the principles of responsibility and solidarity, legitimacy and accountability rests on improving policies and their delivery at national and EU level. The authorities would welcome exchanges of views with the Fund on these issues during the next Article IV consultations.