



EURO AREA POLICIES

February 2022

2021 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES— 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 2021 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 February 4, 2022 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 February 4, 2022, following discussions that ended on November 5, 2021, 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 December 21, 2021.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for the Nordic-Baltic Constituency, on behalf of the euro area member states and the European community.

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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**International Monetary Fund
Washington, D.C.**



IMF Executive Board Concludes 2021 Discussions on Common Euro Area Policies with Member Countries

FOR IMMEDIATE RELEASE

Washington, DC – February 7, 2022: The Executive Board of the International Monetary Fund (IMF) concluded the 2021 discussions on common euro area policies with member countries.¹

The euro area economy is recovering rapidly. After falling by about 6½ percent in 2020, euro area output has rebounded strongly since the second quarter of 2021 thanks to high vaccination levels, strong policy support, and increasing consumer and business adaptation to the pandemic, with real GDP having reached its pre-crisis level by the end of last year. Inflation accelerated in 2021, largely reflecting base effects from last year's low energy prices and transitory factors. Looking ahead, supply chain disruptions, elevated energy prices, and the resurgence of Covid-19 cases—including those related to the Omicron variant—are likely to pose near-term headwinds to growth. However, these factors are expected to dissipate over the course of 2022, and the robust recovery is set to continue on account of a strong labor market, the normalization of the households' savings rate, and the impulse provided by the Next Generation EU Plan. Upside inflation risks have increased. However, with temporary factors dissipating, inflation is projected to decline through 2022 and to remain below the ECB's 2-percent target in the medium term.

Uncertainty remains high and is largely tied to the evolution of the pandemic. As elsewhere, the ongoing wave of infections and renewed concerns about newer and more transmissible Covid-19 variants highlight the continuing risk that the pandemic poses to the recovery, especially if it were to be accompanied by decreased vaccine effectiveness or incomplete vaccination coverage. The ongoing phasing-out of policy support, a potential correction in real estate markets, or spillovers from a sharp slowdown outside Europe could also create headwinds. Conversely, faster-than-expected adjustment to Covid-19 would boost activity, while a material unwinding of large household savings could significantly increase consumption, and an effective implementation of the envisaged reforms and investments could also raise medium-term growth prospects. Rising geopolitical tensions pose a new downside risk to growth and an upside risk to inflation, although the precise impact will depend on how events and related policy responses unfold in the coming weeks.

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

Executive Board Assessment²

Directors commended the authorities' forceful economic policies, which, together with high vaccination levels and better adaptation to Covid-19, helped the euro area economy recover rapidly. Directors agreed that strong growth is set to continue, but also noted that uncertainty remains high and risks to the outlook remain dominated by pandemic dynamics and legacies.

Directors emphasized that fiscal policy should remain supportive, and, as the recovery takes hold, become increasingly targeted to support the vulnerable and limit scarring. They welcomed the approval of national Resilience and Recovery Plans and urged their rapid and high-quality implementation. Directors noted the debate on reforming the EU fiscal framework and agreed that a time-bound transitional arrangement could be desirable until the new rules become effective. They acknowledged that an expenditure growth rule with a debt anchor could be an attractive option for the new framework, and that an EU-level climate investment fund could complement the fiscal rules by creating scope for financing essential climate investments and realizing the potential for positive cross-border spillovers from carbon-mitigation efforts.

Directors observed that, despite rising near-term price pressures, inflation is expected to remain below target over the medium term. They generally concurred with the ECB's recent decision to maintain an accommodative monetary policy stance until its medium-term inflation target is met, while retaining flexibility to adjust course should elevated underlying inflation prove to be more durable than currently projected. Directors welcomed the conclusions of the ECB's strategy review, including an ambitious climate-related action plan.

Directors observed that, while the financial system appears resilient, bank supervisors need to ensure timely loss recognition and appropriate provisioning. They agreed that housing markets conditions warrant a more effective use of macroprudential policies in jurisdictions where real estate risks are higher. Continued progress on European financial architecture reforms and a faithful implementation of internationally agreed bank capital standards would help underpin global financial resilience and stability. Directors saw merit in establishing a single AML/CFT rulebook and making progress towards the harmonization of AML/CFT supervision.

Directors agreed that ambitious structural policies and sizable investments will be needed to increase euro area potential growth and support the digital and green transitions. In this context, they observed that the Next Generation EU provides a unique opportunity to make progress on these priorities. Labor market policies should focus on facilitating reallocation, including through programs for reskilling and upskilling of workers, and temporary and targeted subsidies. Improving the coverage of social safety nets by relying on progressivity and means-testing would help mitigate the impact on the vulnerable of structural economic shifts. Directors welcomed the EU's climate change mitigation agenda, together with the authorities' assurances that the design of any carbon border adjustment mechanism would be compatible with WTO rules.

Directors underscored that the emergence of the Omicron variant illustrated the criticality of continued EU efforts to ensure equitable global access to Covid-19 vaccines.

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>.

Euro Area: Main Economic Indicators										
	2017	2018	2019	2020	Projections 1/					
					2021	2022	2023	2024	2025	2026
Demand and Supply										
Real GDP	2.6	1.8	1.6	-6.4	5.2	3.9	2.5	1.7	1.6	1.4
Private consumption	1.8	1.5	1.3	-7.9	3.5	5.2	3.1	1.7	1.7	1.6
Public consumption	1.1	1.1	1.8	1.3	3.7	0.1	0.9	1.1	1.1	1.0
Gross fixed investment	3.9	3.1	6.7	-7.0	4.6	4.1	3.2	2.4	1.9	1.8
Final domestic demand	2.1	1.7	2.6	-5.8	3.8	3.8	2.6	1.7	1.6	1.5
Stockbuilding 2/	0.2	0.1	-0.1	-0.5	0.3	-0.1	0.0	0.0	0.0	0.0
Domestic demand	2.3	1.8	2.5	-6.2	4.0	3.7	2.6	1.7	1.6	1.5
Foreign balance 2/	0.4	0.1	-0.8	-0.3	1.3	0.4	0.0	0.1	0.0	0.0
Exports 3/	5.6	3.6	2.7	-9.1	9.9	6.2	4.6	3.8	3.4	3.2
Imports 3/	5.2	3.8	4.7	-9.1	7.7	5.9	5.0	4.0	3.7	3.5
Resource Utilization										
Potential GDP	1.5	1.4	1.4	-2.0	3.3	2.0	1.9	1.6	1.5	1.4
Output gap	-0.6	-0.1	0.1	-4.3	-2.6	-0.7	-0.1	0.0	0.1	0.1
Employment	1.6	1.6	1.3	-1.5	0.8	1.2	0.6	0.3	0.2	0.1
Unemployment rate 4/	9.1	8.2	7.6	7.9	7.8	7.5	7.3	7.2	7.1	7.0
Prices										
GDP deflator	1.1	1.5	1.7	1.6	1.7	2.3	1.8	1.8	1.8	1.8
Consumer prices	1.5	1.8	1.2	0.3	2.6	3.0	1.7	1.8	1.8	1.8
Public Finance (percent of GDP)										
Overall fiscal balance	-0.9	-0.4	-0.6	-7.2	-6.3	-3.8	-2.4	-1.9	-1.6	-1.5
Primary balance	0.8	1.2	0.8	-5.9	-5.1	-2.7	-1.4	-0.9	-0.7	-0.6
Structural balance	-0.5	-0.3	-0.5	-4.6	-4.7	-3.3	-2.3	-1.9	-1.7	-1.6
Structural primary balance	1.3	1.3	0.9	-3.3	-3.5	-2.2	-1.3	-1.0	-0.7	-0.7
Gross public debt	87.5	85.5	83.6	97.3	97.4	95.1	93.5	92.4	91.1	89.9
External Sector 5/, 6/										
Current account balance	3.2	2.9	2.3	1.9	2.9	2.8	3.0	2.9	2.8	2.8
Interest Rates (end of period) 4/, 7/										
EURIBOR 3-month offered rate	-0.3	-0.3	-0.4	-0.5	-0.6	...	...	...	...	...
10-year government benchmark bond yield	0.9	1.2	0.4	-0.1	0.3	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.18	1.14	1.11	1.22	1.13	...	...	...	...	...
Nominal effective rate (2005=100)	106.1	107.8	105.7	114.6	111.0	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.3	85.5	84.0	87.3	82.0	...	...	...	...	...

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

1/ Projections are based on aggregation of January 2022 *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 2021.



EURO AREA POLICIES

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES

December 21, 2021

KEY ISSUES

Following a deep recession in 2020 and further contraction in 2021Q1, the euro area economy recovered rapidly in the second and third quarters thanks to high vaccination levels, increasing household and business adaptability to the virus, and continued forceful policy support. Looking ahead, while supply chain disruptions, elevated energy prices, and resurgences of Covid-19 cases—including those related to the Omicron variant—are likely to pose near-term headwinds to growth, the recovery is set to continue in 2022 as the impact of the pandemic on economic activity continues to weaken over time and supply-side constraints ease. Medium-term output losses relative to pre-crisis trends will vary significantly across countries and sectors as will the extent of labor market scarring. Price pressures are building up as production bottlenecks are set to persist for a while. However, inflation—despite increasing significantly in recent months due to transitory factors—is projected to moderate during 2022 and remain below the ECB’s inflation target over the medium term. Uncertainty surrounding the outlook remains high and largely related to pandemic dynamics and legacies, including induced behavioral and preference changes.

The key policy challenge is to sustain the recovery in the face of still elevated uncertainty surrounding pandemic dynamics and legacies. This will necessitate policy agility to adjust course as needed, with a focus on containing economic scarring—including by facilitating a smooth reallocation of resources towards growing firms and industries—and protecting the vulnerable. Addressing longstanding structural gaps and investing in climate-friendly infrastructure and digitalization will be needed to enhance resilience and lift potential growth. Given the diversity of conditions across the euro area, part of the challenge will be allowing for sufficient flexibility in policies across countries while maintaining the strictures of euro area policy rules.

Key Policy Recommendations

- Under staff’s baseline, monetary policy will need to remain highly accommodative for an extended period to durably lift inflation to the ECB’s new symmetric inflation target of 2 percent, potentially calling for additional asset purchases in 2023 and beyond. In this scenario, the ECB should ensure that its self-imposed limits on asset purchases do not unduly constrain monetary policy operations. Risks of large

second-round effects from currently elevated headline inflation appear limited for now, but given the uncharted territory of this pandemic, the ECB should stand ready—and is well equipped—to scale down unconventional measures and adjust policy rates early if evidence of inflation durably overshooting its target materializes. The ECB's Governing Council decided in December to end net purchases under the Pandemic Emergency Purchase Program in March 2022 while overall gradually reducing asset purchases in 2022. They underscored flexibility to adjust course as needed given the heightened uncertainty, which is appropriate.

- Fiscal policy should remain supportive to sustain the recovery and limit scarring, but the focus can now begin shifting toward more targeted interventions, especially as strengthening consumption and labor markets imply less demand for more broad-based assistance. Once the expansion phase is firmly in train, high-debt countries in particular will need to steadily rebuild fiscal buffers. Credible fiscal consolidation strategies should be put forward now. Spending from Next Generation EU grants can alleviate the impact of national fiscal consolidation on growth, while better targeted transfers can help reallocate resources. The current EU fiscal framework should be reformed to make it more efficient and better at preventing debt distress, while allowing for macroeconomic stabilization during downturns. A common fund would help meet the EU's climate investment needs. To allow time for deep consultation across EU countries, a transitional arrangement might be needed to avoid the unrealistic adjustments that would be mandated under the current rules given high public debt.
- Structural policies should facilitate pandemic-induced reallocation of labor and capital while protecting the vulnerable. Job retention schemes should continue to be gradually phased out as activity firms. Training to reskill and upskill workers along with temporary and targeted use of hiring subsidies and wage loss insurance would pave the way for job creation, given lingering uncertainty among potential employers. Improving the coverage of social safety nets in a progressive and means-tested manner would help mitigate the pandemic's impact on the vulnerable. More broadly, difficulties in managing structural transformations indicated a fundamental rethink of labor policies was called for even before the pandemic, and this need has only become more urgent. Recovery and Resilience Plans should support better coordination of national and EU-level policies, help achieve EU green objectives, and boost resilience and growth.
- Financial sector policies require a fine balancing act to allow an unwinding of support measures while ensuring the flow of credit to the economy. As the recovery proceeds, prudential standards can be normalized gradually, in accordance with pre-announced timelines. Supervisors should continue their efforts to achieve timely bank loss recognition and appropriate provisioning. Some euro area national authorities need to tighten their macroprudential stances to ensure resilience in the face of stretched asset valuations, especially in real estate markets. Efforts to address administrative constraints and establish fast-track procedures for debt restructuring would strengthen insolvency and bankruptcy frameworks. A renewed effort to advance architecture reforms, including by completing the banking and

capital market unions, is essential to strengthening the euro area financial system's efficiency and resilience.

- On the vaccine and trade front, the EU should continue efforts to ensure global equitable access to Covid-19 vaccines, while engaging with major partners to strengthen the multinational trading system and address underlying sources of global trade tensions and investment distortions.

Approved By
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 and
Jeromin Zettelmeyer (SPR)

Discussions took place by video conference during October 20–November 5, 2021. Mission members included P. Gerson (head), R. Balakrishnan, B. Barkbu, N. Klein, T. McGregor, V. Nguyen, L. Ratnovski, A. Santos, A. Shahmoradi, N. Suphaphiphat, and F. Toscani (all EUR), joined by A. Bhatia, N. Arnold, N. Belhocine, J. Frie, and L. Rabier (all EUO). Executive Director, M. Pösö, and his advisor, I. Valdés Fernández, and R. Ruffer, ECB observer at the IMF, participated the meetings. S. Domit (EUR), A. Hodge (WHD), Z. Jakab, J. Linde (both MCM), N. O’Hanlon, and Z. Zahn (both STA) contributed to the report. M. Maneely, E. Cohn Bech, and C. Rubio (all EUR) supported the mission.

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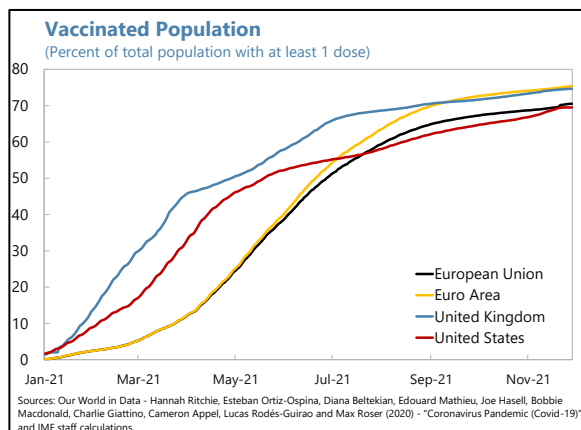
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PANDEMIC CONTEXT

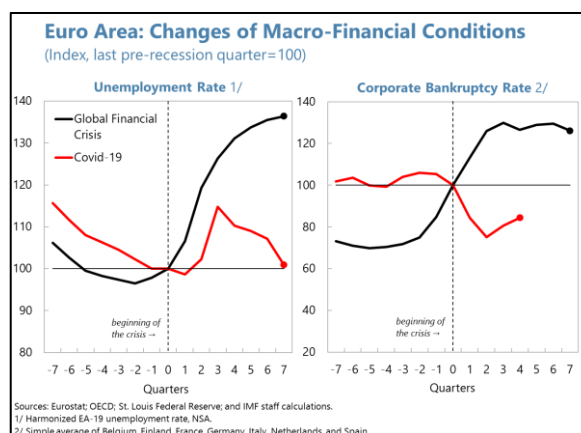
1. The euro area economy is recovering as vaccine rollouts accelerate, but the path of the pandemic remains highly uncertain. Following repeated waves of infections and associated containment measures, which caused economic activity to contract in 2020 and 2021Q1, the euro area economy has recovered strongly as rapidly increasing vaccination rates since 2021Q1 have led to lower hospitalization and mortality rates. Containment measures have been eased, business and consumer confidence has improved, and private demand has increased, including for contact-intensive services. Nonetheless, the ongoing wave of infections, concerns about newer and more transmissible Covid-19 variants, and waning vaccine efficacy cloud the prospects for a durable recovery.



2. Forceful and timely policy support has limited the economic and social impact of the crisis, but the output gap and economic slack remain significant in some countries.

Supportive policies—both at the European Union (EU) and national levels—have cushioned the impact of the pandemic by keeping financial conditions favorable and providing critical support to households and firms, thus preventing massive job losses and a wave of bankruptcies.

Nevertheless, while unemployment has increased only modestly since the onset of the crisis, the number of people in job retention schemes (JRS)—although declining significantly since the crisis peak—remains material and total hours worked are still somewhat below pre-crisis levels. Euro area output remains below its potential level, although heterogeneity is large, with some countries already seeing signs of capacity constraints.

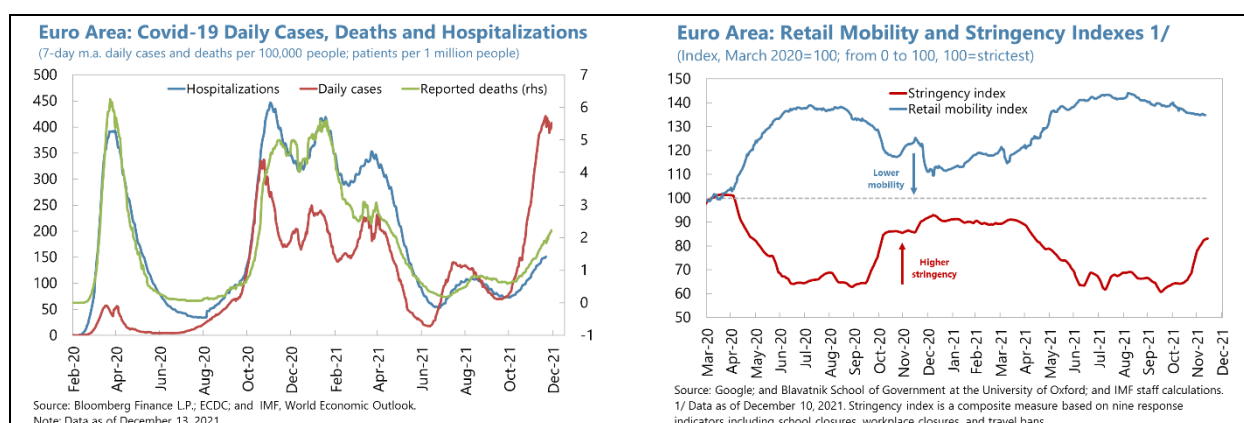


3. Sizable recovery packages will help structurally transform the euro area economy and increase its resilience, but vulnerabilities remain. The Next Generation EU (NGEU) offers a unique opportunity to push ahead with reforms and fill investment gaps that will support green and digital transitions and increase potential growth. Yet, the uneven impact of the pandemic and the multispeed recovery risk further increasing inequality and widening divergences between and within countries. Moreover, while significant headway has been made in recent years to deepen the Economic and Monetary Union and increase resilience—including the agreement on the revised European Stability Mechanism Treaty and introduction of a common backstop to the Single Resolution Fund—progress in areas such as increasing public and private cross-border risk sharing,

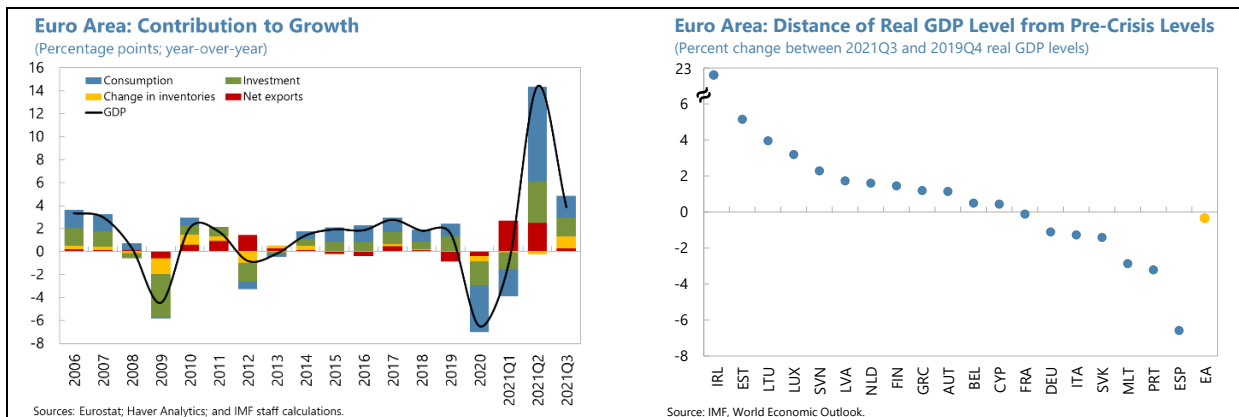
completing the banking and capital market unions, and reforming the existing fiscal rules, has been limited.

RECENT ECONOMIC AND POLICY DEVELOPMENTS

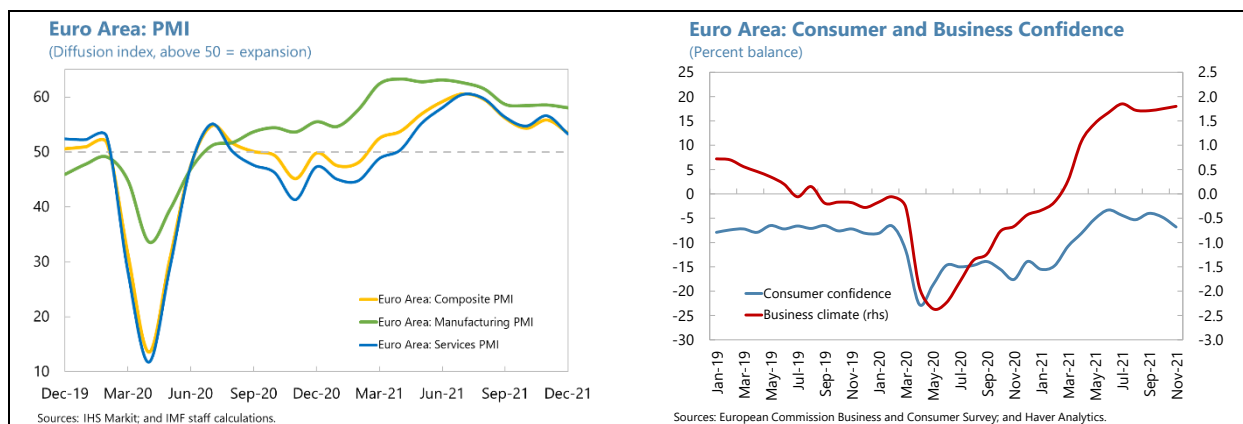
4. Increasing vaccination rates have led to fewer containment measures and higher levels of mobility, although trends started partially reversing in November. After a slow start in 2021Q1, vaccine rollouts accelerated considerably across the euro area, supporting a sharp reduction in the number of infections and hospitalizations in 2021Q2. As of early December, about 76 percent of the euro area population had received at least one vaccine dose with further progress largely constrained by vaccine hesitancy rather than bottlenecks in vaccine production and delivery. This progress has allowed the relaxation of lockdown measures—reversing their tightening in late 2020 and early 2021—and supported an increase in mobility indicators to their highest levels since the onset of the pandemic. More recently, the spread of the Delta variant has led to another wave of infections and—with rising concerns about newer and more transmissible variants such as Omicron—several countries have re-introduced containment measures. Hospitalization and fatality rates remain relatively low but are on an upward trend.



5. Growth has gained momentum, although the pace of the recovery is uneven across countries. Following a contraction of about 6½ percent in 2020, euro area real GDP declined by 0.2 percent (q/q) in 2021Q1 as a resurgence in infections drove countries to reimpose and extend mobility restrictions. As pandemic conditions improved and mobility increased in 2021Q2, growth rebounded by just above 2 percent (q/q) in both the second and third quarters. Despite the strong economic rebound, euro area output remained about ½ percent below its pre-pandemic level in 2021Q3, with the recovery speed varying significantly across countries. In this regard, the recovery in some southern European countries, where contact-intensive sectors such as hospitality and food services account for a sizable share in the economy, has lagged that of euro area peers.



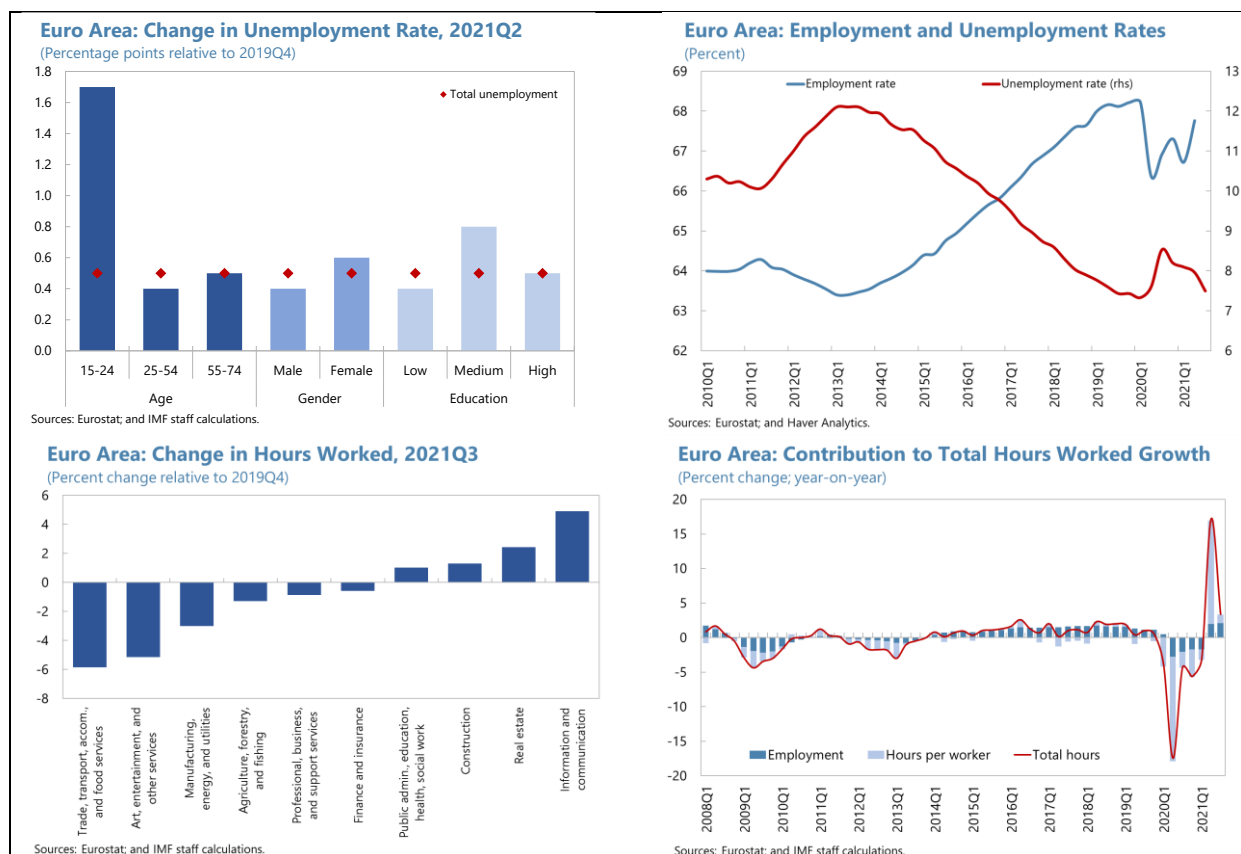
6. Although softening, high-frequency indicators point to reasonably robust activity in 2021Q4 amid growing supply constraints. Consumer and business confidence indicators remained well above their long-term averages in October, although they have softened slightly since their peak in 2021Q3 as reopening effects have started to wear off, Covid-19 cases have increased, and supply shortages have emerged. The composite Purchasing Managers Index (PMI) increased to historically high levels in July given a marked improvement in services and a robust expansion of manufacturing. While still firmly in expansionary territory, the PMI has eased subsequently. This reflects slower expansion of both manufacturing and services due to input shortages and rising costs, and the recent reintroduction of mobility restrictions.



7. The unemployment rate has declined further so far in 2021, but labor market slack in certain sectors and segments of the population remains sizable. The flash estimate for 2021Q3 suggests that euro area employment continued to recover strongly, supporting a further decline in the unemployment rate to 7.3 percent (October, seasonally adjusted), just below its pre-crisis level. With rising labor market demand, vacancies have increased markedly in expanding sectors, but labor shortages have emerged as firms are facing difficulties in filling these jobs.¹ Nevertheless, labor market slack remains: participation and employment rates, which declined sharply at the onset of the crisis, have only partially recovered, and total hours worked remain below pre-crisis levels,

¹ The European Commission’s Business and Consumer Survey indicates that production constraints are compounded by labor shortages, with a record 23.3 percent of managers identifying these as a limiting factor for production.

mainly reflecting lower levels of hours worked per worker, particularly in sectors such as trade, transport, accommodation and food services, and art and entertainment. In addition, the recovery is uneven across demographic groups with youth, female, and lower-skilled employment increasing much more gradually due to the relatively large share of those groups in contact-intensive sectors.



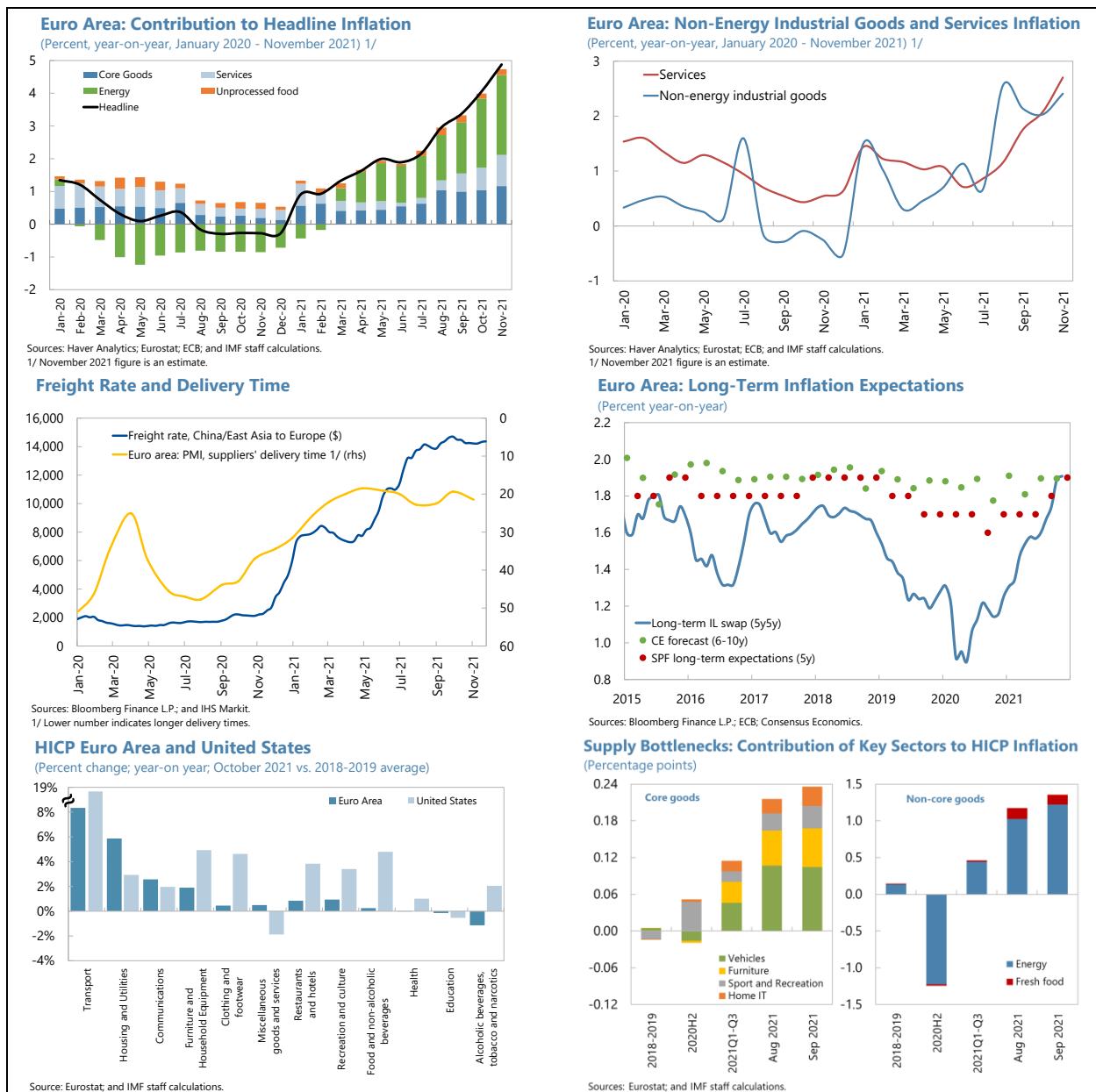
8. Forceful policy support averted a worsening of income inequality and poverty in 2020.

While underlying inequality is likely to increase given the disproportionate labor market impact on the young and low-skilled workers (see [Box 1 IMF 2020 Staff Report](#)), available data for a subset of euro area countries in 2020 show no significant change in the average level of people at risk of poverty or inequality indicators, partly reflecting the impact of existing income support measures. Preliminary EU-wide estimates by the European Commission point in the same direction, indicating that short-term support schemes were sufficiently progressive to offset the regressive labor market impact, with disposable income estimated to have been roughly stable for all income quintiles.² Meanwhile, those with substantial financial assets have benefited from the strong appreciation of asset prices, especially in real estate, likely increasing wealth inequality.

9. Inflation has increased sharply in recent months, mainly due to transitory factors and base effects. Both headline and core inflation rebounded strongly to 4.9 and 2.6 percent

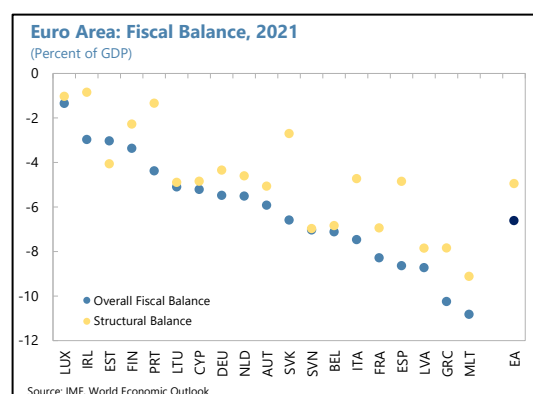
² See European Commission "[Early estimates of income inequities during the 2020 pandemic.](#)" The analysis does find substantial country heterogeneity.

(November), respectively, from historically low levels towards end-2020. The increase largely reflects a mechanical base effect from last year's low energy prices—which were amplified by dwindling reserves of natural gas due to severe weather conditions and limited supply—and one-off factors such as the expiration of the German VAT cut, and new consumer basket weights. Strengthening demand in the face of supply-chain disruptions and labor shortages in certain sectors have also contributed to higher prices more recently, with nonenergy goods inflation reaching 2.4 percent in November—significantly higher than historical levels. Services price inflation has also accelerated to above pre-crisis levels. Trimmed-mean measures of inflation, which exclude components of the most extreme monthly price changes, have increased in recent months to 2.5 percent, as have long-term inflation expectations, with 5y5y inflation swap rates standing at 1.9 percent in December—their highest level since 2014.



10. Sectoral mismatches between demand and supply in specific goods sectors have contributed significantly to core inflation recently. Staff estimate the impact at 0.25 p.p. in September 2021. Supply bottlenecks are most evident in the market for vehicles, where severe shortages in the production of microchips have been reported, exacerbated by a shift toward electric vehicles. In other sectors, such as furniture, home IT equipment, and recreational and sporting goods, a strong pandemic-driven increase in demand has resulted in bottlenecks even as production volumes have recovered to pre-pandemic levels. While the same categories have driven inflation in the United States, price increases have generally been less severe in the euro area than in the United States. Inflationary pressures have also been more broad-based across sectors in the United States, with service sectors tied to the reopening of the economy such as restaurants and hotels experiencing higher inflation than pre-pandemic.

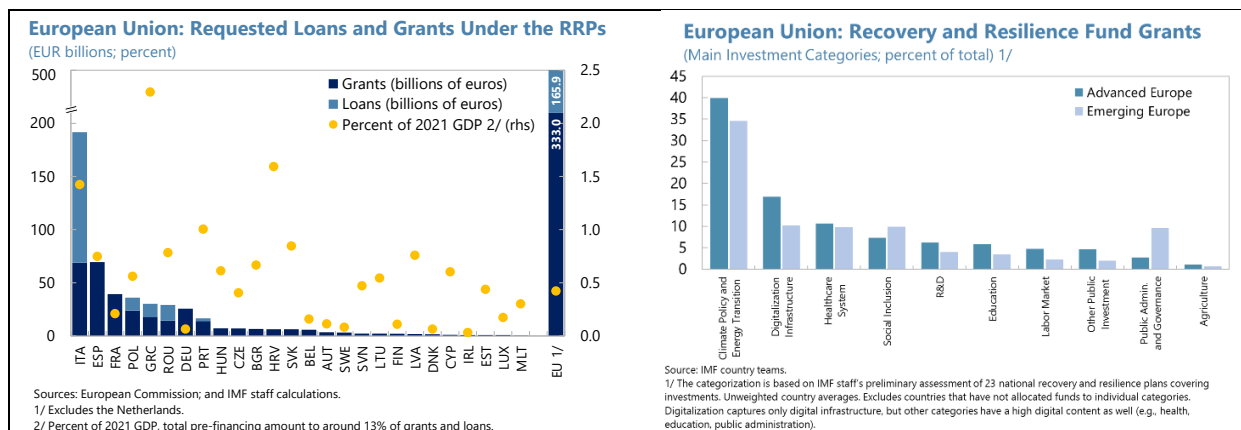
11. Fiscal policies in 2021 remained largely expansionary. While the euro area aggregate headline deficit is expected to improve by 0.6 percentage points compared to 2020, it is still projected to stand at 6.6 of GDP in 2021, given continued fiscal support to households and firms in hard-hit sectors. This reflects both sizable automatic stabilizers, projected at 1.2 percent of GDP, and discretionary measures, projected at 1.5 percent of GDP. Below-the-line measures, including equity support, are also projected to remain large.



12. Funds from the NGEU recovery package have begun to flow, providing further resources to EU countries. As of December 2021, 26 countries had applied for €333 billion of grants and seven countries had applied for €166 billion of loans from [the Recovery and Resilience Facility \(RRF\)](#). Pre-financing (typically 13 percent of total grants and loans and about 0.4 percent of 2021 GDP) is available to member states as their national Recovery and Resilience Plans (RRPs) are adopted, with €54.3 billion already disbursed to 20 countries.³ On average, countries are planning to devote nearly 40 percent of RRP spending to climate change-related investments, exceeding the target of 37 percent. While only 16 percent of spending is directly on digital infrastructure, much of the education and public administration spending is also on digitalization, bringing the total amount above the 20 percent target of spending. National RRP also allocate significant shares of the grants to upgrading healthcare systems (10 percent) and improving social inclusion (8 percent). To finance the NGEU package, the EU is expected to raise around €800 billion and become a major debt issuer during 2021–26.⁴

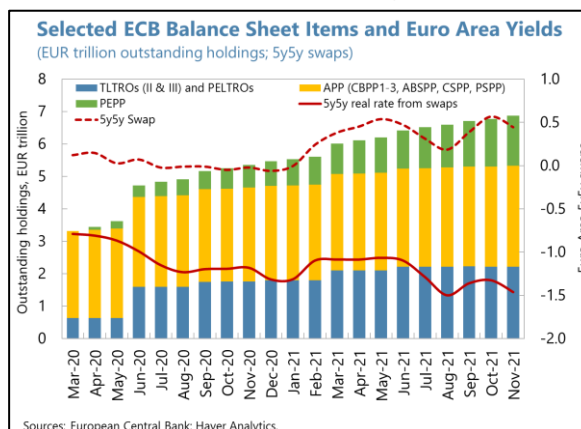
³ Netherlands has yet to submit their RRP.

⁴ To service the debt, the EU envisages to use new own resources, potentially from a Carbon-Border Adjustment Mechanism (CBAM), the Emission Trading System and corporate taxes. Any shortfall in EU own resources relative to debt service requirements would require additional contributions from EU country members, who have committed to contributing up to 0.6 percent of Gross National Incomes annually if such a shortfall materializes.



13. The ECB has maintained a highly accommodative monetary stance, further expanding its balance sheet.

The ECB continued to purchase sovereign and corporate bonds under its €1.85 trillion Pandemic Emergency Purchase Program (PEPP) and Asset Purchase Programs (APP). As euro area long-term sovereign yields increased in early 2021 amid rising global yields, especially in the U.S., the ECB Governing Council reinforced its accommodative monetary policy stance to counteract an undue tightening of financial conditions and stepped-up asset purchases under the PEPP, thus supporting the moderation of sovereign bonds rates—including the decline of long-term real yields to historically low levels. The ECB announced in September a moderate reduction in the pace of purchases in 2021Q4 after the Governing Council judged that favorable financing conditions could be maintained with a slower pace of net purchases. In December, the Governing Council reaffirmed plans to continue with a step-by-step reduction in the pace of asset purchases over the coming quarters by: (i) reducing net purchases to zero under the PEPP by end-2022Q1; and (ii) temporarily increasing asset purchases under the APP to €40 billion in 2022Q2 and €30 billion in 2022Q3, before returning to the pre-pandemic level of €20 billion in 2022Q4. Furthermore, it decided to extend the reinvestment horizon for the PEPP and maintain flexibility—including resuming net purchases under the program as needed—to counter negative shocks related to the pandemic.⁵ Meanwhile, the ECB continued to provide substantial liquidity to the financial sector through longer-term refinancing operations (mainly the targeted “TLTRO III”), supporting bank lending to the private sector (Box 1). The overall liquidity provided through these operations amounted to €2.2 trillion in September, equivalent to more than half of euro area bank excess reserves.



⁵ Principal payments from maturing securities purchased under the PEPP will be reinvested until at least the end of 2024, and they could be adjusted flexibly cross time, asset classes and jurisdictions, including with respect to Greek bonds, which are excluded from the APP.

Box 1. The Impact of the ECB's Targeted Longer-term Refinancing Operations on Bank Lending

Demand for the ECB's Targeted Longer-term Refinancing Operations (TLTROs) has surged during the pandemic. Since 2020Q1, the outstanding amount of TLTROs having tripled to about €2.2 trillion (as of September 2021) as an increasing number of banks opted for central bank liquidity at favorable rates. During this time, the ECB significantly expanded the eligibility and lowered the pricing of TLTRO borrowing. Italy, Spain, and Portugal have the highest take-up rate relative to the size of their banking sectors (chart) while French, German, and Dutch banks have become heavier users in absolute terms.

Staff analysis suggests that TLTROs have been effective in supporting favorable credit conditions—especially for NFCs.

Results from country-level panel data regressions, including a two-stage approach, controlling for macroeconomic factors, banking sector characteristics, financing costs, and demand for credit, and spanning over 17 years (2004–21), indicate that a one-percentage-point increase in the TLTRO take-up rate (relative to banking sector assets)¹ boosts net lending growth in the euro area by about 12 to 23 basis points (y/y) while the impact on lending rates is not statistically significant. Without access to TLTROs or other alternative cheap funding sources, corporate loan growth would have been 0.5 percentage points below the annual average of 2.6 percent observed over the last five years (chart).

Changes in terms and conditions can amplify TLTRO effectiveness. Banks' greater flexibility in accessing TLTROs during the pandemic has tripled the "TLTRO effect," accounting for almost half of new lending growth. Lower borrowing rates and a higher borrowing allowance seem to have increased banks' willingness to bid for TLTRO funding. Historical elasticities suggest that further raising the borrowing allowance could boost lending. While most banks still have sizable headroom, increasing the share of eligible loans from 55 percent to 60 percent for banks that face borrowing constraints has the potential of boosting the impact of TLTRO take-up on the net lending growth by around 10 percent, partially due to banks' anticipation effects.

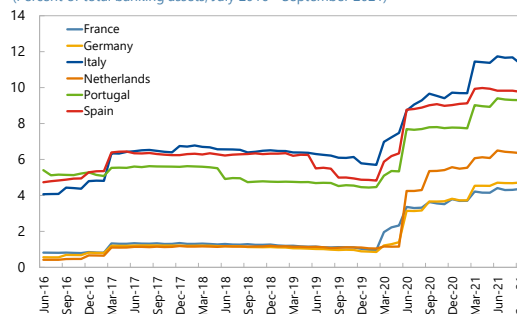
Stronger banks are better positioned to take advantage of TLTRO funding. The "TLTRO effect" on net lending growth is significantly higher in countries where banks have higher regulatory capital and lower nonperforming loans (NPL) ratios. Thus, rebuilding capital buffers in vulnerable countries—together with an effective NPL resolution strategy—would help amplify the "TLTRO effect" on the lending channel and ensure efficient monetary transmission.

Results indicate no evidence of "leakage" and arbitrage via government debt purchases. TLTRO funding does not seem to improve credit conditions for assets outside the borrowing eligibility, such as mortgages. In fact, banks with higher TLTRO take-up seem to raise mortgage rates and cut back on mortgage lending. There are also no signs of safe asset hoarding via sovereign carry of government debt with interest rates above the TLTRO ones, even during the period of strong quantitative easing.

¹ "TLTRO take-up" (i.e., TLTRO balance relative to previous period's total banking sector assets) measures the TLTRO funding by country at quarterly frequency.

TLTRO Take-up by Country

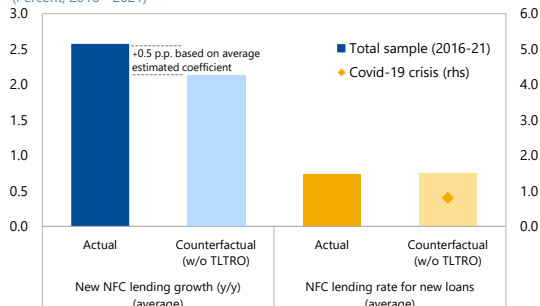
(Percent of total banking assets, July 2016 - September 2021)



Sources: ECB; Haver Analytics; and IMF staff calculations.

Euro Area: Average Impact of TLTRO Take-Up on NFC Lending

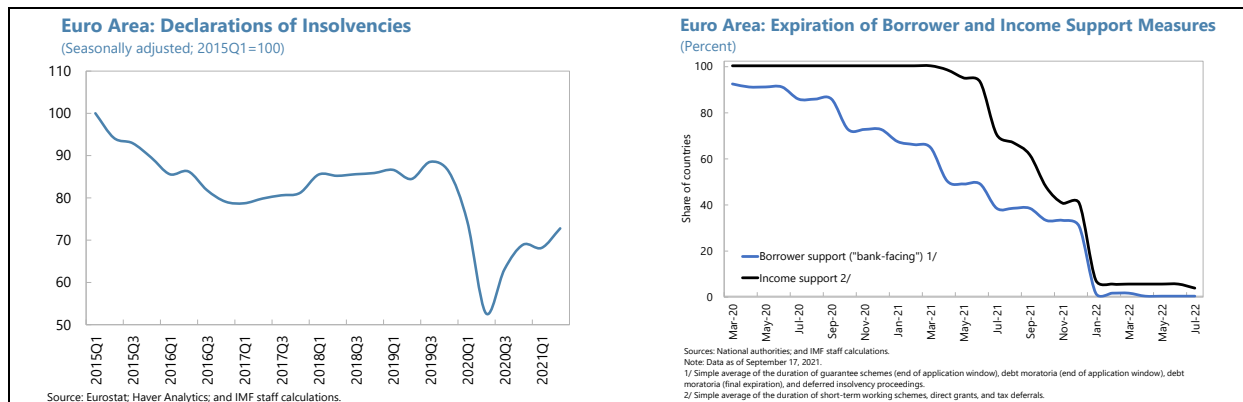
(Percent, 2016 - 2021)



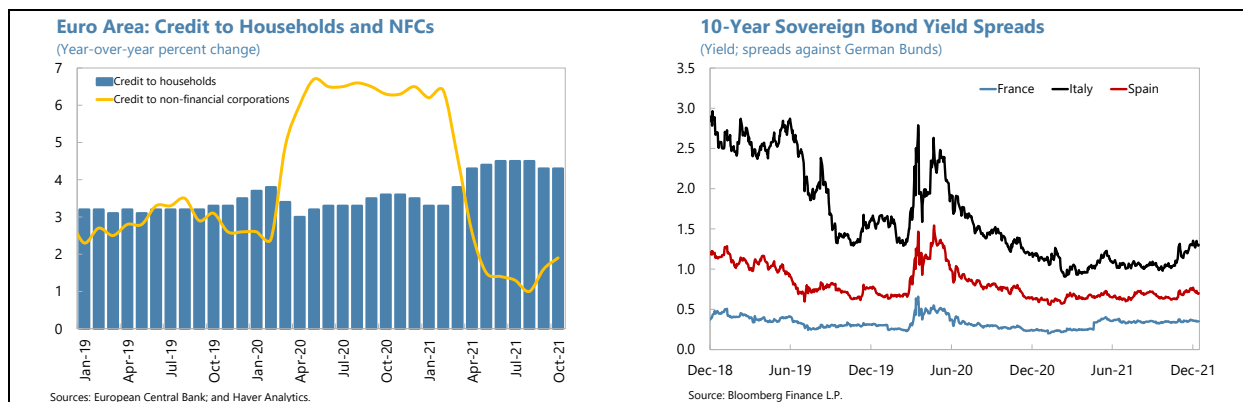
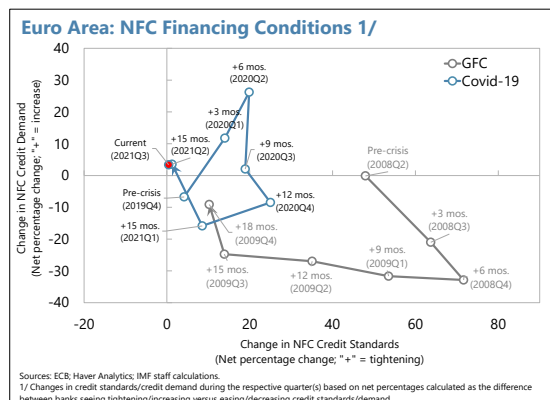
Sources: ECB; and IMF staff calculations.

14. The banking system remains resilient even as lifeline support measures expire. The European Banking Authority (EBA) stress test published in July 2021 indicated that most systemically important banks remain well capitalized. Concurrently, ECB has ended its recommendation to suspend bank dividends, moving to a case-by-case review starting from September 2021 while

continuing bank capital relief measures. This has boosted confidence, bringing European bank equity valuations back to their pre-pandemic levels. Many borrower and income support measures, including debt repayment and insolvency moratoria, have gradually expired. Consistent with this, corporate bankruptcies increased modestly in recent months, but remain below their pre-crisis level.



15. In sharp contrast to dynamics seen during the global financial crisis (GFC), financial conditions remain favorable, supporting borrowers and contributing to stretched asset valuations. With ample liquidity and improved market sentiment, equity prices continued to soar. Throughout the pandemic, sovereign yields have been contained at low levels, although they have drifted up since the beginning of 2021Q3 due to higher realized inflation and investors’ concerns about soaring energy prices. Nonetheless, since 2021Q2, increases in inflation risk premia have been largely offset by a continued decline in real risk premia (Box 2). Credit conditions for firms and households were broadly stable in the first 3 quarters of 2021, following a significant tightening in early 2020 and bank lending rates have remained at historically low levels. Credit to households grew at 4.3 percent yoy in 2021Q3—the highest pace since 2009—with mortgage loans as the main driver, contributing to higher residential property prices in many euro area countries. After some deceleration in most of 2021Q2-Q3 given firms’ ample liquidity buffers, credit to NFCs began to pick up at the end of 2021Q3 (1.6 percent y/y growth).



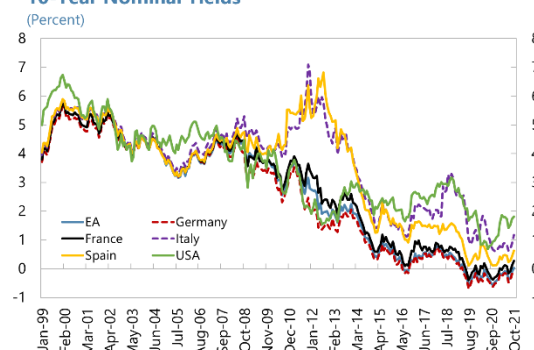
Box 2. Drivers of Euro Area Long-Term Sovereign Yields

The pandemic has kept euro area yields at historical lows. Long-maturity euro area government bond yields have experienced a secular decline since the early 2000s. In particular, average triple AAA euro area sovereign yields have been negative since mid-2019, averaging around -0.3 percent. Even high-debt countries, such as Spain and Italy, have experienced relative yield stability during this period, in contrast to the U.S. which has witnessed a sharp rise in long-term yields.

The behavior of yields is decomposed into nominal and real components. Most yield models decompose the yield curve into two components: a (nominal) expected rate and a (nominal) term premium. Following Hördahl and Tristani (2014), real and inflation risk premia are jointly estimated with expected real and inflation rates, using a macro-finance model with an affine term structure model.

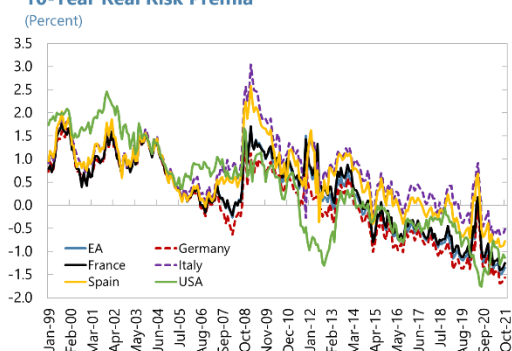
The fall in sovereign yields in the euro area has been primarily driven by a decline in the real risk premium. While expectations of real short-term rates in the euro area have remained relatively stable since 2014, investors have required a smaller compensation for inflation risks since early 2019, reflecting both a fall in inflation expectations and the impact of the pandemic. More recently, inflation risk premia have started recovering as inflation volatility has increased. Nonetheless, the fall in real risk premia has been the primary driver of declining yields, especially over the past year as demand for sovereign bonds has remained strong given ECB purchases and lower uncertainty over the projected path of short-term policy rates following the ECB's forward guidance that rate increases were unlikely in the near term. Weak economic growth since the sovereign debt crisis has also contributed to an increased preference for bonds with investors tolerating even deeper negative term premia. In contrast, the U.S. has seen an increase in the inflation risk premium since 2020 amid a volatile real risk premium, with the former likely reflecting both recent upward inflation surprises and heightened uncertainty surrounding both monetary and fiscal policies going forward.

10-Year Nominal Yields



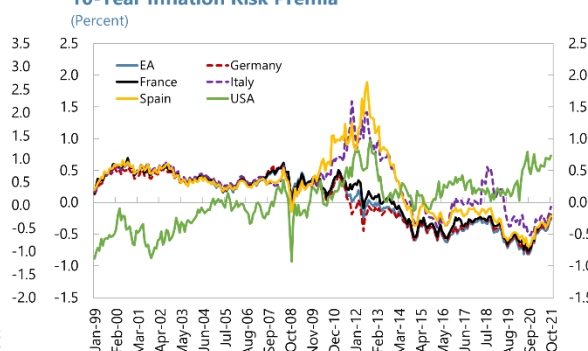
Sources: Bloomberg Finance L.P.; and IMF staff calculations.

10-Year Real Risk Premia



Sources: Bloomberg Finance L.P.; and IMF staff calculations.

10-Year Inflation Risk Premia

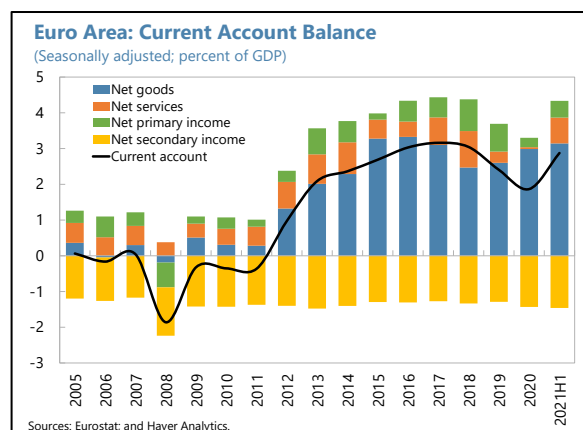


Sources: Bloomberg Finance L.P.; and IMF staff calculations.

16. The current account balance improved in 2021H1, led by a strong recovery in trade.

The current account surplus increased to 2.9 percent of GDP in 2021H1 from 2.0 percent of GDP in 2020, largely reflecting a sizable increase in net exports of services. The goods balance also improved in 2021H1 despite a sharp increase in imports of goods, particularly in 2021Q2. Through

November 2021, the NEER and the REER appreciated by 2.2 and 1.0 percent, respectively, relative to the same period in 2020. The external position in 2021 is assessed as moderately stronger than the level implied by medium-term fundamentals and desirable policies (ESA, Table 2), after being broadly aligned in 2020 (see IMF External Sector Report). However, this assessment is preliminary and subject to a wide range of uncertainty arising from the preliminary nature of data and Covid-19 adjusters for 2021.⁶



OUTLOOK AND RISKS

A. Uneven Recovery Predicated on Continued Adaptation to Covid-19

17. Staff's baseline forecast is for a strong recovery, underpinned by the continued rollout of effective vaccines and therapies, and greater resilience of activity to Covid-19 cases. Covid-19 may well become endemic.⁷ The baseline implicitly allows for this and assumes further progress in protecting the euro area population against severe effects of the virus and possible variants, thus bringing hospitality and mortality rates to low levels in 2022 and beyond and paving the way for a gradual return to normalcy over the medium term. Economic activity is expected to continue benefiting from improving sentiment and demand, including for contact-intensive services, while ongoing policy support will help limit job losses and bankruptcies, thus reducing the risk of adverse real-financial feedback loops. The recent rise in cases driven by the spread of the Delta and Omicron variants suggests that further resurgences could well be in the cards with the arrival of additional new variants. But with effective vaccines and therapies, and increasing business adaptation to social distancing and remote working practices, the impact on activity is likely to be contained.

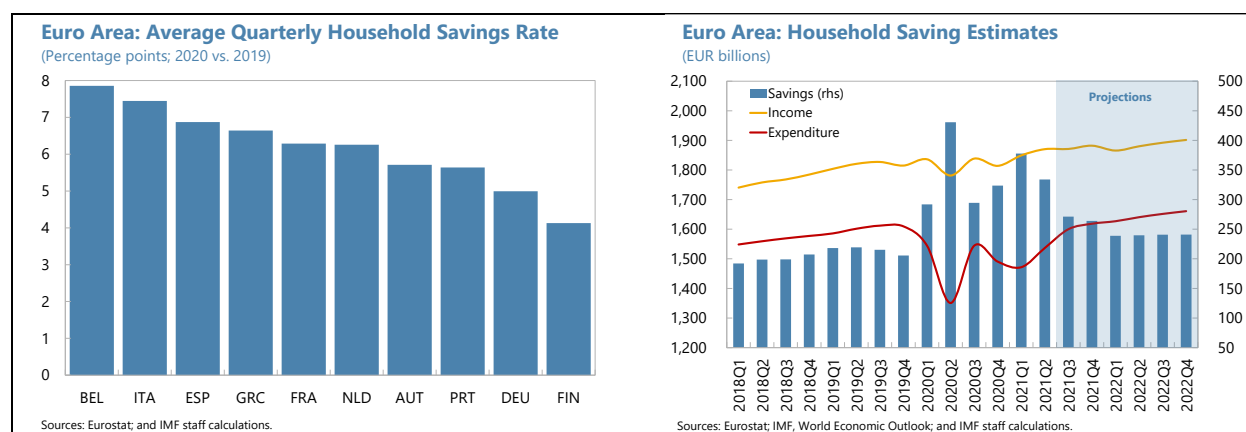
Near-term Outlook (2021–22)

18. Economic activity is estimated to have rebounded strongly in 2021. Real GDP growth is estimated to have accelerated to about 5¼ percent in 2021 and—with output surpassing its pre-crisis level in 2021Q4—growth is set to moderate to about 4¼ percent in 2022. Private consumption is set to be the main driver of growth, given improving consumer confidence and the gradual normalization of the household saving rate. The savings rate saw an unprecedented spike in 2020 across the euro area—largely due to a sharp drop in expenditures on contact-intensive services—but is expected to gradually return to around historical averages in the medium term. The accumulated stock of excess savings of around €780bn as of 2021Q2 (7 percent of 2021 GDP) is not expected to be dissaved in the baseline. This is because, on balance, while savings are highly liquid,

⁶ The final assessment will be provided in the 2022 *External Sector Report*.

⁷ In other words, not eliminated and continuing to circulate in pockets of the population (e.g., like a seasonal flu).

the opportunities for increased spending may be small due to limited pent-up demand and supply disruptions (Box 3). Rebounding activity should increase net exports, while favorable financing conditions and the impulse from RRF-related financing would support public and private sector investment. The demand recovery should reduce excess production capacity, with the output gap declining from 4½ percent in 2020 to ½ percent in 2022, despite a significant recovery of potential growth (Text Table 1).



Text Table 1. Euro Area: Main Economic Indicators, 2019–26

	2019	2020	Projections					
			2021	2022	2023	2024	2025	2026
Real GDP growth	1.6	-6.4	5.2	4.2	2.2	1.7	1.5	1.4
with contributions from (ppt):								
Private consumption	0.7	-4.2	1.9	2.9	1.2	0.9	0.9	0.8
Public consumption	0.4	0.3	0.8	0.0	0.2	0.2	0.2	0.2
Gross fixed investment	1.4	-1.5	1.0	0.9	0.7	0.5	0.4	0.4
Net exports	-0.8	-0.3	1.2	0.4	0.1	0.1	0.0	0.0
Current account (% GDP)	2.3	2.0	2.8	2.9	3.0	2.9	2.8	2.7
Unemployment rate	7.6	7.9	7.9	7.7	7.4	7.3	7.2	7.1
Potential GDP growth	1.4	-2.0	3.4	2.0	1.8	1.5	1.4	1.4
Output gap	0.1	-4.3	-2.6	-0.6	-0.2	0.0	0.1	0.1
Inflation	1.2	0.3	2.5	2.6	1.4	1.6	1.6	1.7

Source: IMF, *World Economic Outlook*.

19. The transitory uptick of headline inflation is projected to continue well into 2022, although there will be step declines in early 2022 as base effects dissipate. Rising demand combined with supply-side disruptions and transitory factors—including sharply rising natural gas prices—are projected to continue, resulting in average HICP and core inflation of 2.5 and 1.4 percent in 2021, respectively. Nevertheless, as base effects of energy prices wane and the impact of German VAT changes fully unwind in early 2022, HICP inflation is projected to decline but remain above 2 percent in 2022, as supply-side constraints and labor shortages in specific sectors continue to add to inflation pressures. Second-round effects are assumed to be limited in the baseline, however, as aggregate labor market slack is likely to persist for an extended period, attenuating any impact on wages and keeping core inflation below 2 percent from 2022 throughout the forecast horizon. Indeed, negotiated wages in the euro area increased by 1.3 percent in 2021Q3 (y/y), broadly in line

with the pre-pandemic average, and the prevalence of wage indexation has declined significantly in recent years and is largely linked to inflation excluding energy prices.⁸

Box 3. Household Savings During Covid-19: Drivers and Implications

Pandemic-induced excess savings are estimated at around €780bn for the euro area as of 2021Q2, corresponding to 7 percent of GDP.

A steep drop in expenditures amid broadly stable disposable income has resulted in a continuous build-up of excess savings since 2020Q1. While the increase in savings in the euro area is unprecedented in recent decades, some other advanced economies (notably the US, Canada, and Australia) experienced even larger excess savings due to an increase in household disposable income.

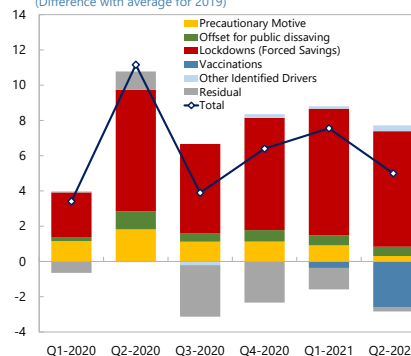
Empirical analysis suggests forced savings account for the bulk of excess savings. Panel regressions for 10 euro area countries covering the period 2000Q1–2021Q2 point to an overwhelming role for forced savings (captured by the Oxford Covid-19 Government Response Stringency Index) as a driver of recent excess savings, while precautionary motives (captured by unemployment expectations and the VIX index) played a smaller role. Vaccinations (representing reduced fear of contagion) contributed to a drop in the savings rate in 2021Q2 relative to previous quarters.

Forced savings were driven by foregone consumption in contact-intensive service sectors. Transport, hotels, and recreation and culture explained around 55 percent of the drop in expenditure in 2020, while restaurants were the largest single category, contributing a further 25 percent. Monetary data show that the bulk of savings were channeled to currency and deposits, and, to a lesser extent, loan repayments. The distributional picture is more mixed. While card transactions and bank data for France suggest that high-income households accounted for a large share of the rise in savings, responses to the European Commission's Consumer and Business Survey point to a broad-based increase in self-reported savings across income and age groups.

A significant rundown of excess savings appears unlikely in the short-term, but even a modest reduction would have large macroeconomic effects. The high share of liquid assets and the large role of forced savings might suggest ample room for “excess consumption” going forward. However, the sectoral composition of foregone consumption and potentially large contribution of higher income households to excess savings suggest limited scope for such a scenario. In addition, current supply bottlenecks may constrain the amount that households can substitute between the consumption of services and consumer goods. Nevertheless, simulations show that even under a moderate dissaving scenario—a 3.5-percent-of-GDP decline in the saving stocks relative to the October WEO baseline over 2022–23—GDP would increase by a similar amount.

Decomposition of Increase in Euro Area Household Saving Rate

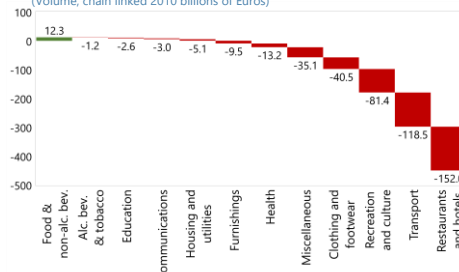
(Difference with average for 2019)



Source: IMF staff calculations.
Note: Underlying quarterly regressions through Q2-2021. Regressions come from a panel for ten euro area countries, representing 95 percent of total disposable income. Euro area results in this graph are obtained by taking a disposable income weighted average of country specific results.

Deviation from Trend of Final Household Consumption Expenditure in 2020 1/

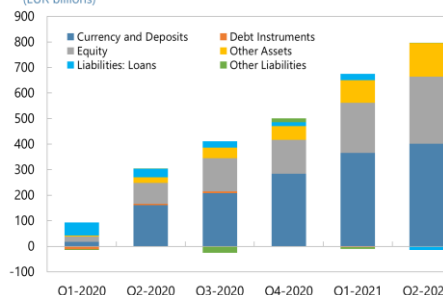
(Volume, chain linked 2010 billions of Euros)



Sources: Eurostat; and IMF staff calculations.
1/ Data from France, Germany, Italy, and Spain.

Allocation of Excess Savings

(EUR billions)



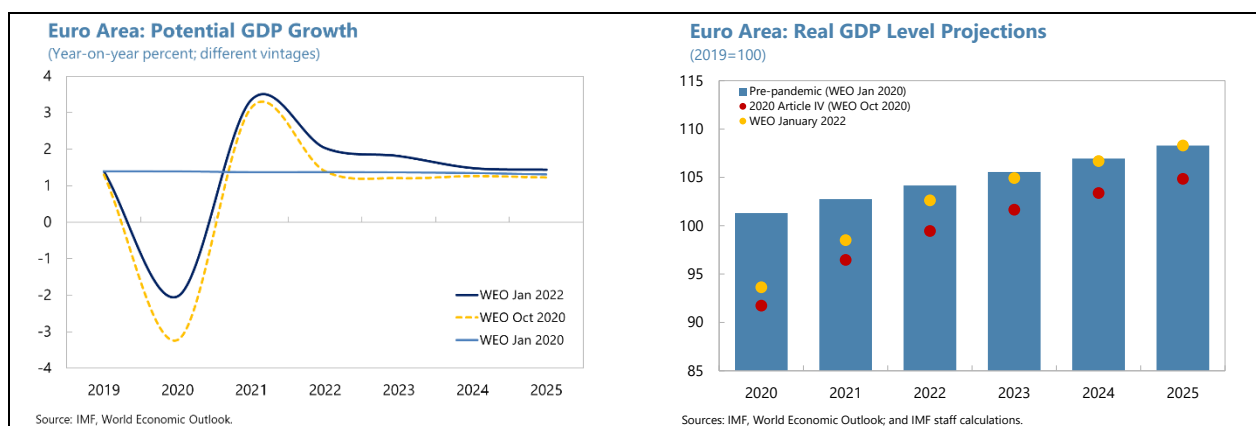
Source: European Central Bank; Haver Analytics; and IMF staff calculations.

⁸ See [ECB economic Bulletin 7/2021](#).

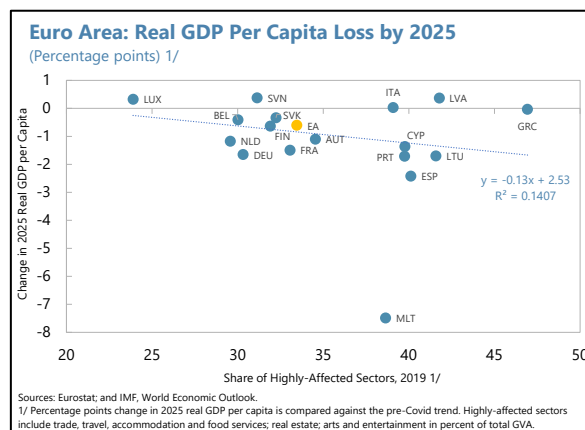
Medium-term Prospects

20. Over the medium term, output should return to potential as demand and supply conditions gradually normalize, but inflation is set to remain subdued for an extended period.

A strong recovery led by domestic demand is projected to close the output gap in 2024, with the unemployment rate returning to pre-crisis levels soon thereafter. However, with a flat Phillips curve and stable inflation expectations, core inflation—while gradually increasing—is projected to remain below the ECB’s 2-percent inflation target throughout the projection horizon. Economic scarring, measured by the output loss relative to the pre-crisis trend, is projected to decline over time and disappear by 2025 given a higher path for potential growth in the coming years than previously projected, partly thanks to significant RRF-related investments.



21. However, the recovery is likely to be uneven across countries and sectors, potentially increasing inequality and disparities both across and within countries. The recovery is likely to be slower in countries with a larger share of contact-intensive services that were hard hit by the pandemic. As young and low-skilled workers are disproportionately employed in these sectors, the crisis may increase income inequality within countries when policy support is withdrawn.



B. Risks Remain High Given Uncharted Waters

22. Uncertainty remains high and largely dominated by the pandemic’s dynamics and legacies (Risk Assessment Matrix, Table 3). Risks remain intertwined with the evolution of the pandemic, the efficacy of vaccines and therapies against potentially ever more transmissible variants such as Omicron, and induced behavioral and preference changes of households and firms. In this regard, a rapid rise in mortality rates, including due to reduced efficacy of vaccines to new variants or incomplete vaccination coverage, could lead to renewed containment measures and impede the recovery. Such developments would also result in deeper scarring effects, especially given less fiscal

space in some countries. On the upside, a combination of reduced vaccine hesitancy, further vaccine and therapy breakthroughs, and fast adaptation of behavior and business practices could lead to virtuous circle of increasing confidence and activity even if Covid-19 becomes endemic.

23. A faster-than-expected resolution of the health crisis could have large positive indirect effects, while other factors could also improve growth prospects. Reduced cases, hospitalizations, and mortality would not just have direct positive effects on mobility and activity but could also lead to a strong unwinding of excess savings, significantly boosting consumption. A stronger-than-anticipated global recovery, and a productivity spurt on account of pandemic-induced accelerating automation and digitalization could also boost growth.

24. Inflation risks are to the upside as supply disruptions could persist for longer than expected, hindering the recovery and resulting in sustained price pressures. Long-lasting supply shortages of intermediate inputs and persistently high energy prices would dampen the recovery. Large second-round effects on nominal wage growth and prices could lead to inflation durably overshooting the ECB's target, prompting monetary policy normalization earlier than currently expected. Monetary tightening aimed at reining in demand would slow the recovery and increase debt service repayment stresses of leveraged households and firms. Higher sovereign yields and a slower recovery would also increase the financing challenges facing high-debt countries.

25. Adverse macro-financial feedback loops would exacerbate vulnerabilities and delay the recovery. A prolonged health crisis with insufficient support measures due to declining policy space in some countries would result in substantial bankruptcies and job shedding, thus increasing economic scarring with repercussions for income inequality and social cohesion. Higher-than-expected loan losses due to the expiration of policy support and/or negative spillovers from exposures abroad would increase impairment charges and diminish banks' willingness to lend. This, in turn, would negatively affect liquidity-constrained households and firms. With elevated debt levels and sizable contingent liabilities—including from borrower-support measures and sovereign-bank links—public sector vulnerabilities could also increase substantially. A large shift in market perception would undermine high-debt countries' ability to roll over and service their debt. A sharp slowdown in China triggered by rising vulnerabilities in the real estate sector could also create important growth headwinds in the euro area, particularly through trade linkages.⁹

26. Escalation of trade tensions could undermine the recovery. Trade tensions with the U.S. have declined but have not been fully resolved, while further delays in implementing the Northern Ireland protocol could increase frictions between the EU and U.K. Moreover, while the European Commission has announced plans to extend temporary equivalence for U.K.-based central counterparties beyond the current deadline of 30 June 2022, failure to reach a long-term solution on regulatory equivalence could potentially lead to financial market disruptions. Tension with China could grow in the coming years, particularly following the recent freezing of the investment

⁹ Direct financial exposures of euro area's financial institutions are limited. However, exports of goods and services to China account for about 8 percent of the euro area's total exports.

agreement with China and mutual imposition of sanctions. Lastly, disagreements about carbon border adjustments could also disrupt trade flows.

27. The robustness of the recovery will critically depend on policy effectiveness and coordination.

- A premature withdrawal of policy support and slower-than-anticipated implementation of the RRP would weaken the recovery. Inability to counteract undue tightening of financial conditions—including due to shifts in market sentiment or potential spillovers from faster-than-expected U.S. monetary policy normalization in response to persistently high inflation and/or de-anchoring of inflation expectations—would also adversely affect growth momentum by straining leveraged corporates and households and limiting policy space of high-debt countries.
- Insufficient efforts to address labor market rigidities, debt overhang, and inefficient insolvency processes could impede efficient reallocation of resources, thus leading to significant labor market hysteresis, low productivity growth, and sizable economic scarring. The likely adverse distributional effects could lead to widespread social discontent and political instability. A belated withdrawal of emergency lifelines could also lock labor and capital in unproductive firms and industries and hinder the needed structural transformation.
- An uneven recovery across countries could potentially weaken the efficiency of policy coordination and lead to fragmentation that could curtail the benefits of a single market. Diverging views among the ECB Governing Council members may become more visible with the pandemic phase in the rear-view mirror, complicating policy communication, especially related to forward guidance.

Authorities' Views

28. The authorities shared staff's general assessment of the macroeconomic outlook.¹⁰

They projected a strong rebound in 2021 and robust growth in 2022, although headwinds to growth stemming from supply bottlenecks and elevated energy prices were likely to persist in the coming months. The strong recovery would continue to be supported by improving labor market conditions, reduction in the households' savings rate, continued favorable financing conditions, and supportive policies, including the deployment of funds under the Recovery and Resilience Facility. Job creation is projected to continue, supporting a further decline in the unemployment rate and the re-absorption of residual workforce still on job retention schemes. Over the medium term, the authorities expected potential growth to return to pre-pandemic levels, with limited scarring from the pandemic.

29. The authorities noted that risks surrounding the growth outlook remained high. While pandemic dynamics were the primary source of uncertainty, the authorities noted that economic

¹⁰ The term 'authorities' refers to regional institutions responsible for common policies in the currency union and not to the respective member states' authorities, unless specifically identified by the country's name.

activity was becoming more resilient to the pandemic given high vaccination levels and increasing adaptation to remaining restrictions. They stressed, however, that more persistent supply-side pressures and cost pressures from high energy prices would weigh on economic activity. Risks stemming from China's real estate market warranted close attention given the potential impact on China's growth outlook and spillovers to the rest of the world, while monetary policy normalization in the U.S. was likely to have limited direct impact on the euro area given expectations of continued strong monetary accommodation by the ECB. On the upside, the authorities argued that buoyant consumer confidence could result in a faster reduction of the savings rate, boosting consumption and economic activity, while ambitious investments and reforms supporting the green and digital transitions could significantly stimulate productivity and growth.

30. Recent high levels of inflation continued to be viewed as largely transitory. The authorities agreed that the spike in headline inflation in 2021 was largely driven by the increase in energy prices and transitory factors, most of which were likely to fade in early 2022. Nevertheless, growing supply-demand imbalances are more persistent than previously assumed, pushing up production costs. This could pose upside risks as firms may pass through cost push shocks to consumer prices more strongly-than-previously assumed. At the same time, a renewed tightening of pandemic-related restrictions could weigh on future economic recovery, posing downside inflation risks. While the authorities still expect wage rises to be contained by well-anchored inflation expectations and labor market slack, wage negotiations were expected to be more frequent in the near term as many contract renewals were put on hold during the pandemic, potentially accelerating the adaptation of wages to the new inflation outlook. The more limited use of ex-post indexation in wage setting compared with past decades would help containing second round effects.

31. The authorities agreed that the euro area's external position had strengthened in 2021 as external demand, including for services, continued to recover. At the same time, the authorities noted that models point to somewhat smaller current account gaps, while stressing that the final external sector assessment would hinge on the outturn of the euro area current account in 2021H2, which may prove weaker than currently projected. The authorities further highlighted the role of national policies in reducing external imbalances at the country level.

POLICIES: CHARTING A ROBUST RECOVERY UNDER HIGH UNCERTAINTY AND BUILDING FORWARD BETTER

The policy challenges of sustaining a recovery given the still elevated level of uncertainty surrounding pandemic dynamics and legacies remain daunting. Agility and policy coordination will be indispensable to adjust policies to the stage of the recovery and the strength of private demand. As the recovery gains momentum, policies should become increasingly targeted to foster post-crisis resource reallocation and contain economic scarring, while mitigating the pandemic's deleterious impact on equality and poverty. Looking ahead, "building forward better," enhancing resilience, and reducing income divergence across countries will require important structural

reforms and high-quality investments, including in climate-friendly infrastructure and digitalization. Rebuilding policy space should begin once the expansion is clearly underway but credible-medium term fiscal plans should be announced now.

A. Monetary Policy: Continued Focus on Underlying Inflation Dynamics

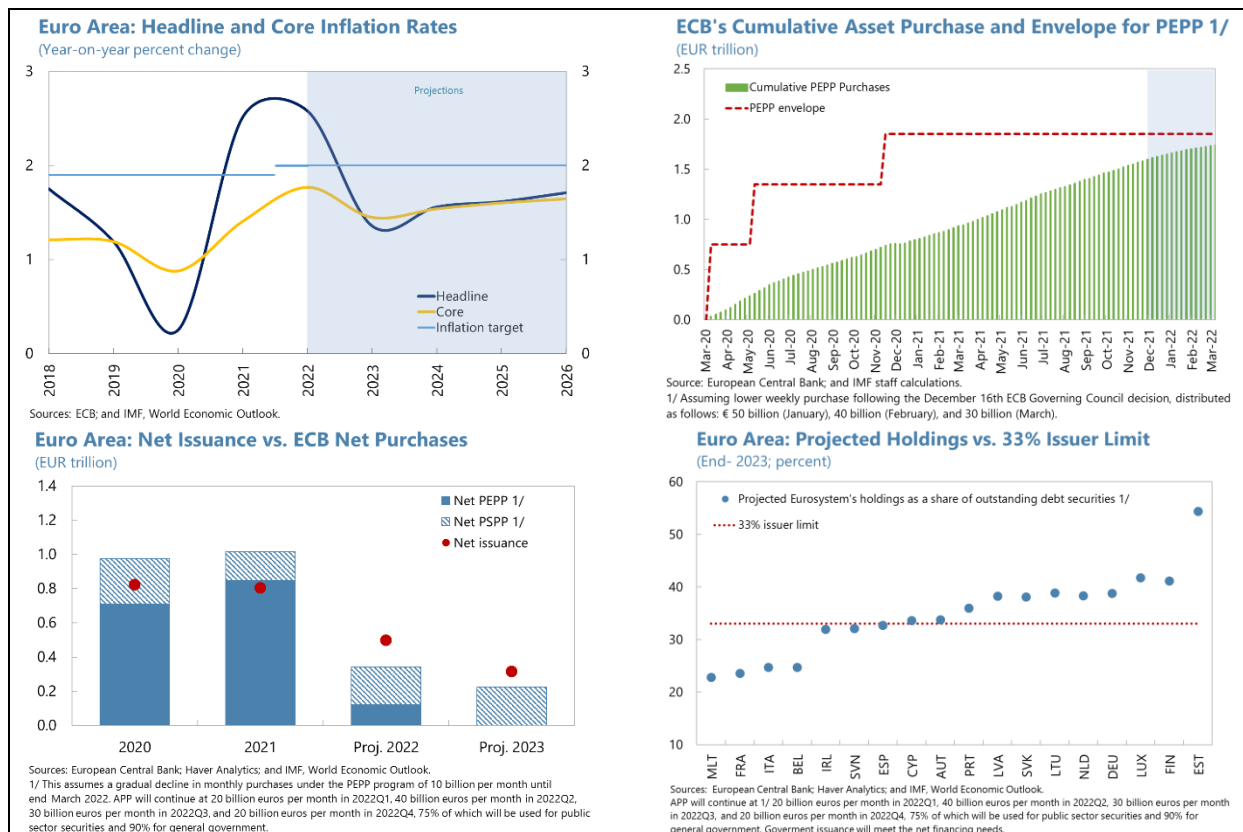
32. In July 2021, the ECB Governing Council concluded its strategy review and announced important changes to its monetary policy framework. These include: (i) formally adopting a symmetric inflation target of 2 percent; (ii) including owner-occupied housing (OOH) costs in the measurement of the Harmonized Index of Consumer Prices (HICP); (iii) increasing focus on financial stability risks and macro-financial linkages, and (iv) incorporating climate change considerations in the areas of disclosure, risk assessment, the collateral framework, and corporate sector asset purchases. The ECB reiterated that, while its primary policy instruments are policy rates, unconventional tools such as forward guidance, asset purchases, and LTROs would continue to play important roles when the key rates are close to the effective lower bound. The ECB also decided to improve its communication strategy via more direct and regular channels and recognized the need for more regular strategy reviews.

33. The adoption of a 2-percent symmetric inflation target is in line with staff recommendations. This shift, which formally codifies Governing Council emphasis on symmetry in recent years, provides welcome clarity by removing the ambiguity surrounding the previous target of “below, but close to, 2 percent”—especially the perception that 2 percent is a ceiling—and better anchoring inflation expectations. In this context, the ECB clarified that—while viewing both negative and positive deviations from the target as equally undesirable—it would accept transitory periods of inflation moderately exceeding the target without actively seeking to overshoot the target as in average inflation targeting frameworks.

34. With underlying inflation having undershot the target for many years and medium-term dynamics projected to be weak under the baseline, a highly accommodative monetary stance will likely be needed for an extended period. The ECB’s forceful response since the onset of the pandemic has been appropriate and helped counter the pandemic’s disinflationary pressures. Under the announced-policies baseline, headline and core inflation are projected to decline in 2023, once transitory factors dissipate, and—while gradually recovering—remain below the 2 percent target over the medium term. The baseline is predicated on limited second round effects given the low degree of wage indexation, and—withstanding the tighter labor market conditions—on weak wage bargaining dynamics, consistent with the pre-pandemic experience. This underscores the importance of looking through transitory inflation overshooting—consistent with the symmetric inflation targeting framework—and maintaining a highly accommodative monetary policy stance for an extended period. In this regard, the ECB Governing Council’s clearly communicated commitment to not hike policy rates until inflation projections remain durably at 2 percent is welcome.

35. The Governing Council’s decision in December to maintain a strategy of flexibility and optionality in the conduct of monetary policymaking is appropriate. Given a brighter

Eurosystem staff outlook for growth and inflation, the Governing Council decided to end net PEPP purchases while overall gradually reducing asset purchases in 2022. They also underscored flexibility to adjust course in the face of the elevated uncertainty. The announced policies suggest that overall asset purchases will revert to the pre-pandemic levels in 2022Q4, but the ECB may need to provide further support via additional asset purchases if inflation projections continue to be below target in 2023 and beyond. In this scenario, given that several countries could breach the 33 percent issuer limit in the coming years (chart), the ECB’s self-imposed limits on asset purchases will likely need to be revisited before they become binding. In this regard, the issuer limit could potentially be raised¹¹ (but remain below 50 percent), and/or deviations from the capital key could be tolerated for a longer period.¹² The upcoming issuance of EU bonds to finance the NGEU also provides an opportunity for the ECB to lift its purchase limit on supranational or institutional bonds, currently set at 10 percent of the Public Sector Purchase Program (PSPP) holdings. TLTROs have been effective in boosting bank lending to corporates and households (see Box 1). With first loan repayments under TLTRO III due in 2022H2, concerns around cliff-edge effects may warrant the extension of the program through 2022 and beyond if there is sufficient credit demand.



¹¹ In 2015, the ECB Governing Council decided to raise the issue share limit from 25 to 33 percent.

¹² The issuer limit is meant to reduce the risk that an outsized Eurosystem holding hampers the functioning of national government bond markets. It also prevents the ECB from having a blocking majority in case of sovereign debt restructuring.

36. Policy should remain agile and ready to respond to potential upside inflation risks.

Second-round effects that bring underlying inflation closer to the target are welcome. If, however, sustained wage pressures—from a stronger-than-projected recovery or from durable supply-side disruptions—result in persistent inflation overshooting, the ECB is well-equipped to respond by scaling down and then terminating asset purchases and TLTROs, followed by a gradual adjustment of key interest rates towards historically more typical positions. In addition, the ECB may need to adjust its reinvestment strategy of the principal from maturing securities purchased under the APPs and PEPP. In such a scenario, clear communication about the transitory versus permanent impact of pandemic-related developments and policies on inflation, and the ECB's actual forward guidance, would be essential to anchor inflation expectations over the medium term.

37. The ECB's plan to include the owner-occupied housing (OOH) costs in the HICP would provide a more accurate reflection of consumer spending, but implementation will take time.

To further enhance the representativeness of the HICP and its cross-country comparability, the ECB Governing Council recommended a roadmap to include OOH costs in the HICP. While a number of approaches could be used for computing OOH costs, each involving some degree of compromise, the ECB has expressed a preference for the net acquisitions approach (see Annex II). This approach, while conceptually closest to the HICP requirement of being based exclusively on actual monetary transactions, faces implementation challenges that mean full implementation will take many years.^{13,14} These stem from the lack of timely monthly data on construction and house prices, and the ability to separate asset prices and shelter services. The ECB should explore ways to address these challenges in a timely manner, possibly by using certain hedonic methods that are more suited for compiling monthly house price indices, and/or real estate asking prices from web portals rather than administrative data on property transactions that are often only available with a significant lag. Similarly, the feasibility of compiling monthly output-based construction price indices for residential housing could be assessed.

38. Climate-related measures could potentially have far-reaching effects on financing conditions, although the operational details of most measures are yet to be published. The ECB has recognized that climate change falls within its mandate when certain conditions are met and plans to reflect climate change risks in its policy framework. In addition to including climate factors in its monetary policy assessments, the Governing Council plans to incorporate climate change criteria in its corporate bond purchases and introduce disclosure requirements for eligibility as collateral and asset purchases. Furthermore, the ECB will introduce new indicators for green financial instruments and financial institutions' carbon footprints and exposures to climate-related physical risks. Finally, the ECB has emphasized measures to mitigate climate change-related risks, including conducting system-wide stress tests with the European Systemic Risk Board and the European Commission and reviewing valuation and risk control measures in its collateral framework. The ECB's [detailed roadmap](#) of climate change-related actions, which will be implemented in line

¹³ Under the roadmap, the official quarterly HICP including OOH costs will become available by 2026.

¹⁴ Other approaches (notably rental equivalence) do not face these challenges and have been successfully implemented by major advanced economies, but do not meet the current HICP requirement of being based exclusively on actual monetary transactions.

with the progress on the EU policies and initiatives in the areas of environmental sustainability disclosure and reporting, suggests that the calibration of most envisioned measures will be spread over 2021–24.

39. Climate actions such as enhanced monitoring, stress testing, and disclosures are welcome, but the case for greener monetary policy operations needs careful analysis.

Enhanced monitoring and stress testing will allow supervisors and banks to better account for climate-related risks.¹⁵ Improving climate-related disclosures will promote transparency and data availability, thus fostering sustainable finance, improving market confidence, and potentially strengthening the link between Environmental, Social, and Governance (ESG) scores and emission growth.¹⁶ Meanwhile, integrating the climate agenda into monetary policy operations, while desirable as a way to address market failures (emissions externalities), can face both practical and political challenges. For example, green corporate asset purchases seem constrained by market depth, green TLTROs may influence the credit quality of bank lending, and green adjustments to the collateral framework may interact with the ECB's own balance sheet risk management. The effectiveness of green monetary policies in changing the relative prices of carbon-intensive activities is also lessened if firms' financing sources are easily substitutable. Finally, the resource allocation impact of green monetary operations could raise questions of democratic legitimacy and proportionality, thus potentially undermining the ECB's independence.

40. The ECB is investigating the scope for a digital euro, while a decision on issuance will only come later. A digital euro could help maintain the "strategic autonomy" and competitiveness of the euro in a world with private stable coins and other central bank digital currencies. It could also provide citizens with cheaper, more secure, and faster payments. The design of a digital euro would need to mitigate risks to the payment system, financial stability and integrity, and central bank operations. Existing strong euro payments infrastructure implies limited urgency in the introduction of a digital euro. The eventual success of such a digital euro would depend on its attractiveness, efficiency, operational resiliency, and public trust, objectives which will require careful design to meet.

41. At this juncture, the burden on monetary policy is being reduced by continued fiscal support at the EU and national levels. Staff's analysis suggests that, with policy rates close to their effective lower bound for an extended period, a gradual fiscal consolidation in the next few years, especially for countries with fiscal space, helps reducing scarring and—withstanding a flat Phillips curve—also modestly lift core inflation relative to a rapid-consolidation scenario.¹⁷ The draft national budgets for 2022, which imply a gradual withdrawal of fiscal support, go in this direction.

¹⁵ The ECB first economy-wide climate stress test [results](#) (September 2021) indicate that portfolios most vulnerable to climate risk are 30 percent more likely to default in 2050 compared with 2020 if climate risks are not mitigated (i.e., a "hot house world" scenario).

¹⁶ See IMF Working Paper [2021/112](#).

¹⁷ See Annex I for an illustrative scenario.

Authorities' Views

42. The ECB agreed that maintaining an accommodative stance is necessary given that the medium-term inflation outlook remains subdued. The ECB is committed to using both conventional and unconventional policy instruments to preserve favorable financing conditions and support a durable convergence of inflation to the 2-percent inflation target. In this regard, the Governing Council plans to review its monetary policy instruments in context of the fresh macroeconomic projections in December, noting that asset purchases and TLTROs would remain part of the ECB's toolkit given the effective lower bound on policy rates. While arguing that the self-imposed limits related to asset purchases were unlikely to become a binding constraint in the near term, they could be adjusted—within the existing legal constraints—should it be deemed necessary to achieve price stability.

43. Risks to the inflation outlook warrant close monitoring. The ECB argued that some degree of wage inflation may assist in achieving the inflation target, but noted that inflation uncertainty has increased recently, pushing up inflation risk premia. In this regard, the ECB concurred that maintaining clear and effective communication regarding the inflation outlook and monetary policy stance was key, particularly given market expectations for an earlier lift off of policy rates. Continued close monitoring of inflation developments, including potential second-round effects, would be important.

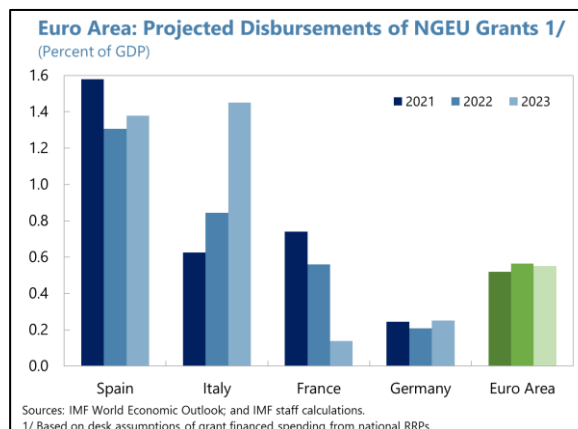
44. The Strategy Review was seen as essential to cope with structural changes and ongoing challenges. The formalization of the symmetric inflation target had helped better anchor inflation expectations while allowing for moderate and transitory upward deviations from the target when interest rates are close to their lower bound. In addition, the integration of financial conditions in the monetary policy strategy was particularly important in the face of rising asset prices in a low interest rate environment. The ECB stressed that the existing monetary operational framework may amplify climate-related market inefficiencies and agreed that the challenges associated with incorporating the green aspect to monetary instruments required careful analysis. On the introduction of owner-occupied housing costs into the HICP, the ECB expressed commitment to pursue the net acquisitions approach, which better captures increases in housing prices, and plans to explore how implementation challenges can be addressed in a timely manner. The incorporation of OOH costs in the HICP is not expected to have a meaningful impact on average prices over the longer term.

B. Fiscal and Structural Policies: Helping Sustain the Recovery, Building Forward Better, and Addressing Inequality

Near-term Fiscal Stance and Medium-term Fiscal Plans

45. The accommodative fiscal stance that appears to be embedded in euro area countries' 2022 budget plans is consistent with supporting the recovery and limiting scarring. An assessment of the fiscal position is complicated by the treatment of temporary lifelines in structural

balances, greater uncertainty regarding estimates of output gaps since the pandemic began, and deficit-neutral but expansionary NGEU grant financed spending. On aggregate, the *fiscal stance* (as measured by the level of the aggregate euro area structural balance) for 2022 remains accommodative at -3.5 percent of potential GDP. While the 1.5 percent of GDP improvement in the structural balance would appear to imply a contractionary *fiscal impulse* (measured by changes in the structural balance), most of this reflects the phasing out of temporary lifelines and NGEU spending will provide an additional impulse.¹⁸ As discussed in 141, continued supportive fiscal policy, especially for countries with fiscal space, could have important spillover effects, helping to speed up the EU-wide recovery and reducing the burden on monetary policy. The fiscal stance at the national level should reflect country-specific circumstances, including medium-term fiscal sustainability considerations. Should aggregate demand pressures surprise on the upside, fiscal accommodation could be reduced accordingly, especially in countries with high debt.



Text Table 2. Euro Area: Public Finance Indicators

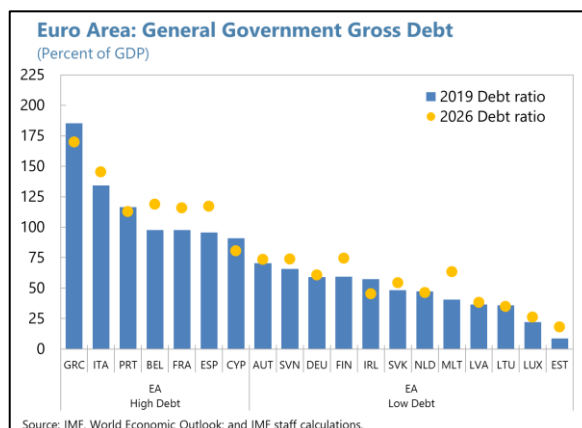
	2017	2018	2019	2020	Projections 1/					
					2021	2022	2023	2024	2025	2026
Public Finance (percent of GDP)										
Overall fiscal balance	-0.9	-0.4	-0.6	-7.2	-6.6	-3.9	-2.4	-1.9	-1.6	-1.6
Primary balance	0.8	1.2	0.8	-5.9	-5.4	-2.7	-1.3	-1.0	-0.7	-0.7
Structural balance	-0.6	-0.4	-0.7	-4.7	-5.0	-3.5	-2.3	-2.0	-1.7	-1.6
Structural primary balance	1.3	1.3	1.0	-3.3	-3.8	-2.4	-1.3	-1.0	-0.7	-0.7
Gross public debt	87.5	85.5	83.6	97.3	97.6	95.4	94.3	93.2	92.1	90.9

Sources: IMF, *World Economic Outlook*.

46. The composition of fiscal support is shifting from crisis lifelines to more targeted measures. The timing of when to start winding down lifeline measures and reducing broad support to the economy will differ across countries and sectors, with support for hard-hit sectors (e.g., tourism, hotels) potentially extended for longer than for others. Given the uncertainty surrounding the outlook, it is appropriate to keep programs nimble. As the need for emergency lifelines winds down, spending can be switched to bolster safety nets, facilitate reallocation and training, and boost public investment.

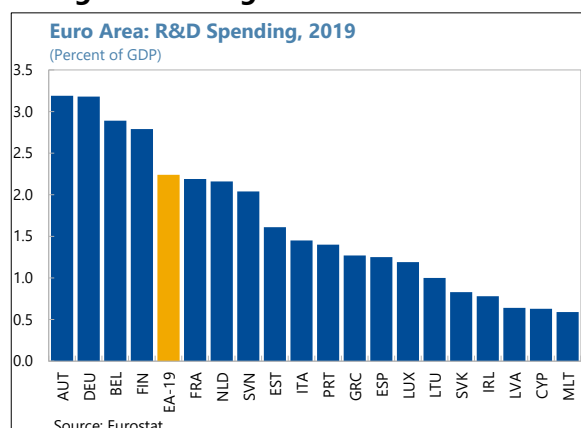
¹⁸ The European Commission in its assessment of draft 2022 budget plans, uses a measure of the fiscal impulse based on the annual increase in net primary expenditure relative to 10-year potential growth (where expenditures include those financed by RRF grants and exclude temporary emergency measures related to the Covid-19 crisis). Based on this measure, the fiscal impulse will be expansionary in 2022.

47. Once the expansion phase is firmly entrenched, high-debt countries will need to embark on a gradual but steady fiscal adjustment to rebuild buffers. The crisis has narrowed the already-limited fiscal space for some high-debt countries, further exacerbating vulnerabilities to future shocks. High-debt countries should formulate credible adjustment plans now, and should stand ready to implement them once the expansion phase is underway. Any drag from greater restraint on spending from own resources could be partially mitigated by spending financed by NGEU grants. Moreover, improving the quality of spending and the progressivity of taxes could boost growth and further mitigate the impact of spending restraint.



48. Changes to the composition of fiscal policies can create space for investment to sustainably boost potential growth and accelerate the green and digital transformations.

While some countries have substantial space for investment, high-debt countries in particular will need to shift resources from tax expenditures to productive public investments and better target transfers. This will also require devoting additional resources to R&D, especially in southern euro area countries where levels of R&D spending are half those of northern countries. Reforming tax policies will be necessary to ensure those benefiting the most from growth contribute commensurately. Moreover, in several countries there is scope for tax reforms that would boost women's participation in the labor force. Finally, taxes on carbon emissions, combined with transfers to lower-income households to mitigate the impact on them, would help to address climate change.



Reforming the EU Fiscal Rules

49. There is widespread recognition that the EU fiscal framework needs to be reformed.

The current framework involves an intricate set of constraints, both at the EU and national level, which complicates effective monitoring and public communication, and in addition to being procyclical, creates risks of inconsistency and overlap between different parts of the system. The complexity of the framework has resulted in both unintended violations and the exploitation of loopholes, as well as increasingly discretionary enforcement. As a result, many of the high-debt countries failed to reduce their debt ratios in the years preceding the pandemic, despite relatively robust growth.

50. Deep consultation will be needed to reform the rules, suggesting a transitional arrangement may be desirable. In light of the rise in debt ratios during the pandemic, the application of the current rules would require unrealistically large—and counterproductive—adjustments by some high-debt countries. It would therefore be preferable to reform the rules before the general escape clause is deactivated, which is expected in 2023. However, even if EU countries agree on the main features of a reform by the end of 2022, the process of implementing the reform could take time, especially if it requires legislative changes. To avoid a potentially destabilizing application of the current rules, countries could agree on a time-bound transitional period, until a reform of the rules can become effective. For example, they could suspend the application of the debt benchmark and use the flexibility under the current framework to limit the adjustment to that consistent with the existing expenditure growth rule, excluding NGEU-financed spending.

51. There is a vibrant debate on how to improve the fiscal framework. The [European Fiscal Board](#) has proposed a framework based on a single debt anchor, net expenditure growth as a single operational rule, and a single escape clause, based on independent economic judgement, while keeping the 3 percent of GDP overall fiscal deficit as a reference. The Board also supports the creation of new instruments, including a central fiscal stabilization capacity; and a mechanism to prevent counterproductive spending cuts, for example through the EU budget. Others have considered a similar set of rules, but with country-specific debt targets that allow differentiation according to country vulnerabilities. Some have suggested abandoning the rules in favor of [fiscal standards](#) with independent fiscal councils or the European Commission making a qualitative assessment of whether the standards are met. Staff is exploring alternative reform proposals, with the aim to come out with a concrete proposal in early 2022. An expenditure growth rule with a debt anchor remains a pertinent option for reform, but staff is considering a number of design issues related to the appropriate degree of country-specificity in the rules, the role of debt sustainability assessments, and how to allow adequate room for stabilization and green investments (Box 4).¹⁹ Moreover, further strengthening national fiscal councils, the European Fiscal Board, and national medium-term budget frameworks could also play an important role in the new EU framework.

52. A central fiscal capacity and/or a green investment fund would complement the fiscal rules. As long argued by IMF staff, a central fiscal capacity for macroeconomic stabilization would enhance the resilience of the euro area and provide incentives by making access contingent on compliance with the fiscal rules. In light of the large investment needs, policymakers could also consider introducing an EU-level investment fund. A particular focus on climate investment would be an efficient way to progress toward the EU's common climate goals, given that investment returns may be higher in countries with less fiscal space and the benefits of reducing carbon emissions are felt across national borders.

¹⁹ A forthcoming staff paper will provide a more in-depth analysis of the proposed reform, as well as discuss fiscal institutional reforms, incentives for compliance, calibration issues and potential legal constraints.

Box 4. Reforming the EU Fiscal Rules

In October 2021, the EC launched a consultation of the [EU's economic governance framework](#). The pandemic has underlined the challenges facing the framework and made them more acute. Several stakeholders have argued that the fiscal rules need to be reformed before the escape clause is deactivated in 2023, and that previous reform proposals will have to be reassessed given the pandemic-related surge in debt and sizable public investment requirements. Staff will contribute to the consultation and is currently developing a concrete proposal.

The fiscal rules should foster sustainability while allowing macroeconomic stabilization. Building on an earlier proposal by the IMF (Andrle and others, 2015) and others (for example, European Fiscal Board, 2018, 2019, and 2021), staff is looking at an expenditure growth rule (net of discretionary revenue changes) as an operational instrument with a debt anchor that reflects new realities on interest rates and starting debt levels. Given country-specific conditions, the operational instrument would be set to help stabilization, and ensure overall fiscal sustainability. Preliminary simulations suggest this could lead to a gradual but steady reduction in the debt ratio over time with high probability and have less negative effects on growth compared to a strict application of the current rules for high-debt countries. Staff will explore different sets of rules and parameterizations, building on the ongoing public debate.

Political will and ownership are essential to an effective EU fiscal framework. The success of fiscal rules hinges on clear articulation of the fiscal objectives and pressures to be addressed with the rules, well-designed rules, ownership, and a political commitment to follow the rules; and on effective institutions to monitor and enforce them. In this regard, fiscal institutional reforms, including further strengthening of national fiscal councils and the European Fiscal Board, can play an important role. For instance, more independent fiscal councils could help enhance budget transparency by assessing the quantification of fiscal policy proposals (Netherlands, U.S. CBO); provide long-term sustainability assessments, including on climate change risks to public finances (Netherlands); provide direct inputs to mitigate the inherent complexity of certain rules (Chile, U.K.); and perform timely public assessment of compliance with rules (Sweden).

The new fiscal framework should ensure sustainability, while helping countries address climate change. The public investment required to achieve the 2050 carbon emissions reduction target is substantial; and only a portion can be covered by NGEU and EU Green Deal funds, and carbon pricing revenues. Excluding such investments from the fiscal rules, however, would raise risks of "creative accounting," such as classifying current as capital spending, undermine balanced resource allocation across all policy fields including for health and education, disincentivize budgeting for maintenance, and weaken political and civil society oversight. Not least, it may reduce incentives to design sufficiently ambitious carbon pricing schemes. Instead, a green investment fund at the EU level could help countries meet their common climate goals more efficiently, including by financing and prioritizing those investments that achieve the largest carbon reduction at the lowest cost and coordinating projects that require cross-country investments.

Authorities' Views

53. The European Commission agreed that fiscal policy should remain accommodative in 2022. They viewed the draft 2022 budgets as broadly appropriate, with a 1 percent of GDP expansionary stance, based on net primary expenditure developments relative to medium-term potential growth (including the RRF support and excluding the temporary emergency measures to tackle the Covid-19 crisis), but cautioned that some governments had increased permanent net current expenditure significantly. They stressed that without adjustment in primary balances beyond what is already decided, public debt would continue to increase for several countries, with high-debt countries being a particular concern. High-debt countries should start a gradual consolidation in

2023, taking advantage of the favorable conditions created by the RRF, provided the economic and health conditions allow. Formulating credible medium-term plans now would reduce uncertainty and support growth-friendly debt reduction strategies.

54. The consultation process to reform the fiscal rules has been relaunched. Most stakeholders saw a reform as necessary, but the political process to reach agreement on any legislative (or non-legislative) changes is deemed challenging. The European Commission stressed the need for a thorough analysis and debate to establish a consensus on any potential changes. The goals of achieving medium-term debt reductions while protecting investment were important anchors for the debate. With the likely de-activation of the general escape clause in 2023, the Commission saw the need for some flexibility in the current framework until a reform is in place but viewed the staff proposal for a formal time-bound transitional arrangement as difficult to agree on and implement.

55. Countries submitted ambitious and well-calibrated RRP, with the focus now shifting to implementation. The European Commission highlighted the overall high quality of countries' RRP, including the balance of investment and reform commitments in the plans. Additionality was judged to be high. They were optimistic that implementation would proceed well, despite acknowledging risks. The Commission and EU member states were discussing "operational arrangements", bilateral agreements, which specify the arrangements for implementation monitoring, the verification mechanisms for the fulfilment of milestones and targets conditioning each disbursement, and the indicative timeline for future payment requests. There would be continued close engagement between member states and the Commission, and the Commission stand ready to provide technical assistance to improve implementation and absorption capacities. A publicly available website, the Recovery and Resilience scoreboard, would track RRP progress. The Commission noted that striking the right balance between speed of disbursements and risk control would be critical. Preliminary Commission analysis shows that investment resulting from the RRP could lift EU real GDP by 1.3 percentage points by 2026.

Policies to Facilitate Reallocation, Build Forward Better, and Address Inequality

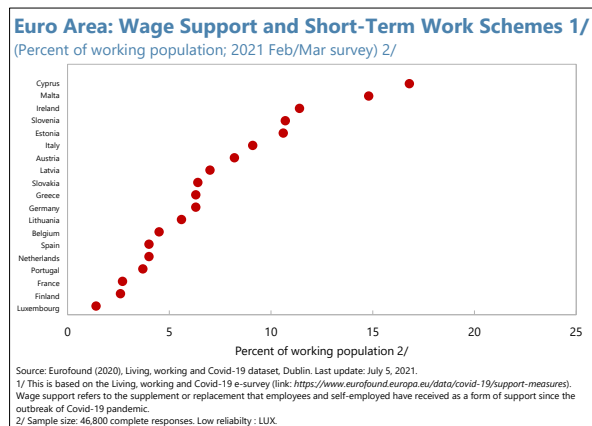
56. The NGEU recovery package can complement policies at the national level to help the recovery, facilitate reallocation, build forward better, and tackle inequality. To the extent that NGEU funds have been allocated to countries based on the impact of the pandemic and per capita income, the package should help mitigate any increase in divergences between countries and boost potential growth. Proposed reforms in the national RRP related to the green and digital transformations, public administration, education, and healthcare are encouraging and should be accompanied by other structural reforms aimed at enhancing governance, promoting competition, improving labor markets, the business environment, and pension sustainability. Future disbursements of funds should be linked to implementation progress and policymakers will have to navigate the tradeoff between disbursing rapidly and ensuring that investments and reforms are of high quality and in line with countries' implementation capacity. Moreover, while the EU has strong public financial management and anticorruption frameworks in place, the NGEU funds should adhere to the highest standards of transparency and accountability. In this regard, the role of the

new European Public Prosecutor Office in investigating any misuse of NGEU funds is critical. Enhancing transparency of beneficial ownership in procurement, AML/CFT information exchange, and audit mechanisms will also contribute to maintaining the high quality of the reforms and detecting any abuse.

57. Labor market policies should facilitate the pandemic-induced reallocation of labor while minimizing unemployment and inactivity. The extensive deployment of JRS has been

essential in containing the increase in unemployment. However, as the pandemic abates and demand for workers increases, these schemes are being phased out to support the post-pandemic economic transformation and associated reallocation needs. In this regard, staff's analysis suggests that changes in consumer behavior and working practices could lead to meaningful employment shifts across sectors and occupations, in addition to the large shifts already implied by pre-crisis trends (Box 5). To minimize

the social costs associated with unemployment and inactivity, policies will have to support job-to-job transitions, including through reskilling and upskilling workers while still under JRS. A gradual adjustment of the generosity of JRS and a tightening of their eligibility criteria would promote job search, while temporary and targeted hiring subsidies and wage-loss insurance—which would incentivize vulnerable workers to move to occupations and sectors that offer lower pay initially—could pave the way for job creation given lingering uncertainty among potential employers. This would help facilitate mobility while avoiding detrimental transitions through unemployment spells.^{20,21} Linking hiring subsidies and wage-loss insurance to vocational training during this transitional period would increase the likelihood of retaining these workers once the insurance payments are terminated.



58. Difficulties in managing pre-pandemic structural transformations already suggested the need for a fundamental rethink of labor market policies, and the pandemic has simply increased the urgency of this. The reallocation flows induced by the pandemic are likely to be low compared to those already associated with pre-existing transitions related to automation, digitalization, and climate change mitigation (Box 5). Looking at previous episodes of large reallocations suggests that high degrees of labor and product market flexibility and a focus on training low-skilled workers are particularly important in determining success.²² The pandemic

²⁰A forthcoming departmental paper on the impact of the pandemic on European labor markets and associated policy options will go into more depth on these issues.

²¹ Wage loss-insurance is given for fixed period of time, to compensate, partially or fully, the loss in earnings from switching to a lower-paying job. While in principle wage-loss insurance schemes should consist in pre-existing funded programs, paid for by an insurance premium levied on employers or employees, they have generally been introduced as nonfunded schemes, financed via other sources.

²² Episodes include Finland in the 1990s, Canada in the mid-2000s, and the Czech Republic in the 1990s.

Box 5. Potential Labor Market Reallocation in the Euro Area

The Covid-19 pandemic could potentially lead to a significant structural transformation with far-reaching effects. Persistent changes in consumer preferences and firm behavior along with accelerated trends in teleworking, automation, and e-commerce may lead to a significant change in the euro area labor markets landscape in the long term, although uncertainty remains very high given the uncharted territory.

The pandemic's potential effects are analyzed through 10-year simulations.¹ The analysis, which explores how changes in the final demand for a particular good or service affect sectoral output and labor, considers two scenarios—*moderate impact* and *strong impact*—which differ in the extent of long-term economic changes resulting from the pandemic. In both scenarios, increased telework and preference for social distancing is the primary force of economic change, resulting in lower demand (relative to pre-crisis trends) for nonresidential construction and business travel as well as for industries that depend on large gatherings.

Conversely, demand for virtual services is likely to increase, with positive effects on IT and computer-related occupations. The pandemic-induced effects are simulated as deviations from the pre-pandemic baseline, which incorporates long-term trends such as population ageing, globalization, and increasing automation. Under this baseline, the service sector is set to expand whereas industries and agriculture are expected to contract.

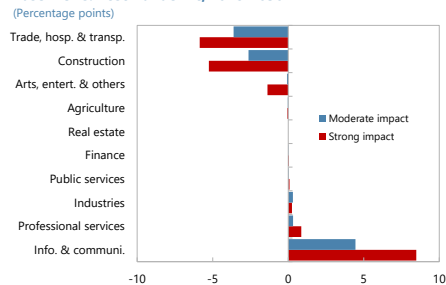
The results point to a sizable change in sectoral employment composition and occupational staffing. Several industries are expected to benefit from structural labor market changes caused by the pandemic. These are predominantly concentrated in the information and communication sector. In contrast, employment in construction, trade, food, accommodation, and transportation will see the largest declines (relative to pre-pandemic trends), although the magnitude varies across countries reflecting in part differences in labor market institutions and employment protection. As for occupations, most of the largest four euro area countries will see the biggest increase in the employment of information and communication technology professionals. However, the employment of sales and service workers is set to decline in all the largest countries.

Overall, however, the reallocation induced by the pandemic is likely to be much smaller than that caused by preexisting transitions related to automation, digitalization, and climate change mitigation.² The pre-pandemic baseline already embeds significant sectoral and occupational shifts, which the pandemic will largely reinforce, with the exception of the construction, trade, food, accommodation, and transportation sectors, as well as the service and sales occupations. Under the baseline, about 5 million jobs would be created over the next 10 years, with the pandemic reducing this by up to 1½ million.

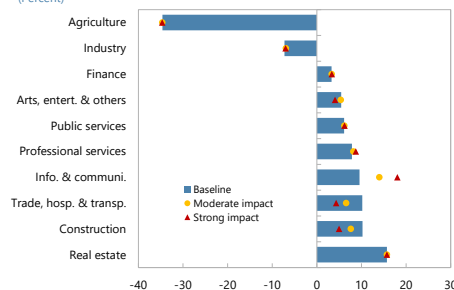
1/ These scenario analysis follow the strategy and assumptions outlined in the Monthly Labor Review [paper](#) by the U.S. Bureau of Labor Statistics.

2/ The pre-pandemic baseline is produced by the European [Centre for the Development of Vocational Training](#).

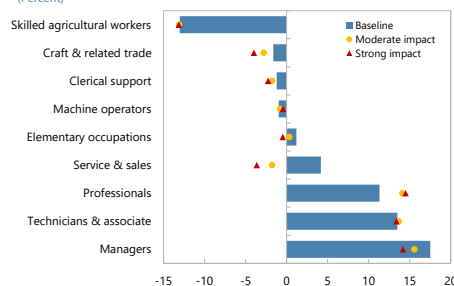
**Difference in Percent Employment Changes by Sector
Baseline vs. Post-Pandemic, 2018-2030**
(Percentage points)



Percent Change in Employment by Sector, 2018-2030
(Percent)



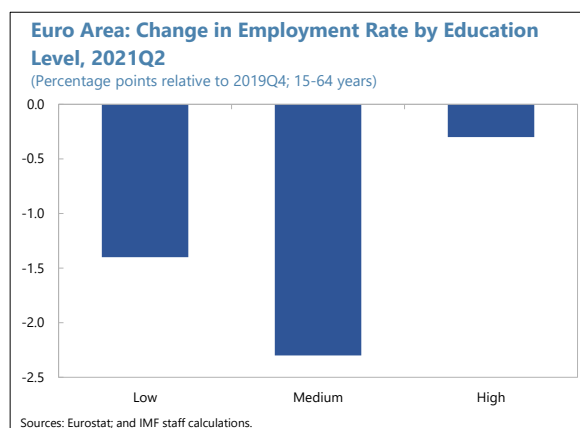
Percent Change in Employment by Occupation, 2018-2030
(Percent)



Sources: Eurostat; BLS (2021); CEDEFOP (2020); and IMF staff calculations.

Note: The estimates refer to Germany, France, Italy, and Spain. Long-term employment incorporates CEDEFOP 2020 Skills Forecast data.

continues to disproportionately affect low-skilled and young workers, exacerbating underlying inequality trends. Targeted policies will be needed to protect and support the vulnerable, who may find it difficult to transition to new jobs or enter the labor market, including by providing educational and vocational programs that are adapted to ongoing transitions and post-pandemic labor demand. National RRPs, which focus on education and training to support digital skills, could also facilitate more rapid transitions to new occupations. Importantly, other planned labor market reforms in some countries such as modernizing the labor code, strengthening active labor market policies, and improving access to childcare and early childhood education, could ease long-standing labor market bottlenecks and support the reallocation. Meanwhile, improving the coverage of social safety nets in a progressive and means-tested manner will help mitigate the impact on the vulnerable while limiting leakage to unintended beneficiaries.



Authorities' Views

59. The labor market recovery is marked by noticeable differences between sectors and countries. The authorities concurred that JRS had played a crucial role in buffering the labor market impact of the crisis, and noted that, with the recovery taking hold, schemes were largely phased out. The overall labor market picture remained mixed, with evidence of continued slack combined with pockets of labor shortages emerging in some sectors that had recovered strongly. Vacancies had strongly recovered but several factors such as the desire to search for teleworkable jobs and reduced mobility were affecting labor supply and making the matching process slower. The European Commission agreed that re-skilling and up-skilling would be needed for the transition, even though re-skilling also has its own limits. They also noted that the recommendations for [Effective Active Support to Employment](#), including providing hiring and transition incentives, promoting entrepreneurship, and strengthening employment services support, were well designed to create jobs and facilitate reallocation.

Climate Policies

60. EU policies to address climate change will be critical to accelerate the green transition. The EC's "[fit for 55](#)" suite of climate policies will promote more robust carbon pricing. The package aims at reducing greenhouse gas emissions by at least 55 percent by 2030 (relative to 1990) and achieving net-zero emissions by 2050. In line with IMF recommendations, the package gives a more central role to carbon pricing by reducing the Emissions Trading System (ETS) cap, extending the scheme to the maritime sector, and introducing a new ETS for road transport and buildings. It also establishes a fund to help the most vulnerable households and proposes a CBAM, which will apply carbon pricing to certain industrial imports and several emission-intensive sectors at high risk of carbon leakage. The design of the proposed CBAM, should be given careful consideration, and its

phase in, which should be done in close collaboration with trading partners, could increasingly put more weight on actual embodied carbon content rather than relying on benchmark levels. It should also be accompanied by a reduction in free allowances in the affected sectors to enhance compatibility with WTO rules.

61. Reducing carbon emissions in line with the EU goals will require significant changes in practices and new investment across the economy. Estimates of investment needs to achieve EU's ambitious climate goals point to high levels of spending. As part of the overall EU climate package, the investment and reforms included in national RRP will play a key role in supporting the green transition. In this regard, model simulations suggest that proposed RRP investments would contribute to a reduction of GHG emissions by about 2½ percent CO₂ equivalent compared to 2019 levels (Box 6). Beyond the impact of the RRP-related investment, the 2021–27 EU budget targets at least 25 percent of funds going to green spending, including through the Just Transition Mechanism. However, there is scope to go further, particularly in the use of the Common Agricultural Policy (CAP) to encourage GHG emissions cuts in the agricultural sector, where it is harder to achieve cuts with carbon pricing alone. Efforts to upgrade building codes; mitigate the environmental impacts of steel, cement and petrochemical production; and change the composition of energy generation in some EU countries are welcome. But other EU regulatory changes, such as vehicle emissions standards, can also contribute to reducing emissions.

62. Coordinated national climate policies are also key to achieve the EU's green goals. In the near term, increasing road fuel taxes could help encourage the shift toward hybrid or electric vehicles. However, where this faces significant political resistance, other mechanisms, such as “fee-bates” could be used. Domestic policies will also be needed to reduce emissions in the building sector, which could include a mix of binding regulations and subsidies to retrofit older buildings and those of low-income households. Policies also need to protect the most vulnerable from unintended consequences of the green transition, including higher energy prices, while avoiding interference with market dynamics or dampening incentives for the transition to a decarbonized economy. Similarly, national agricultural policies, including regulations on land use and tax and spending policies, will be necessary to reduce emissions in that sector. As discussed in ¶52 and Box 4, an EU level climate investment fund could also play a key role in helping member states achieve their climate goals.

Authorities' Views

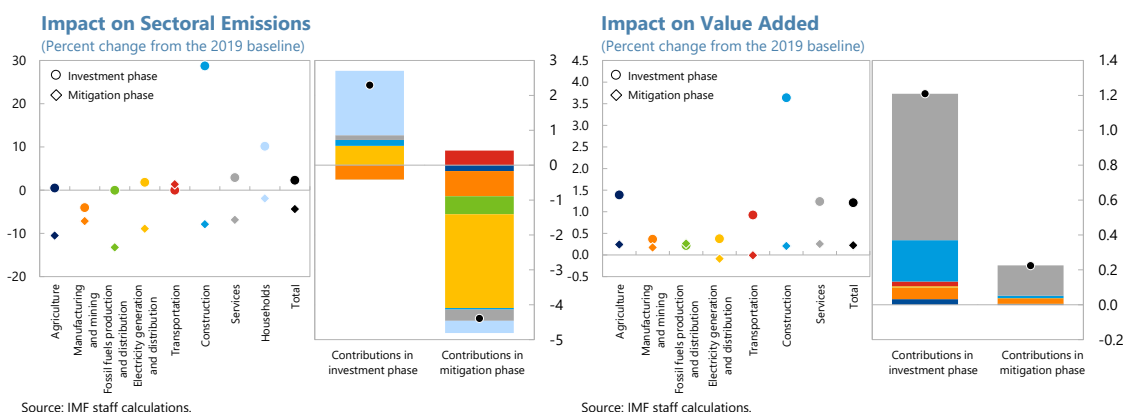
63. The RRP are part of the EU's broader framework to address climate change issues. The European Commission noted that the EU's additional investment needs were estimated at about €390 billion for the 2021–30 period (2.8 percent of the EU27's estimated 2021 GDP) a year, of which the adopted RRP in total are expected to provide €177 billion (1.3 percent of the EU27's estimated 2021 GDP) over the next five years. However, Modernization, Innovation, and Just-transition funds should also help firms and member states to achieve their climate goals, along with Invest EU. In terms of the financing of the NGEU, green bonds are expected to account for 30 percent of the raised funds. They also noted that the CBAM was designed carefully to ensure compatibility with WTO rules with a long phase-in for implementation and compliance.

Box 6. Sectoral Analysis of the Recovery and Resilience Plans

A computable general equilibrium model is used to assess the sectoral impact of submitted [Recovery and Resilience Plans \(RRP\)](#) spending on value-added and emissions across the EU.¹ The model includes the EU27 economies and the rest of the world, with 18 production sectors, based on an extended GTAP (Global Trade Analysis Project) model and Data Base. The regional economies are linked through bilateral trade relations and a Greenhouse Gas (GHG) emission module calculates detailed emission profiles in the model. The model uses 2019 as the baseline and computes the impact of additional RRP spending on various economic and environmental metrics, including on value-added and CO₂ emissions for all EU countries.

Simulation results show an initial rise in emissions followed by a reduction, as abatement measures take hold.² RRP spending is expected to have a twofold impact: At first, in the investment phase (2021–26), additional spending will boost demand through public expenditure and investment in various projects, with limited effect on emissions. GHG emissions initially would increase in virtually all sectors in tandem with output (a total of about 2 percent compared to 2019 levels), while they would decline in manufacturing, reflecting changes in relative prices and the composition of industries across the EU. Construction and services are expected to be the biggest beneficiaries of the proposed spending, accounting for about ¾ of the 1.2 percent value-added increase in the investment phase.

As expected, the mitigation phase will be marked by substantial emission reductions. Investment in climate-friendly projects, like enhancing the efficiency of energy production and retrofitting buildings, along with improvements in total factor productivity and changes in the composition of industries, would lead to a reduction in energy intensity and emissions. Using the GHG abatement coefficients provided by the International Energy Agency,³ the model suggests that GHG emissions would decline by about 4.5 percent of CO₂ equivalent in the mitigation phase, despite a slight increase in transportation emissions due to higher economic activity and international trade. Over both phases, value added is expected to expand by 1.4 percent and GHG emissions is estimated to decline by 2.1 percent compared to 2019 levels.



¹ The CGE model used in this exercise is dynamic and it takes the changing behavior of economic agents as the relative prices change. It focuses on the impact of RRP on output and GHG emissions, and does not include other measures (e.g., the ETS) that are already in place to curb emissions.

² In reality, the investment and mitigation phases would not be separate, but rather continuous. However, from an analytical point of view, it is useful to make this distinction as investment is unlikely to reduce emissions immediately.

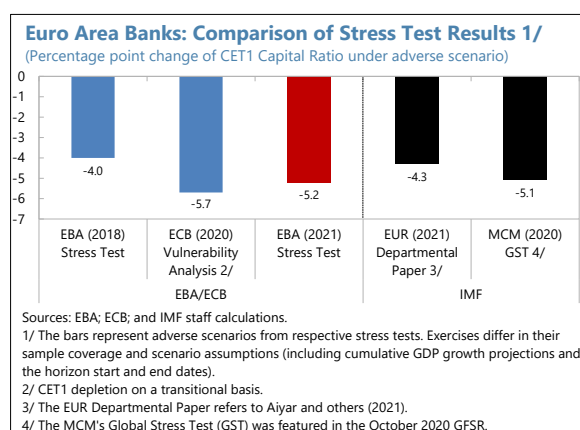
³ According to the International Energy Agency, the abatement cost of one metric ton of CO₂ varies by country and abatement measures and can be up to €200. We used the upper ceiling in our simulations to estimate a floor for the reduction in CO₂ emissions, assuming that all climate-related funds are efficiently directed to mitigation.

C. Financial and Corporate Sector Policies

64. Large-scale policy support has supported lending and cushioned the pandemic’s impact on the asset quality of banks. Both households and firms, particularly SMEs, have significantly benefited from debt moratoria and credit guarantees, limiting their vulnerabilities to reductions in earnings and consumer spending. This helped to prevent a surge of loan defaults and bankruptcies, with NPLs for the euro area as a whole reaching their lowest level on record, at 2.7 percent, during 2021H1. Thanks to the credit guarantee schemes; as well as effective capital conservation measures and lower capital charges for SME loans, infrastructure investment and sovereign exposures; banks have been able to continue to lend and absorb impairments without a significant change in their capital ratios.

65. While the July 2021 stress test confirms that banks can absorb potential near-term loan losses, continued vigilance of banks’ health remains warranted. The European Banking Authority (EBA)’s stress test suggested that the pandemic-linked recession would induce bank CET1 capital losses of, on average, 5 percentage points in an adverse macroeconomic scenario.

This is broadly comparable to the findings of past IMF exercises. Nevertheless, a rise in corporate sector insolvencies as public guarantee schemes are lifted, a more complete recognition of credit losses, and a possible correction in asset values (especially in real estate markets) could affect bank capital. Even when most banks stay above their regulatory capital minima, loan losses and depleted capital buffers may leave them little headroom to lend, especially for banks that are heavily exposed to hard-hit sectors in countries where private sector leverage is high.

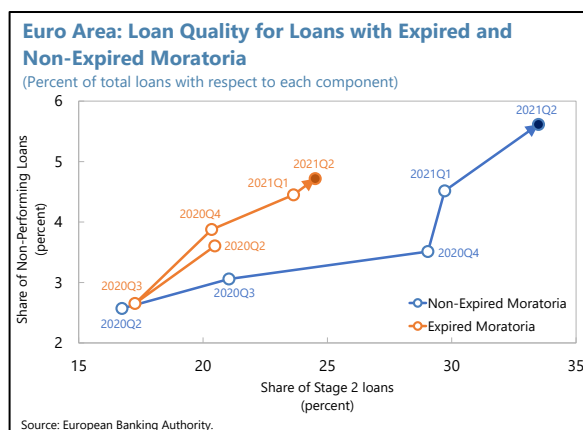


66. Financial sector policies require a fine balancing act to unwind support measures while ensuring the flow of credit to the economy:

- *Prudential standards can be normalized gradually, in accordance with pre-announced timelines.* Supervisors should continue to clearly communicate the availability and usability of buffers. Rebuilding capital buffers should be linked to the pace of the recovery, helping ensure banks’ continued capacity to extend credit. The ECB’s decision to assess dividend payouts and share buybacks on a bank-by-bank basis, while lifting its previous general recommendation to restrict these, is appropriate.
- *Supervisors should continue their efforts to achieve timely bank loss recognition.* Greater balance sheet transparency will support a bank-led triage of viable borrowers. The adequacy of loan loss provisioning should be carefully monitored, especially if the asset quality of loans that have benefited from government support measures worsens over the coming quarters. In cases of

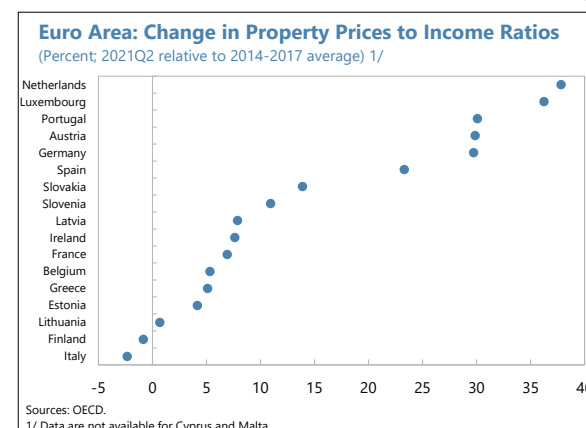
particular concern, regulators may intensify on-site inspections or direct banks to undertake independent asset quality reviews.

- *Over time, continued borrower support, if any, should become more targeted.* While the phasing out of debt moratoria has been appropriate, the coverage of government loan guarantees could be reduced gradually to avoid an abrupt tightening of lending conditions, while increasing monitoring incentives for lenders. Reforming insolvency regimes—including by developing out-of-court workouts and making fast-track procedures more widely available, especially for SMEs—and harmonizing them across the euro area, will help banks remove NPLs from their balance sheets.



67. More targeted policy support to firms and enhanced debt restructuring will mitigate the risk of zombification and help facilitate efficient reallocation of resources. As the recovery

gains momentum, policy support should become targeted towards distressed but viable firms that cannot obtain financing through private markets at a reasonable cost. Viability assessments should ideally be conducted by financial institutions that are familiar with firms' business models and be based on transparent criteria. Where policy space is limited, priority should be given to viable firms with activities deemed essential for the functioning of the economy and society. Such support—which will require continued use of the flexibility in the EU State aid framework—should be carefully calibrated to mitigate moral hazard, market concentration, and public sector balance sheet risks.²³ In this regard, grants and hybrid financing instruments such as subordinated and profit participation loans may be the most feasible option for micro and unincorporated SMEs. For larger incorporated firms, equity and preferred equity injections and subordinated debt instruments (e.g., convertible bonds) could be considered. Making debt forgiveness nontaxable (or offering loss carryovers), providing tax credits to private creditors that grant haircuts, and offering haircuts on government claims would provide incentives for efficient debt restructuring.



68. In an environment of low interest rates and rising house prices, activating some macroprudential measures could prevent excessive risk taking. In some euro area countries, the loosening of lending standards combined with high growth in residential real estate prices suggest

²³ In January 2021, the Commission decided to extend the [State aid Temporary Framework](#) through end-2021, and expanded its scope by raising the ceilings and allowing the conversion of pandemic-affected firms' repayable instruments into direct grants.

that vulnerabilities may be building up. According to the ECB, new mortgage loans originated in countries with higher house price growth have historically had on average higher loan-to-value (LTV) and loan-to-income (LTI) ratios. Moreover, countries that imposed borrower-based macroprudential measures, including limits to LTV and LTI ratios, experienced a reduction of riskier loans.²⁴ A gradual adoption of tighter LTV, debt-service-to-income (DSTI) or LTI limits for mortgages, loan maturity limits below 30 years, and amortizing loans with principal and interest payments, would help restrict the systemic risk from rising house prices in affected countries.

69. A strong macroprudential approach for investment funds and other regulatory actions for the nonbank financial sector will be necessary before the cycle turns. Some investment funds, especially those exposed to real estate and other illiquid assets, experienced significant redemption pressures at the onset of the crisis. While these pressures receded quickly, stretched asset valuations continue to pose risks for investment and money market funds. A strong macroprudential framework (which might include liquidity buffers, limits on liquidity risk, lock-up periods or early redemption penalties, all possibly subject to prudential triggers) would encourage consistent risk management practices across the sector and mitigate spillovers to the broader financial system. The ECB's expansion of the supervisory perimeter to systemic investment firms with "bank-like" risks and over €30 billion in assets will also raise the level of microprudential oversight in areas where spillover and potential reputational risks are highest. In this context, the EC's current reviews of the Alternative Investment Fund Managers Directive and the Money Market Funds Regulation are timely.

70. The European Commission's recent Banking Package aims to support lending and contribute to the green transition, but could lead to some divergence with global standards. The package appropriately enhances supervisory powers and fit and proper requirements across national competent authorities and takes important steps to address ESG-related risks. However, it also widens the gap between EU capital regulations and Basel III standards in some areas, in particular as relates to the long phase-in period for the treatment of certain bank exposures.

71. Progress on the key financial architecture projects must also remain a high priority, to build a more resilient and vibrant financial system. The endpoint of banking union is a single, borderless banking system—one that supports financial stability, growth, and monetary transmission—as a necessary element of the economic and monetary union. Further reforms in the areas of prudential oversight, resolution, and deposit insurance must seek to engender trust and address legitimate concerns in the host jurisdictions, removing the rationale for defensive measures that limit the cross-border fungibility of bank liquidity and capital and impede cross-border banking consolidation. The capital market union, in turn, seeks to enhance financing and investment options choices for both households and firms, where policy measures should focus on lowering information costs, ensuring robust consumer protection, enhancing pension portability, and improving national bankruptcy processes. Both projects would support more cross-border private risk sharing, as a critical complement to the public risk sharing arrangements. Finally, establishing a single AML/CFT

²⁴ See ECB's [Financial Stability Review](#) (May 2020).

rulebook and progress towards the harmonization of AML/CFT supervision would help in ensuring the consistency of financial integrity oversight.

Authorities' Views

72. The authorities agreed that, even with the recent indications of bank strength, credit risks warranted continued vigilance. The ECB Banking Supervision anticipates some rise in NPLs over time as support measures are phased out and losses are more fully recognized. Accordingly, improvements in banks' credit risk management practices were a key objective for the ECB Banking Supervision, with a view to closing any gaps between supervisory expectations and bank practices in that area. Particular attention will be given to banks' actions on forbearance, unlikely-to-pay assessments, and the implementation of IFRS-9. Other supervisory priorities include the examination of risks in leveraged finance, unregulated nonbanks, and prime brokerage. The authorities also intend to continue their analysis of structural challenges in European banking, including those related to climate risk, digitalization, and cyber security. The authorities intend to normalize pandemic-related macroprudential guidance (including the IFRS-9 risk identification guidance and the policies on the use of the capital conservation buffer and the liquidity coverage ratio) as economic conditions improve, in accordance with the communicated timelines.

73. The ECB and the European Systemic Risk Board see vulnerabilities on the rise in residential real estate markets, especially in cases when these are amplified by high household debt. Borrower-based macroprudential tools should be tightened in several countries, especially where these were loosened during the pandemic and not yet normalized. In this context, consideration could be given to introducing a minimum set of harmonized borrower-based tools in the EU in 2022. In some countries, borrower-based measures may usefully be complemented by supply-side policies, such as changes in taxation, further developing rental markets, and ensuring that housing supply better matches demand.

74. The European Commission is working to implement global regulatory standards. The delayed application of the final Basel III standards envisaged in the recently published Banking Package were unavoidable given the need for consultation, legislative approval, and operational implementation by banks and supervisors. The proposed adjustments to the Basel III framework reflect the specific features of the European financial system (e.g., few corporates have credit ratings, banks keep low-risk mortgages on their balance sheets as well as high-quality specialized lending exposures) and are mostly transitory, with the end-point representing a faithful implementation of the framework. The authorities are committed to strengthening the prudential framework for investment funds and nonbanks.

75. Further improvements in the European financial architecture remain essential. The authorities called for an ambitious workplan for the Banking Union. This included a speedy resolution of the ongoing debates on European deposit insurance to foster cross-border bank consolidation, enable better risk-sharing, and create economies of scale needed to deal with the challenges of bank profitability and financial sector digitalization. The European Commission also intends to continue work on the CMU-related initiatives, including the creation of the single access

point (ESAP) for corporate disclosure and strengthening and better harmonization of national insolvency regimes.

D. Trade Policies and Global Issues

76. EU trade policy aims at supporting the recovery and transforming the economy, while ensuring long-run prosperity. The recent EU trade policy [review](#) aims to respond to recent global trends and challenges by promoting open strategic autonomy, and laying out actions—through close cooperation with partners—to reform the World Trade Organization (WTO). The priorities are restoring effective dispute settlement, strengthening WTO rules in areas like domestic farm and industrial subsidies, intellectual property rights, and technology transfer, and completing new market-opening agreements. In addition, the European Commission seeks to strengthen the EU regulatory impact and ensure equal treatment, support the green and digital transitions, and deepen trade and economic relations with countries outside the European Union.

77. The EU should continue its international engagement with major partners to address underlying sources of global trade tensions and investment distortions. In June 2021, the EU agreed with the U.S. to resolve a 17-year dispute over Boeing-Airbus subsidies and temporarily suspend punitive tariffs. Both sides also reached an agreement on U.S.-imposed tariffs on EU's steel and aluminum exports in October 2021. While this is welcome, tensions in the aluminum and steel markets are global in nature and need global solutions, requiring appropriate multilateral arrangements. The ratification of the [EU-China bilateral Comprehensive Agreement on Investment](#) (CAI) was suspended in May 2021 due to EU concerns about human rights violations in China, while the ratification of the EU-Mercosur agreement will likely require actions to address deforestation in the Amazon. In May 2021, the EC adopted a [proposal](#) to address foreign industrial subsidies, which provides the EC the power to impose measures to alleviate distortive effects of financial contributions granted by non-EU governments to companies active in the EU. While the proposal is well calibrated, it is critical that the EU uses its unilateral tools carefully and in line with multilateral agreements, and continues to aim for global solutions.

78. The proposed global minimum tax puts a floor on tax competition and reduces the scope for profit shifting by multinationals, and will require agreement by all EU countries. The new global corporate tax system is expected to take effect by 2023. The two-pillar agreement would (i) levy a global minimum effective corporate income tax of at least 15 percent on large multinational corporations (with more than €750 million in revenue), thus helping to reduce pressures from profit shifting and tax competition, and (ii) allocate new taxing rights to market jurisdictions, thereby contemplating the removal of unilateral digital service taxes and similar measures. The implementation of the proposed tax rules will require unanimous backing from all EU members, which may be challenging. Moreover, going forward, it will be important to ensure that the implementation would not undermine the ability of low-income countries to enforce their effective tax rates above the agreed minimum rate, and that the remaining technical issues are promptly resolved.

79. Efforts to ensure global equitable access to Covid-19 vaccines should be strengthened.

Strong global action is essential to attain the goal of vaccinating at least 40 percent in every country by end-2021 and at least 60 percent by mid-2022, as recommended by the multilateral Task Force on Covid-19 vaccines. As one of the leading exporters of Covid-19 vaccines, the EU should continue its efforts to increase global vaccine production, including by helping to develop local manufacturing capacity in line with the [Rome Declaration](#) of the Global Health Summit. EU member states have pledged to donate 200 million Covid-19 vaccines to poorer nations (September 2021), on top of an earlier commitment to deliver about 250 million doses. However, overall mobilization has been slow so far. In this regard, the recent commitment to deliver 100 million doses by the end-2021 is welcome.

Authorities' Views**80. The authorities consider EU trade policy and proposed instruments to be in line with WTO rules.**

The authorities noted that the procurement instrument was a WTO-consistent tool to leverage reciprocal EU access to foreign markets. They also viewed the proposed instrument to address the impact of foreign subsidies as filling a gap in the EU's state-aid regime, which was carefully crafted to ensure WTO consistency and avoid interference with public procurement. The European Commission was also exploring the need for an EU export credit agency to complement member states' efforts. The European Commission considers the WTO Ministerial Conference (MC12) as an important opportunity for strengthening the global trading system, including by facilitating the use of compulsory licensing of intellectual property rights of pandemic-related vaccines, equipment and medicines, and by launching of formal WTO reform discussions among the membership.

81. The progress toward trade and investment agreements has been uneven. The authorities noted that the EU had suspended the WTO dispute settlement proceedings against the US and will not increase rebalancing duties that had been scheduled for November and January, giving more time to deal globally with overcapacity and de-carbonization issues related to aluminum and steel productions. The EU-Mexico agreement was on track to be approved but concerns about deforestation in the Amazon loom over the formal conclusion of the EU-Mercosur agreement. The authorities do not see an easy path toward approval of the CAI with China at the present juncture.

82. The authorities noted that the EU remains a major supplier of vaccines to the world.

They emphasized EU's efforts to deliver vaccines to low- and middle-income countries, and have continued to export even when vaccines were scarce at home. Currently, the EU continues to export nearly 80 percent of its vaccine production, with shipments to more than 150 countries.

STAFF APPRAISAL

83. Following a deep recession, economic activity in the euro area has rebounded strongly, although growing supply bottlenecks, elevated energy prices, and Covid-19 resurgences pose

near-term headwinds to growth. Output increased sharply in the second and third quarters of 2021 thanks to high vaccination levels, continued forceful policy support, and increasing adaptation of households and business to pandemic dynamics. While growing supply-demand imbalances, elevated energy prices, and potential disruptions related to rising infections are likely to slow growth momentum in 2021Q4, the recovery should continue in 2022, with output gradually converging to its pre-pandemic path over the medium term. The recovery, however, is likely to be uneven across countries and sectors, potentially increasing inequality and disparities both across and within countries.

84. Uncertainty remains high and largely tied to pandemic dynamics and legacies. Further restrictions and reduced social mobility resulting from lower vaccine efficacy, including to newer Covid-19 variants such as Omicron, or incomplete vaccination coverage could impede the recovery and increase scarring. The expiration of policy support, a potential correction in real estate markets, or spillovers from a sharp slowdown in China could also lead to significant headwinds. On the upside, faster-than-expected adjustment to Covid-19 would boost activity, while a material unwinding of large excess savings could significantly increase consumption. Pandemic-induced acceleration of automation and digitalization could also boost productivity and potential growth.

85. The external position in 2021 is assessed as moderately stronger than the level implied by medium-term fundamentals and desirable policies. This assessment is consistent with a strong recovery in trade that induced a widening of the current account surplus in the first half of 2021. However, this assessment is preliminary and subject to a wide range of uncertainty arising from the preliminary nature of data and Covid-19 adjusters for 2021.

86. The ECB should look through transitory inflation pressures and provide the necessary support to lift inflation durably to its inflation target. With underlying inflation dynamics expected to remain weak over the medium term, the ECB will likely need to sustain a highly accommodative monetary policy stance for an extended period. While asset purchases are set to gradually decline in 2022, further support via additional asset purchases may be needed if inflation projections continue to be below target in 2023 and beyond. Given elevated uncertainty, the Governing Council's focus in their December statement on retaining flexibility to adjust course as needed was appropriate. A careful review of the ECB's self-imposed limits on asset purchases will help ensure that those rules do not unduly constrain monetary policy operations. At the same time, the ECB is well equipped to respond should high inflation prove to be more durable than expected by adjusting both unconventional and conventional policy instruments. Clear and effective communication would be essential to anchor market expectations in the face of an extraordinary level of uncertainty.

87. The conclusion of the ECB's Strategy Review is proving to be timely. The formal adoption of a symmetric 2-percent inflation target has improved the clarity on the ECB's target and its response to temporary inflation overshooting, while the strengthened link between monetary and financial analysis underscores a holistic approach to dealing with stretched asset prices. Climate-related measures, including enhanced monitoring, stress testing, and disclosures, will allow supervisors and banks to better account for climate-related risks. The scope for greener central bank

policies—which could potentially help reduce market failures associated with emissions externalities—requires careful analysis. The proposed inclusion of OOH costs into the HICP will more accurately reflect consumer spending; ways to improve the timeliness of construction and house price indices should be explored.

88. Fiscal policy should remain supportive but increasingly shift toward more targeted interventions. As the recovery continues, stronger private consumption and labor markets should reduce demand for broad lifelines such as job retention schemes, with support increasingly targeted to help the most affected sectors and households and limit scarring. Individual countries should carefully calibrate their fiscal position to their economic situation, including medium-term fiscal sustainability considerations. While the timing of consolidation will depend on individual country circumstances, credible medium-term consolidation plans should be put forward now. Once the expansion is firmly in train, high-debt countries in particular should gradually rebuild fiscal buffers. In addition, shifting the composition of public spending toward much-needed green and digital investments could increase potential growth while still bringing deficits down.

89. The NGEU package is a unique opportunity to push ahead with reforms, close investment gaps, support green and digital transitions, and increase potential growth. The package can help address the trend of increasing divergence among EU countries by supporting potential growth and cushioning the drag from greater spending restraint once consolidation starts, especially in high debt countries. Policymakers now have to navigate the tradeoff between timely disbursement of funds and ensuring that supported investments and reforms are of high quality and implemented in line with national RRPs. Funds will also need to adhere to the highest standards of transparency and accountability. Progress is also needed on structural reforms to enhance governance, promote competition, increase labor market flexibility, improve the business environment, and ensure pension sustainability.

90. The EU fiscal framework should be reformed to make it more efficient at preventing debt distress, while allowing adequate room for macroeconomic stabilization and green investment. The surge in public debt due to the pandemic has exacerbated the difficulty in applying the current fiscal rules, which would require unrealistically large—and counterproductive—adjustments by some high-debt countries. As it will be difficult to complete the reform before the general escape clause is lifted in 2023, a time-bound transitional arrangement would be desirable until the new rules become effective. Further strengthening of national fiscal councils, the European Fiscal Board, and national medium-term budget frameworks could play an important role in the new framework. A green investment fund at the EU-level could be an efficient way to finance investment to meet the EU's common climate goals, especially since the benefits of reducing carbon emissions are felt across national borders.

91. Structural policies should also focus on facilitating reallocation of resources, protecting the vulnerable, and mitigating poverty and inequality. Given the ongoing recovery, job retention schemes should be phased out gradually, with the focus of labor market policies shifting to facilitating reallocation. Training to reskill and upskill workers, paired with a careful use of temporary and targeted hiring subsidies and wage-loss insurance, should pave the way for job creation given

lingering uncertainty among potential employers. Improving the coverage of enhanced social safety nets with greater reliance on progressivity and means-testing would help mitigate the pandemic's impact on the vulnerable. Targeted policies should be put in place to help the young, women, low-skilled, and other vulnerable groups to avoid rising inequality and poverty.

92. EU policies to address climate change will be critical to facilitate the green transition and achieve ambitious EU goals. The "Fit for 55" climate change mitigation agenda is welcome as it gives a more central role to carbon pricing. The design and phase-in of the proposed carbon border adjustment mechanism should be given careful consideration to ensure compatibility with WTO rules, take into account the views and concern of trading partners, and be based increasingly on actual embodied carbon content rather than benchmark levels, and other international commitments. Additional steps, including at the national level, to reduce greenhouse gas emissions in the agricultural, building, and transport sectors should also be considered. In the context of the current spike in energy prices, policy measures to protect the most vulnerable should not undermine efforts to attain the EU's green goals and strengthen the European energy market.

93. A continued and gradual normalization of financial sector policies is appropriate, but supervisory vigilance is critical to ensure banking system resilience. Crisis-related prudential accommodations for banks should be normalized over time, in accordance with pre-announced timelines, while tightening the macroprudential stance would help address stretched asset valuations and elevated household debt in some jurisdictions. Corporate sector policies should shift from broad liquidity support to targeted solvency support for intrinsically viable firms. Supervisors should ensure that banks maintain sufficient buffers to allow absorption of potential losses, that loan loss recognition is sufficiently forward-looking, and that provisioning levels are appropriate. The recently announced banking package appropriately enhances supervisory powers and fit and proper requirements across national competent authorities, and takes important steps to address ESG-related risks. However, it also widens the gap between EU capital regulations and Basel III standards relating to implementation timelines and the treatment of certain bank exposures. A timely and faithful implementation of internationally agreed bank capital standards would help underpin global financial stability.

94. Progress on key financial architecture projects must also remain a high priority to build a more resilient and vibrant financial system. Further improvements in bank supervision and resolution ultimately underpinned by common European deposit insurance, would help create a truly single market that would help European banks to respond efficiently to the structural challenges of low profitability and accelerating digitalization. Continued progress toward CMU also remains important to create a more balanced and efficient financial system in Europe. Finally, establishing a single AML/CFT rulebook and progress towards the harmonization of AML/CFT supervision would help in ensuring the consistency of financial integrity oversight.

95. EU engagement on global issues such as trade, taxation, and vaccine availability remains crucial. The EU's leadership role on WTO reform and the negotiation of new WTO agreements are welcome. The EU should continue its engagement with major trading partners to address underlying sources of global trade tensions and investment distortions. Prompt resolution

of outstanding technical issues is needed to finalize the proposed global corporate minimum income tax. As one of the leading exporters of Covid-19 vaccines, the EU should continue its efforts to increase global vaccine production, which is critical to ending the pandemic.

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

Table 1. Euro Area: Main Economic Indicators

	2017	2018	2019	2020	Projections 1/					
					2021	2022	2023	2024	2025	2026
Demand and Supply										
Real GDP	2.6	1.8	1.6	-6.4	5.2	4.2	2.2	1.7	1.5	1.4
Private consumption	1.8	1.5	1.3	-7.9	3.7	5.5	2.2	1.6	1.7	1.5
Public consumption	1.1	1.1	1.8	1.3	3.5	0.1	0.9	1.1	1.1	1.1
Gross fixed investment	3.9	3.1	6.7	-7.0	4.7	4.0	3.1	2.4	1.9	1.9
Final domestic demand	2.1	1.7	2.6	-5.8	3.9	4.0	2.1	1.7	1.6	1.5
Stockbuilding 2/	0.2	0.1	-0.1	-0.5	0.3	0.0	0.1	0.0	0.0	0.0
Domestic demand	2.3	1.8	2.5	-6.2	4.1	3.9	2.2	1.7	1.6	1.5
Foreign balance 2/	0.4	0.1	-0.8	-0.3	1.2	0.4	0.1	0.1	0.0	0.0
Exports 3/	5.6	3.6	2.7	-9.1	9.4	6.2	4.5	3.8	3.3	3.2
Imports 3/	5.2	3.8	4.7	-9.1	7.3	5.8	4.7	4.0	3.6	3.5
Resource Utilization										
Potential GDP	1.5	1.3	1.4	-2.0	3.4	2.0	1.8	1.5	1.4	1.4
Output gap	-0.6	-0.1	0.1	-4.3	-2.6	-0.6	-0.2	0.0	0.1	0.1
Employment	1.6	1.6	1.3	-1.5	0.6	1.0	0.8	0.3	0.3	0.2
Unemployment rate 4/	9.1	8.2	7.6	7.9	7.9	7.7	7.4	7.3	7.2	7.1
Prices										
GDP deflator	1.1	1.5	1.7	1.6	1.4	2.0	1.5	1.6	1.6	1.8
Consumer prices	1.5	1.8	1.2	0.3	2.5	2.6	1.4	1.6	1.6	1.7
Public Finance (percent of GDP)										
Overall fiscal balance	-0.9	-0.4	-0.6	-7.2	-6.6	-3.9	-2.4	-1.9	-1.6	-1.6
Primary balance	0.8	1.2	0.8	-5.9	-5.4	-2.7	-1.3	-1.0	-0.7	-0.7
Structural balance	-0.6	-0.4	-0.7	-4.7	-5.0	-3.5	-2.3	-2.0	-1.7	-1.6
Structural primary balance	1.3	1.3	1.0	-3.3	-3.8	-2.4	-1.3	-1.0	-0.7	-0.7
Gross public debt	87.5	85.5	83.6	97.3	97.6	95.4	94.3	93.2	92.1	90.9
External Sector 5/, 6/										
Current account balance	3.2	2.9	2.3	2.0	2.8	2.9	3.0	2.9	2.8	2.7
Interest Rates (end of period) 4/, 7/										
EURIBOR 3-month offered rate	-0.3	-0.3	-0.4	-0.5	...	...	...	...	...	...
10-year government benchmark bond yield	0.9	1.2	0.4	-0.1	0.3	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.18	1.14	1.11	1.22	1.14	...	...	...	...	...
Nominal effective rate (2005=100)	106.1	107.8	105.7	114.6	110.5	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.3	85.5	84.0	87.3	82.4	...	...	...	...	...

Sources: IMF, *World Economic Outlook*, Global Data Source; Reuters Group; and Eurostat.1/ Projections are based on aggregation of January 2022 *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 2021.

Table 2. Euro Area: External Sector Assessment

Overall Assessment: *The external position in 2021 is assessed as moderately stronger than the level implied by medium-term fundamentals and desirable policies. However, this assessment is preliminary and subject to a wide range of uncertainty arising from the preliminary nature of data and Covid-19 adjustors for 2021. The final assessment will be provided in the 2022 External Sector Report.* Data for the first half of 2021 show an increase in the seasonally adjusted current account (CA) surplus to 2.9 percent of GDP, on the back of stronger external demand, especially for services. But with growing supply bottlenecks, the CA surplus is projected to moderate in the second half of the year and stand at 2.6 percent of GDP for 2021 as a whole. In the medium term, the euro area’s CA surplus is projected to remain broadly at the 2021 level, although the range of uncertainty around this projection is exceptionally high given the nature of this crisis. Imbalances that existed prior to the Covid-19 outbreak could remain sizable at the national level.

Potential Policy Responses: Short-term policies should continue focusing on containing the Covid-19 outbreak and reducing scarring from the crisis. The recent initiatives both at the national and EU-levels, including NGEU, have supported these efforts and could potentially help reduce the CA surplus by supporting investment and consumption, thereby increasing imports. Going forward, monetary policy should remain accommodative until inflation has durably converged to the ECB’s medium-term price stability objective while fiscal support should remain in place until the expansion phase is firmly in train, before gradually consolidating towards medium-term objectives. If imbalances in policy gaps that existed prior to Covid-19 were to persist at the national level, then countries with excess CA surpluses should continue to strengthen investment and potential growth, whereas those with weak external positions should undertake reforms to raise productivity, reduce structural and youth unemployment, and enhance competitiveness as the acute phase of the pandemic recedes. Euro Area-wide initiatives to make the currency union more resilient (e.g., banking and capital markets union and fiscal capacity for macroeconomic stabilization) could further reinvigorate investment and, hence, reduce the aggregate CA surplus.

Foreign Asset and Liability Position and Trajectory

Background. The NIIP of the euro area had fallen to about -23 percent of GDP by the end of 2009 but has since risen substantially to about -5.1 percent of GDP by mid-2021. The rise was driven by stronger CA balances and modest nominal GDP growth. Relative to 2020, the NIIP increased by 0.4 pp of GDP, reflecting primarily the net increase in outbound FDI and debt portfolio securities, partially offset by a milder increase in inbound portfolio equity and other investments. Gross foreign positions were about 270.0 percent of GDP for assets and 275.1 percent of GDP for liabilities as of mid-2021. Net external assets reached elevated levels in large net external creditors (e.g., Germany and the Netherlands), whereas net external liabilities remained high in some countries, including Portugal and Spain.

Assessment. Projections of continued CA surpluses over the medium term suggest that the NIIP-to-GDP ratio will rise further, at a moderate pace. The region’s overall NIIP financing vulnerabilities appear low. Despite rising CA balances over the medium term, large net external debtor countries still bear a greater risk of a sudden stop of gross inflows.

2021H1 (% GDP)	NIIP: 5.1	Gross Assets: 270.0	Debt Assets: 103.9	Gross Liab.: 275.1	Debt Liab.: 104.2
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Current Account

Background. The CA balance for the euro area is projected to increase to 2.6 percent of GDP in 2021 from 2.0 percent of GDP in 2020. The services balance has recovered especially strongly, alongside the primary income balance, while the goods balance remained somewhat constrained by supply chain disruptions. Both private and public sector saving are estimated to have increased compared to 2020, outpacing the increase in investment. Some large creditor countries, such as Germany and the Netherlands, continued to have sizable surpluses, reflecting high corporate and household saving and weak investment. At the end of the projection horizon, the CA balance will be above the pre-pandemic level, mainly driven by higher private sector savings in Italy and some smaller countries, including Ireland.

Assessment. The EBA model estimates a CA norm of 0.8 percent of GDP, against a cyclically adjusted CA of 2.3 percent of GDP. This implies a gap of 1.5 percent of GDP. IMF staff analysis indicates a somewhat higher CA norm than estimated by the EBA model, consistent with the assessed external positions of euro area member countries. The higher CA norm considers policy commitments to reduce the large net external liability positions in some countries (e.g., Spain) and uncertainty about the demographic outlook and the impact of recent large-scale immigration (e.g., Germany). In addition, adjustments to the underlying CA were made in Ireland and the Netherlands given measurement issues. Adjustments for the transitory impact of the Covid-19 crisis on the shift in household consumption composition, medical goods, and tourism are estimated at 0.3 percent of GDP. Considering these factors and uncertainties in the estimates, including the cyclical adjustment, the IMF staff assesses the CA gap to be 1.4 percent of GDP for 2021, with a range of 0.6 to 2.2 percent of GDP. This assessment is preliminary and may change as more data for 2021 becomes available. The final assessment will be published in 2022 ESR.

Table 2. Euro Area: External Sector Assessment (concluded)

2021 (% GDP)	CA: 2.6	Cyc. Adj. CA: 2.3	EBA Norm: 0.8	EBA Gap: 1.5	Covid-19 Adj.: 0.3	Other Adj.: -0.4	Staff Ca Gap: 1.4
Real Exchange Rate	<p>Background. The CPI-based REER appreciated by 1.0 percent in the first 11 months of 2021 compared to the same period of 2020. This reflected a nominal appreciation of 2.2 percent, which was partially offset by weaker euro area inflation relative to its trading partners. The ULC-based REER depreciated by 1.4 percent.</p> <p>Assessment. The staff CA gap implies a projected REER gap of -4.1 percent in 2021, applying an estimated elasticity of 0.35.¹ The EBA REER index model suggests an overvaluation of 6.2 percent, and the EBA REER-level model implies an overvaluation of 0.1 percent. Consistent with the staff CA gap, staff assesses the REER gap to be in the range of -6.4 to -1.8 percent. As with the CA, the aggregate REER gap masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 9.6 percent in Germany to an overvaluation of 5.4 percent in Belgium. The substantial differences in REER gaps within the euro area highlight the continued need for net external debtor countries to improve their external competitiveness and for net external creditor countries to boost domestic demand.</p>						
Capital and Financial Accounts: Flows and Policy Measures	<p>Background. Mirroring the CA surplus in 2020, the euro area experienced net capital outflows, largely driven by portfolio investment, which more than offset the net inflow of direct and other investment into the euro area. Net capital outflows from the euro area in 2021 were largely driven by outbound FDI and portfolio debt investment.</p> <p>Assessment. Gross external indebtedness of euro area residents increased by 8 percentage points of GDP due to increases in both short-term debt securities and government and Eurosystem liabilities.</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>						
<p>¹ The export and import elasticities are taken as the average of estimates from Consultative Group on Exchange Rate Issues (CGER)-inspired export and import equations using various types of REERs relevant for the euro area (with an ADL (2,2,2) model on quarterly data 2000–19). The trade balance elasticity is calculated using the share of exports and imports for <i>extra-EA trade</i> in GDP.</p>							

Table 3. Euro Area: Risk Assessment Matrix¹

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Global Risks			
Global resurgence of the Covid-19 pandemic	Medium Local outbreaks lead to a global resurgence of the pandemic (possibly due to vaccine-resistant variants), which requires costly containment efforts and prompts persistent behavioral changes rendering many activities unviable.	High The recovery is delayed with scarring effects amplifying vulnerabilities in the private sector. More layoffs lead to a considerable increase in unemployment and labor market hysteresis, which will weigh on productivity growth. Firms' liquidity problems translate into insolvencies while highly leveraged corporates may experience significant stress, leading to higher credit spreads, potential downgrades, inability to refinance debt, and defaults. Banks' asset quality continues to deteriorate, resulting in widespread capital shortfalls, thus impairing the lending channel with further adverse implications to growth.	<ul style="list-style-type: none"> • Deploy containment measures to lower the risk of infection and mortality. Provide further support to the healthcare sector. • Further support the recovery by alleviating any tightening of funding conditions, preventing liquidity problems from becoming massive defaults and bankruptcies. Sustain support to households and firms, especially SMEs. • Maintain an accommodative monetary stance by expanding the existing tools and exploring additional policy options. Develop NPL strategies to quickly repair private sector balance sheets. • Boost the EU policy response and address pre-existing structural issues at the national level to support the recovery.
Disorderly transformations	Medium Covid-19 triggers structural transformations, but the reallocation of resources is impeded by labor market rigidities, debt overhangs, and inadequate bankruptcy resolution frameworks. This, coupled with a withdrawal of Covid-19-related policy support, undermines growth prospects and increases unemployment, with adverse social/political consequences and an adverse impact on bank balance sheets. Adjustments in global value chains and reshoring (partly driven by geostrategic and national security concerns) shift production activities across countries.	High Multi-faceted changes to the economy lead to increasing income polarization and leaves behind a material share of the population (particularly lower-skilled, lower-income workers).	<ul style="list-style-type: none"> • Protect the vulnerable and mitigate the likely increase in inequality by ensuring adequate access to healthcare and social assistance including unemployment benefits. • Enhance bankruptcy and insolvency procedures, provide incentives for debt restructuring, and remove impediments to setting up new businesses. • Use active labor market policies and enhanced training and reskilling programs to facilitate reallocation of workers toward expanding firms and sectors.
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 3. Euro Area: Risk Assessment Matrix (continued)

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Widespread social discontent and political instability	Medium Social tensions erupt as a withdrawal of pandemic-related policy support results in unemployment and, amid increasing prices of essentials, hurts vulnerable groups (often exacerbating pre-existing inequities).	High Social tensions around economic adjustments cause disruptions and erode trusts in policy makers. The resulting political instability complicates reaching political consensus on policies to address the pandemic. Public protests may also lead to an increased Covid-19 infection rate.	<ul style="list-style-type: none"> • Policies need to target the vulnerable population by ensuring adequate access to healthcare and social assistance including unemployment benefits. • Active labor market policies should be used to facilitate reallocation of workers toward expanding sectors and limit labor market hysteresis.
De-anchoring of inflation expectations in the U.S. leads to rising core yields and risk premia	Medium A fast recovery in demand (supported by excess private savings and stimulus policies), combined with Covid-19-related supply constraints, leads to sustained above-target inflation readings and a de-anchoring of expectations. The Fed reacts by signaling a need to tighten earlier than expected. The resulting repositioning by market participants leads to a front-loaded tightening of financial conditions and higher risk premia, including for credit, equities, and emerging and frontier market currencies.	Medium Rising rates in the U.S. could lead to a broader tightening effect on euro area financial conditions, weighing on consumption and investment and reducing the policy space to support the recovery. Higher risk premia and lower investor appetite induce a correction in asset prices.	<ul style="list-style-type: none"> • Maintain a sufficiently accommodative monetary stance by expanding existing tools. • Existing EU support lines could be drawn upon. • High debt countries should announce credible medium-term consolidation plans.
A sharp slowdown in China's growth	Medium Efforts to rein in property speculation in China spill over to the financial sector, and lead to a negative macro-financial feedback loop with an adverse impact on China's growth.	Medium Lower growth in China will affect the euro area through trade and financial channels. While direct financial linkages are limited, slower export growth, combined with weaker consumer and business confidence, will weigh on the corporate sector and result in lower investment and higher unemployment. Lower growth in the euro area will lead to a further deterioration in public debt sustainability in some high debt countries.	<ul style="list-style-type: none"> • Accelerate structural reforms to spur investment, productivity and competitiveness. • Adopt a more accommodative fiscal stance in countries with available fiscal space. • Continue accommodative monetary policy to raise inflation and support demand.
Euro Area Risks			
An abrupt shift in market sentiment	Medium An abrupt adjustment in risk asset prices could interact—and amplified by—preexisting vulnerabilities, and lead to a substantial tightening of financial conditions with adverse real-financial feedback loops.	High Sharp increases in funding costs further strain leveraged corporates and households and weaken the recovery momentum. Insolvencies increase, resulting in a rapid deterioration of bank balance sheets and profitability with adverse effects on the credit channel. High-debt countries may face potential downgrades, further undermining their ability to service their debt.	<ul style="list-style-type: none"> • Maintain a sufficiently accommodative monetary stance by expanding the existing tools and exploring additional policy options. • Existing EU support lines could be drawn upon. High debt countries should announce credible medium-term consolidation plans.

Table 3. Euro Area: Risk Assessment Matrix (continued)

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Euro Area Risks			
Faster than expected rebound in economic activity	Medium A fast unwinding of precautionary and forced savings, coupled with a stronger-than expected global recovery, and a larger-than expected fiscal impulse I significantly boost demand. The output gap closes faster than projected, despite expansion of the supply side due to fast adaptation of businesses to the new normal, higher investment, and strong productivity growth.	Medium The accelerated recovery results in a lower economic scarring and tighter labor market conditions. Unemployment declines, and inflation expectations increasing, fueling wage growth and increase price pressures. With lower credit risk, firms and households increase leverage to finance investment and consumption.	<ul style="list-style-type: none"> • Scale back supportive policies and tighten, as needed, helping ensure price stability • Facilitate resource reallocation toward firms and sectors with strong post-pandemic viability prospects. • Embark on fiscal consolidation in high-debt countries to rebuild buffers.
Higher and persistent inflation	Medium Continued supply-side disruptions, combined with a stronger domestic and global recovery leads to large second-round effects on wages and prices. Inflation persistently overshoot the ECB 2-percent target.	Medium There could be a vicious cycle of higher inflation feeding into higher inflation expectations which then feeds back to higher inflation. Equity markets could get spooked as expectations could suddenly shift to earlier withdrawal of monetary accommodation, and inflation risk premia would rise.	<ul style="list-style-type: none"> • Gradually taper unconventional tools before raising the key policy rates. • Enhance communication to anchor inflation expectations. • Employ macro- and micro-prudential tools to mitigate financial stability risks. • Accelerate the implementation of structural fiscal reforms to further enhance the credibility of fiscal frameworks and limit any increase in funding costs, especially in higher debt countries.
Insufficient policy support and coordination	Low A premature withdrawal of policy support, slower-than-anticipated implementation of the RRP, and insufficient efforts to facilitate reallocation of resources delay the recovery and increase economic scarring.	Medium Undue tightening of financial conditions together with insufficient fiscal support result in higher unemployment and corporate bankruptcies, significant labor market hysteresis and adverse distributional effects. Higher sovereign yields will also limit policy space of high debt countries.	<ul style="list-style-type: none"> • Maintain a sufficiently accommodative monetary stance by expanding existing tools, • Provide continued fiscal support until the expansion phase is firmly in train. • Implement long-standing structural reforms and use active labor market policies and enhanced training and reskilling programs to facilitate reallocation of workers toward expanding firms and sectors. • Protect the vulnerable and mitigate the likely increase in inequality by ensuring adequate access to healthcare and social assistance, including unemployment benefits.

Table 3. Euro Area: Risk Assessment Matrix (concluded)

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Euro Area Risks			
Escalation of trade tensions	Low Trade tensions with the U.S. and China, disagreements about carbon border adjustment, as well as further delays in implementing the Northern Ireland protocol could undermine the recovery.	Medium Rising trade tensions could result in a slowdown in exports, weaken confidence, and dampen the recovery. Disagreement about carbon border adjustment could undermine ambitious reforms toward greening the economy. Finally, significant Brexit-related disruptions, including border delays, could lead to efficiency losses especially for countries with closer links to the U.K.	<ul style="list-style-type: none"> • Redouble efforts to secure the benefits of economic integration and cooperation across the EU. • Implement measures to support growth and productivity, such as scaled up domestic public investment. • Contingency planning and collaboration between U.K. and EU authorities to reduce cliff-edge effects and disruptions.

Annex I. The Impact of Coordinated Post-Covid Monetary and Fiscal Policies in the Euro Area¹

Euro area activity is set to recover strongly from a deep recession in 2020. However, labor market slack is projected to persist, along with weak underlying inflation dynamics. With monetary policy being constrained by the effective lower bound, fiscal policy could temporarily provide additional support, thus helping to further reduce scarring, create jobs, and lift underlying inflation.

1. Fiscal policy can play an important role in supporting the recovery in the euro area when monetary policy is constrained.

The economic scars from the pandemic could be large and inflation in the euro area is set to remain below the ECB's target of 2 percent over the projection horizon after some temporary acceleration in 2021. Yet, boosting inflation remains challenging due to the flattening of the Phillips curve and the effective lower bound (ELB) on interest rates. Meanwhile, when interest rates are near the ELB, output and inflation respond more strongly to fiscal support. Increased government spending could crowd in private consumption and investment, thereby shrinking medium-term output losses and reducing labor market scarring, which could also increase inflation.

2. A more gradual withdrawal of support in 2022 and 2023 would close the output gap and reduce scarring more quickly.²

Under the October WEO baseline, the aggregate euro area structural fiscal balance improves by 4 percentage points between 2022 and 2025, frontloaded in 2022. If, instead, the improvement is more gradual, allowing for additional spending of 2 percent of GDP over several years (for example 2022–23),³ fiscal policy could help close the output gap as early as 2022Q3 (Figure 1a). The draft 2022 national fiscal budgets go in this direction. The impact would, however, depend on the composition and efficiency of the fiscal package, with a lower multiplier from general transfers and a higher one from public investment. The cumulative two-year fiscal multiplier considered in this exercise ranges from 0.6 to 1.3, comparable to the literature in which public spending often has a greater-than-unity multiplier at the ELB.⁴ While there is uncertainty around the precise number, alternative multipliers would not change the results significantly. Output would gradually catch up with the pre-Covid trend and the cumulative output loss over five years (2021–25) would be between 20 to 50 percent lower (Figure 1b). With productivity-enhancing measures, potential output would be higher by an average of 0.2 p.p. every year starting from 2022. The extra boost to economic activity would also support the labor market, boosting hours worked by 1½ percent over 2022–23, partially offsetting the 3½ percent drop in hours worked between

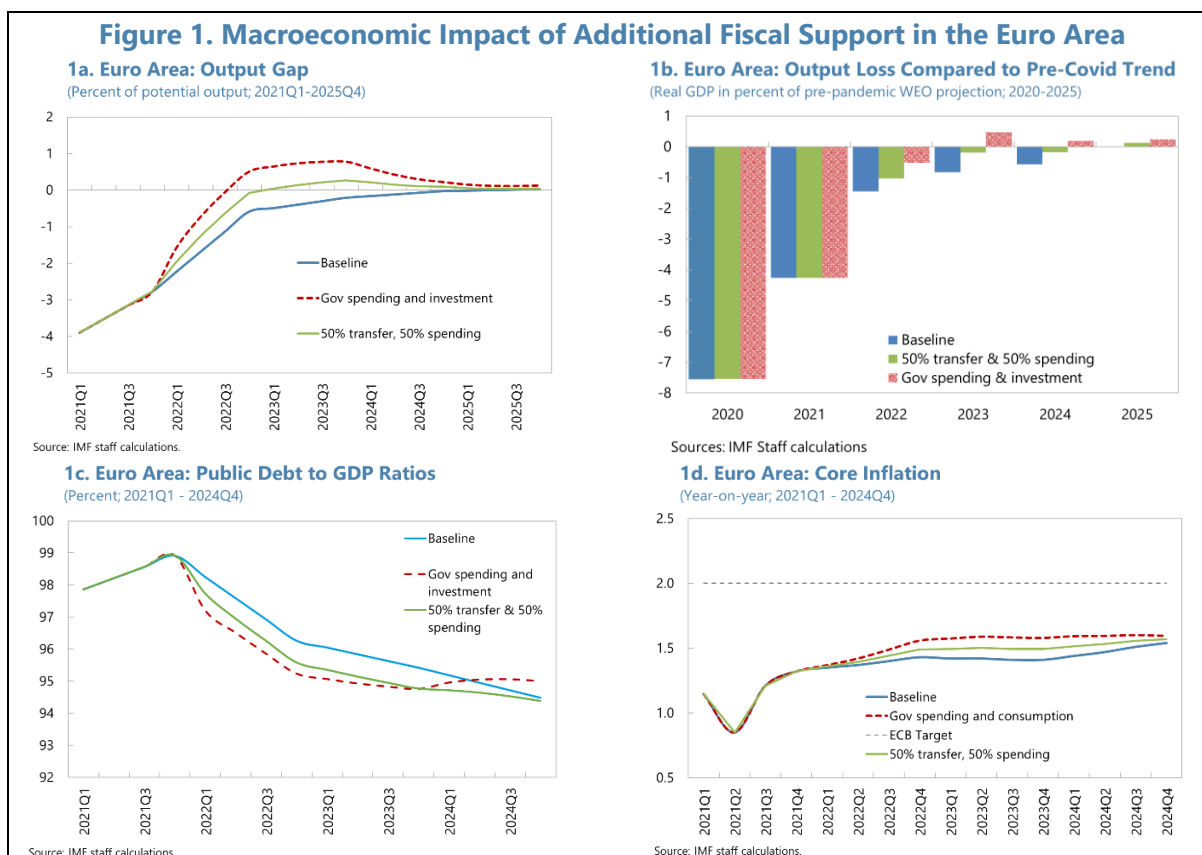
¹ Prepared by Vina Nguyen, drawing from Balakrishnan et al., forthcoming.

² The simulations are based on a two-country New Keynesian DSGE model, similar to one in [Lindé and Pescatori \(2019\)](#). The model contains nominal and real rigidities, two types of households, imperfect financial integration, producer currency pricing, and a financial accelerator mechanism. Baseline projections are from the October 2021 *IMF World Economic Outlook*.

³ This amounts to slightly less than €240 billion over two years.

⁴ Relevant estimates include 1.6–2.8 ([IMF Working Paper 2019/133](#)), 1.5 ([Ramey and Zubairy 2018](#)), 3.6–3.8 ([Serio et al. 2020](#)), 1–2.7 with the median value of 1.8 ([ECB Strategy Review 2021](#)).

2019Q4 and 2021Q2. Meanwhile, due to higher output and ongoing favorable financing conditions, the proposed more gradual fiscal adjustment path would not worsen euro area debt-to-GDP dynamics, especially with efficient public investment (Figure 1c). A much larger fiscal package, while beneficial to short-term output and inflation dynamics, could lead to a premature tightening of monetary policy and ultimately worsen debt dynamics.

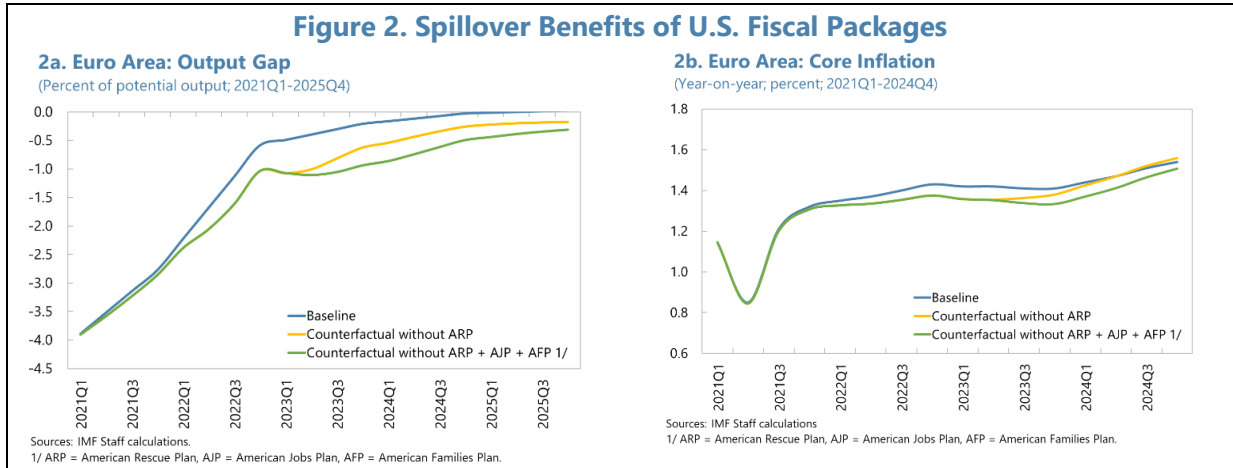


3. The impact on inflation would be mild (Figure 1d). The slower withdrawal of fiscal support over 2 years would temporarily increase demand. Starting from 2022, core inflation would accelerate, peaking at 0.2 p.p. higher than the baseline projection.⁵ In the outer years, since the temporary demand boost would fade away but the increase in productivity is more persistent, the output gap will be less positive, reducing inflationary pressure.

4. The euro area is also expected to benefit from a combination of U.S. Covid-related policies (Figure 2). The U.S. government has introduced and proposed a series of fiscal packages to support the economy during the pandemic and invest in infrastructure and modernize the economy. These are the American Rescue Plan (8.2 percent of GDP), the American Jobs Plan (10.1 percent of GDP), the American Families Plan (6.9 percent of GDP). Together, these fiscal packages, along with a new flexible AIT framework from the Federal Reserve, would have a net positive spillover to euro

⁵ This effect is equivalent to an increase in asset purchases by the ECB of 3 to 6 percent of GDP ([Rostagno et al. ECB Working Paper June 2021](#), [Lhuissier and Nguyen, Banque de France Working Paper February 2021](#)).

area output and inflation. The trade channel is expected to play the most important role, as higher consumption in the U.S. increases demand for euro area exports.



Annex II. Inclusion of Owner-occupied Housing Costs in the Harmonized Index of Consumer Prices¹

Following the ECB's strategy review, the Governing Council has decided to include owner-occupied housing (OOH) costs in the Harmonized Index of Consumer Prices (HICP) over the medium term. This decision is in line with the practice at most advanced economies with inflation-targeting central banks. While several approaches can be used for computing OOH costs, the ECB has expressed a preference for the net acquisition approach, which has some conceptual advantages, but requires a longer implementation period. The inclusion of OOH costs will have implications for monetary policy over the medium term, which would need to adjust accordingly.

1. Housing costs can be computed in different ways. Total housing costs are a combination of tenants' and homeowners' (owner occupiers') spending on shelter services. Whereas the former tends to be measured by data on rents, the latter needs to be estimated. There is no international consensus on whether or how to include OOH expenses in consumer prices. Three broad approaches are typically used, with these costs being proxied by:²

- *Rental equivalence*: how much homeowners would have to pay to rent their dwelling, excluding costs typically borne out by landlords (e.g., insurance, maintenance, property taxes);
- *User-cost*: the sum of recurring actual user costs (e.g., insurance, maintenance, property taxes, mortgage interest rate payments), estimated depreciation costs (based on the current market value of the owner-occupied housing stock and an average rate of depreciation), and opportunity costs (forgone income from alternative investments) net of capital gains;³ or
- *Net acquisition*: the cost of purchasing a dwelling (excluding the land component but including transfer costs) as well as other ownership costs (e.g., insurance, maintenance, and renovations).

2. An important limitation of some of these approaches relates to the treatment of house prices. Because the scope of a CPI should be limited to household consumption expenditures (therefore excluding investment), in principle its OOH component should exclude buy-to-let purchases and only capture the structure part of owner-occupied dwellings (which represents the consumption of shelter), while their land component (which represents an investment asset) should be excluded.⁴ In practice, though, this distinction is often hard to make due to data limitations. And

¹ Prepared by Sílvia Domit, Vina Nguyen, and Niall O'Hanlon.

² [Consumer Price Index Manual: Concepts and Methods \(2020\)](#). While a fourth method—the payments approach—exists, in practice it has several limitations and is used by very few countries, see [Diewert, Erwin, 2003](#) and [Diewert, Erwin, 2009](#).

³ While, in theory, opportunity costs are a feature of the user-cost approach, in practice, there is no consensus on how they should be computed, and they are often excluded.

⁴ Eurostat (2017) "[Technical manual on Owner-Occupied Housing and House Price Indices](#)."

even when this distinction is possible, communication challenges may arise to the extent that CPI inflation will not fully reflect rising house prices as perceived by the public.

3. Each of these approaches has its own limitations:

- **Rental equivalence** might not be a good proxy for OOH costs when the rental market is small, concentrated (either geographically or demographically), subject to rent control, or unrepresentative of the stock of owner-occupied dwellings (which tend to be of higher quality).
- By construction, the **user-cost approach** includes interest rates and house prices in the CPI, directly linking the index to an asset price and potentially creating a cyclical mechanism whereby monetary policy works in the ‘wrong’ direction: tighter (looser) monetary policy raises (lowers) CPI inflation in the short-run.
- The **net acquisition approach** can also create a stronger link between CPI inflation and asset prices if the available price indices can’t separate a property’s investment asset (i.e., the land) and shelter services (i.e.: the dwelling structure). It might also prove difficult to implement due to data limitations, including availability (e.g., the lack of a price index for newly built housing purchased by owner occupiers), volatility (fluctuating weights over the housing cycle), and timeliness.⁵

4. In the euro area, the exclusion of OOH costs from the HICP arises from the lack of timely monthly data inputs. Quarterly OOH price indices are available for most euro area countries through the net acquisition approach.⁶ But the absence of timely monthly house price and construction price indices has prevented Eurostat from incorporating the existing OOH costs indices into the monthly euro area HICP.⁷ House price and construction price indices are only available on a monthly frequency for a few euro area countries and, even then, they are not as timely as the HICP (Table 1). Producing these on a monthly and timely basis would be a multi-year project.

	AUT	BEL	CYP	DEU	ESP	EST	FIN	FRA	GRC	IRL	ITA	LTU	LVA	LUX	MLT	NLD	PRT	SVK	SVN	
	Available monthly																			
House Price Index	12	12	13	11	10	11	4	9	7	6	11	11	11	13	13	3	12	8	12	
Construction Price Index	3	9	12	5	8	3	3	12	4	3	7	4	10	10	12	12	6	12	10	

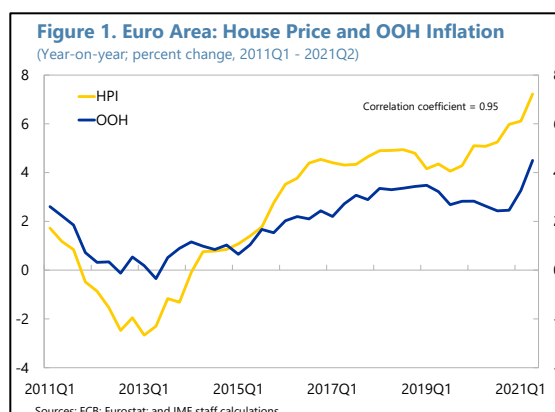
Source: Eurostat and IMF Staff Calculations

⁵ Hill, Robert J., Miriam Steurer, and Sofie R. Waltl, 2019.

⁶ These are available for all EA-19 countries except Greece.

⁷ Eurostat, 2018. “[Harmonized Index of Consumer Prices \(HICP\) Methodological Manual](#).”

5. Methodological preferences also play a role. The rental equivalence approach is not favored by the European Commission (EC) and the ECB Governing Council because its use of imputation was deemed inconsistent with an index used for monetary policy purposes.⁸ There are also concerns about using this approach in member countries with rent control or where the rental market is either small or structurally unrepresentative of the stock of owner-occupied dwellings (e.g., different quality or property types). The appropriateness of the user-cost approach for the euro area has not been as thoroughly assessed, possibly because of the inclusion of interest rates, but it also relies on imputation to a certain degree. The net acquisition approach has been assessed by the EC and the ECB Governing Council to fulfil the euro area HICP requirement of being based exclusively on actual monetary transactions.⁹ A clear drawback of this approach, and another reason why it would require at least several more years to be satisfactorily implemented, is that available data do not allow for fully distinguishing investment in housing as an asset from consumer spending on shelter services. This issue creates a strong link between HICP inflation and house price growth (Figure 1), which complicates the use of the former for monetary policy.¹⁰ The net acquisitions approach is also not immune from ‘small market’ concerns often associated with the rental equivalence approach, as compiling robust price indices for new dwellings—a step required under the net acquisitions approach—presents significant challenges in countries where few new properties are transacted.



6. Many advanced inflation-targeting economies have successfully included OOH costs in their reference index (see Table 2). Some do so by using modified versions of the ECB’s preferred approach, while others use different approaches.

- Australia and New Zealand use modified versions of the net acquisitions approach that rely on construction rather than house purchase price indices, eliminating the undesirable link to an investment asset.¹¹ While both countries base their monetary policy on quarterly CPIs, their cases are relevant to the extent that monthly construction price indices would be easier to compile in the euro area than house price indices. The Czech Republic compiles quarterly OOH costs’ indices through the net acquisitions approach and includes them in the monthly CPI through extrapolation techniques.

⁸ Article 3(3) of Regulation (EU) No. 2016/792 sets out that the HICP “shall be based on the price changes and weights of products included in the household final monetary consumption expenditure,” while the European Commission in its [2018 report](#) states that the focus on ‘actual monetary transactions’ in Article 3(3) of Regulation (EU) No. 2016/792 rules out the use of imputation.

⁹ Eurostat (2017). “[Technical manual on Owner-Occupied Housing and House Price Indices](#)” and European Central Bank (2021), [An Overview of the ECB’s Monetary Policy Strategy](#).

¹⁰ [Eglsperger, Martin, and Bernhard Goldhammer, 2018](#).

¹¹ [Hill et al. \(2017\)](#) and [Analytica \(2018\)](#).

- The user cost approach has been implemented by Canada and Sweden with modifications to minimize the impact of short-term movements in house prices (through smoothing) and interest rates (by excluding the contribution of mortgage rates when their weight is nonnegligible).
- The rental equivalence approach is used by the U.S., Japan—with similar rental market sizes to the euro area’s—and Norway, with a rental market smaller than those in many euro area countries (Figures 2 and 3). The US’ Personal Consumption Expenditure deflator has included OOH costs estimated using the rental equivalence approach since 2001. The academic literature notes that this approach avoids undesired properties from alternative approaches, notably links with house prices and interest rates.¹² Concerns around representativity of the rental stock—similar to those discussed in Europe—are addressed through modifying the weights used to aggregate across locations and property types.¹³ And while controlled rents exist in some U.S. states, these are excluded from the sample of rent prices used for the calculation of the OOH costs’ index. Japan has used the rental equivalence approach since the 1970s. More recently, the Japanese national Statistics Commission deemed rental equivalence a more appropriate approach for Japan, given its sizeable rental market and the desire to avoid direct links to interest rates.¹⁴ The use of imputation has also not been a major concern, with quality adjustment methods and the implications of rent stickiness being more widely studied.

Table 2: CPI and Housing in Advanced Inflation Targeting Economies

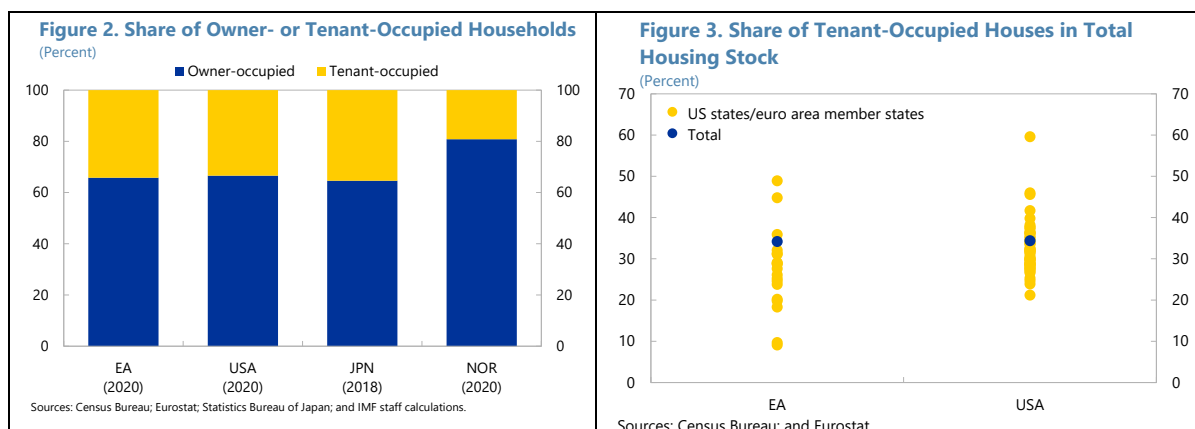
Central Bank	Inflation Target Benchmark Index	Does the benchmark index include OOH?	Which approach is used to compute OOH?
Australia 1/	CPI	Yes	Modified Net Acquisitions
Canada	CPI	Yes	Modified User Cost
Czech Republic	CPI	Yes	Modified Net Acquisitions
Euro Area	HICP	No	-
Japan	CPI	Yes	Rental Equivalence
New Zealand 1/	CPI	Yes	Modified Net Acquisitions
Norway	CPI	Yes	Rental Equivalence
Republic of Korea	CPI	No	-
Sweden	CPIF	Yes	Modified User Cost
UK	HICP	No	-
US	PCE deflator	Yes	Rental Equivalence

Sources: National authorities.
1/ Benchmark index only available at quarterly frequency.

¹² [Kudlyak \(2012\)](#).

¹³ US-focused research has shown that location, rather than property type and condition, is the key determining driver of changes in rent prices, making the process of carefully matching owner-occupied units with equivalent rental units less relevant. While rent levels differ by type and condition, the OOH costs’ index measure changes in rent, not rent levels, and changes in rent across units tend to be similar within a given location. See for example [Ptacek, Frank, and Baskin, Robert M., 1998](#).

¹⁴ Statistics Commission of Japan, [Minutes of the February 2018 Meeting](#).



7. International experience points to three broad options for including OOH costs in the euro area HICP. These are:

- Option 1—Modified net acquisition approach:** additional research and methodological changes could allow for timely monthly OOH indices. For example, consideration could be given to the use of forward extrapolation (as done in the Czech Republic), implementing those hedonic methods that are better suited for compiling monthly house price indices,¹⁵ and the use of asking prices from real estate web portals rather than administrative data on property transactions; and to changing reporting requirements for construction price indices from quarterly to monthly (**Option 1A**).¹⁶ Alternatively, monthly construction prices could be used instead of house prices to estimate the cost of acquiring a dwelling, as done in Australia and New Zealand (**Option 1B**), although this modification would rely on imputation, as it assumes that contract margins remain fixed. Both options would require a change in data reporting requirements, which would involve a change in EU regulation.
- Option 2—Rental equivalence approach:** While this approach would require compromising on the degree of imputation, it would allow for capturing OOH costs without compromising on timeliness, periodicity, or desired properties (i.e., undesired links with interest rates and house prices). Because timely monthly inputs needed for this methodology are already available,¹⁷ it would allow for a faster compilation, therefore shortening the implementation timeline compared to Options 1 and 3. Concerns around representativity of the rental stock could be addressed through modification of the weights used to aggregate across locations and property types—as done in the U.S.—and through rental sample enhancement.

¹⁵ For example, the rolling window and repricing methods which facilitate pooling of data over longer time periods.

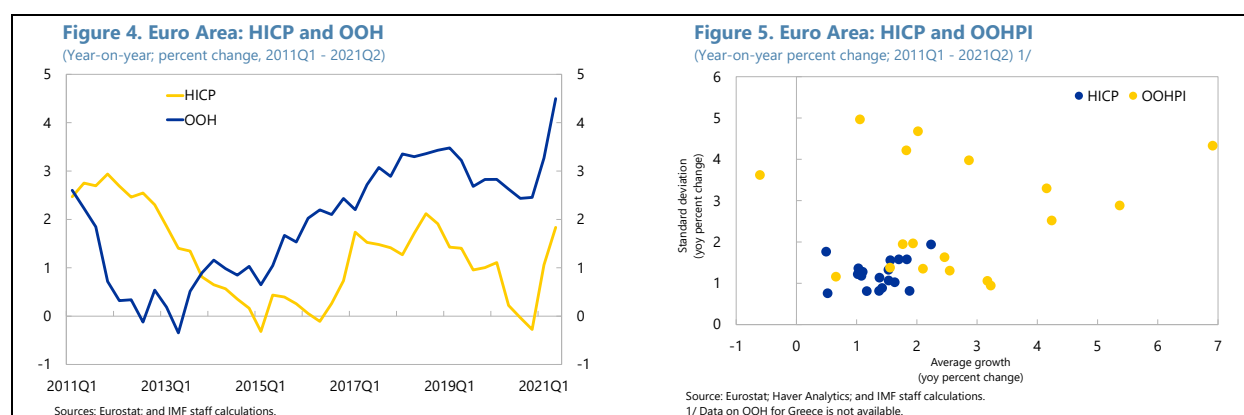
¹⁶ For applications of hedonic methods and real estate web portal data, please see [IMF Country Report No. 18/200; Hill, Robert J., Alicia N. Rambaldi, and Michael Scholz, 2020](#); and [Shimizu, Chihiro, Kiyohiko Nishimura, and Tsutomu Watanabe, 2010](#).

¹⁷ As available source data for rent prices could be used to compile rent indices reflecting the stock of OOH under the rental equivalence approach.

- **Option 3—Modified user cost approach:** A modified version of the user cost approach as done in Canada or Sweden would involve a smaller degree of imputation than the rental equivalence approach but require monthly house price indices and therefore changes to data-reporting requirements.

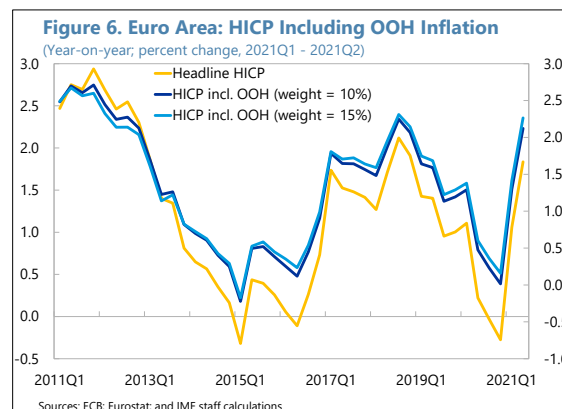
8. Each option would involve some degree of compromise, notably regarding imputation and the implementation timeline. The trade-off boils down to compromising on the use of imputation versus speed of implementation. The net acquisition and the user-cost approaches can be modified to minimize undesired links with interest rates and/or house prices, but this would require accepting a higher degree of imputation (Options 1B and 3). Option 1A could also be adjusted to remove the links to house prices, but that would require compilers to either estimate land price movements or to assume that land price and dwelling structure price inflation rates are equal, which could arguably also be considered a form of imputation. While the extent of imputation would likely be larger under rental equivalence (Option 2), other concerns around representativity and rent controls can be circumvented, and this approach would allow for a faster compilation of an aggregate OOH costs' index. Each option would require some degree of legislative change to the HICP regulation, and also, in the case of Option 1, to the Short-term Statistics Regulation.

9. Given the ECB's preference to use the net acquisitions approach, efforts should be directed towards additional research to overcome computational challenges. Following its strategy review, the ECB Governing Council recommended a roadmap to include OOH costs in the HICP using the net acquisitions approach. While conceptually closest to the HICP requirement of being based exclusively on actual monetary transactions and minimizing imputation, this approach faces challenges that mean full implementation will take several years. Additional research to address these challenges—notably the lack of timely monthly data on construction and house prices, and the inability to separate asset prices and shelter services—should be prioritized.



5. Inclusion of OOH costs would have implications for monetary policy for it would affect the level and the volatility of inflation and the dispersion across countries.

- OOH inflation in the euro area has risen steadily in the past decade before easing to below 3 percent pre-pandemic and again rising to 3.5 percent more recently. In contrast, HICP inflation has remained below 2 percent for most of this period (Figure 4). There is also a large divergence across euro area countries and OOH inflation has also been overall more volatile than HICP inflation (Figure 5). Depending on the weights¹⁸ of the OOH component, its inclusion under the net acquisitions approach would have increased the HICP inflation by around 0.4 percentage points in 2021H1 (Figure 6).



- Monetary policy would need to adjust accordingly and any changes to the reference index should ensure that the inflation target remains credible, transparent, and well-understood by the public. In particular, since inclusion of OOH costs under any statistical approach should exclude asset price movements and therefore not fully reflect rising house prices, clear communication will be crucial to minimize criticism that the index understates living costs.

¹⁸ An OOH weight of 10 percent in the HICP would be closer to the U.S. (11.6 percent) while 15 percent would resemble Japan (15 percent), the Netherlands (15.8 percent), and Norway (14.1 percent).

Annex III. 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 and cooperate closely.²

1. European statisticians have ensured the continued, and enhanced, provision of statistical information during the Covid-19 pandemic. The ESS and the ESCB, in close cooperation, offered help to simplify processes, while maintaining the quality of the statistical information at a level that is fit for purpose and providing additional data.

- ECB and Eurostat published a number of methodological guidance and explanatory notes to provide guidance to national compilers and to help users to understand the possible statistical effects of measures taken to fight the pandemic (e.g., lockdowns) on various statistics.
- Furthermore, the ESS and ESCB developed a joint template to identify the impact of Covid-19 related government policy measures on government revenue, expenditure and debt. Eurostat is developing guidance on the statistical treatment of these measures. The GFS data provided by countries is being closely monitored in order to ensure sound and comparable statistical treatments. Eurostat also developed a new reporting template in order to monitor the impact of the newly established EU Recovery and Resilience Fund which provides support to national economies. The ECB continues to publish a monthly report on the issuance of debt securities by EU governments, the main financing instrument in the Covid-19 pandemic. The two systems producing European statistics shall continue to cooperate closely on these matters.
- Starting with the 2020Q1 reference quarter, Eurostat has collected and published metadata on the timing and severity of the Covid-19 impact on economy, estimation techniques used, as well as on the quality and reliability of the estimates.
- On December 10, 2020, the ECB Governing Council decided on modifications to the terms and conditions³ of the third series of targeted longer-term refinancing operations (TLTRO III), which continue to be accompanied by additional data collection measures from the banking sector.

¹ Prepared in consultation with Eurostat and the ECB.

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

³ Extension by an additional 12 months to June 2022, a period of favorable interest rates for banks that lend to the real economy; three additional three-year operations in June, September and December 2021; borrowing allowance raised to 55 percent of eligible loans. Source:

https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr201210_1~e8e95af01c.en.html.

All Member States should ensure full and timely data transmissions under the European System of National and Regional Accounts (ESA) 2010 at the legal deadlines—Eurostat will continue to follow up the progress and prepare an overall analysis of the implementation.

The move to the definitions required under the Integrated European Social Statistics Regulation are underway and have disrupted time series and comparability of the Labor Force Survey. Eurostat regularly communicates progress across countries, as users have found analysis of the Labor Market challenging in this context.

2. Despite the pandemic, Eurostat and the ECB continued actively working on the 20 recommendations of the second phase of the G20 Data Gaps Initiative (DGI-2), as members of the Inter-Agency Group on Economic and Financial Statistics and are cooperating closely on a possible continuation of the work in specific priority areas.

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. By August 2021, 13-euro area countries (and 18 EU member states overall) had already adhered to the SDDS Plus.

4. Eurostat and the ECB continued their efforts to ensure the quality of statistics underlying the Macroeconomic Imbalance Procedure (MIP). The ESS–ESCB quality assessment report on statistics underlying the Macroeconomic Imbalances Procedure is produced on an annual basis; latest in July 2021. The implementation of the Memorandum of Understanding on the quality assurance of statistics underlying the MIP⁴ progressed with: i) the publication of the lessons learnt from MIP visits;⁵ and ii) the follow up of the visits from 2017. Due to the Covid-19 pandemic the 2021 visits were postponed and will be resumed in 2022.

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

- *Climate change.*
 - On July 8, 2021, the ECB presented an action plan to include climate change considerations in its monetary policy strategy. As part of this plan, the ECB will develop new experimental indicators, covering relevant green financial instruments and the carbon footprint of financial institutions, as well as their exposures to climate-related physical risks. This will be followed by gradual enhancements to such indicators, starting in 2022, also in line with progress on the EU policies and initiatives in the field of environmental sustainability disclosure and reporting. Eurostat is undertaking a review of environmental statistics in response to the European Green Deal, and working on the development of new indicators (such as quarterly estimates of greenhouse gas emissions).

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

⁵ <https://circabc.europa.eu/sd/a/c8612347-6bfd-4f26-aaf4-7ff7032145b4/2020-06-17%20-%20MIP%20quality%20-%20Visits%20-%20lessons%20learned1%20-%20final%20for%20publication.pdf>

- The ESCB Statistics Committee's (STC) *Expert Group on the Climate-Change and Statistics* report in October 2020 illustrated the existing ESCB data demands and their analytical objectives, the methodological challenges and data gaps that need to be overcome, and made proposals for priorities regarding the development of indicators and statistics related to climate-change. As a follow-up, the STC mandated the Expert Group to initiate work for the development of indicators, and methodological best practices, on exposures of financial institutions to climate-related physical risks and carbon footprints of the portfolios of financial institutions, as well as on sustainable financial investments ("green" bonds).
- The Committee on Monetary, Financial and Balance of Payments Statistics' (CMFB) Task Force on the statistical treatment of sustainable finance and climate-related risks completed its work with a number of recommendations to (i) improve knowledge of and accessibility to already existing potential data sources for compiling sustainable finance indicators, (ii) harmonise and standardise presentation of data by the integration of relevant statistical classifications (such as NACE) and common identifiers, and (iii) for an effective ESS-ESCB cooperation on methods and sources to ensure long-term compatibility of indicators.
- *National accounts.*
 - Both Eurostat and the ECB are very active participants in the ongoing update of the System of National Accounts (SNA) and the Balance of Payments manual (BPM), as part of the joint international effort to complete these updates by 2025. Digitalization, globalization, nonbank intermediation and sustainable finance are emerging phenomena that are already posing challenges for the analysis of European economies.
 - The regular reporting exercise on the quality of ESA 2010 data transmitted by EU member states to Eurostat continued. Eurostat's assessment report on 2020 transmissions will take into consideration the data coverage after all derogations for EU member states data transmissions expired.
 - Following a first release in April 2018, the EU inter-country input-output tables for 2010–18 were released in spring 2021 in current prices, and are being followed by annual regular production.
 - ECB and Eurostat are working with EU Member States on developing guidelines for reducing vertical discrepancies observed between non-financial and financial sector accounts. The guidelines are expected to be finalized in 2021, while their implementation will be made progressively until the 2024 coordinated European benchmark revision of national accounts.
- *Price statistics.*
 - The outcome of the ECB Monetary Policy Strategy Review, announced in July 2021, recommends Eurostat to start providing—first on an experimental basis—quarterly indices combining the HICP with the existing stand-alone owner-occupied housing (OOH) price

index. This new index would provide considerable new information to users, in particular as regards the contribution of housing costs to inflation. Eurostat plans to start releasing the new index in April 2022.

- In October 2020, the first dissemination of quarterly house sales indices took place. Data on the value of house sales as well as the number of sales transactions are now available for a majority of EU countries.
- Concerning Commercial Real Estate indicators, Eurostat and the ECB continued to work with member states to close data gaps.
- *Financial accounts.* As part of the implementation of the medium-term strategy for financial accounts, the ESCB is improving the availability of data for the non-bank financial sector, to better capture the effects of globalization, and on households' financial portfolios. As a first step, and following a recent update of the ECB Guideline, more granular reporting for the financial sector, enabling a distinction between other financial institutions which are financial intermediaries and those which are not will be launched by euro area countries in 2022 and published by the ESCB.
- *External statistics.*
 - As of March 2021, new b.o.p. and i.i.p. details are being collected by the ECB following the amended ECB Guideline on External Statistics (ECB/2011/13). These details include further sectoral, geographical and currency breakdowns and more granularity of FDI debt instruments. Euro area aggregates for the new details will be released in 2022.
 - Modernization of intra-EU trade in goods statistics. To reduce the reporting burden while maintaining quality in international trade in goods statistics, the exchange of micro-data on intra-EU exports between the EU Member States will start in 2022. In 2021, the preparation for the start of the micro-data exchange focused on testing the IT system.
 - Quality improvement of extra-EU trade in goods statistics: Preparations are also underway for the exchange of customs data between the Member States. This exchange will enable the use of customs data lodged in another Member State. The exchange, which will also start in 2022, will be arranged using the same IT system as developed for the intra-EU micro-data exchange.
- *Monetary and financial statistics.*
 - The ECB has finalized the [Regulation ECB 2020/59 amending Regulation ECB 2013/43 on payment statistics](#). This amending Regulation, published on December 11, 2020, introduces new reporting requirements in relation to information on innovative payment services and channels, payment schemes, and fraudulent payment transactions. This information will enable the ECB to more effectively perform its catalyst and oversight roles in the areas of retail payments and payment systems. In addition to improving performance, more detailed

and frequent statistical information on card payments will help to enhance the ECB's understanding of cross-border trade and economic forecasting.

- The ECB has adopted a recast Regulation on the balance sheet items of credit institutions and of the monetary financial institutions sector (ECB/2021/2) on January 22, 2021. This new Regulation introduces new reporting requirements to enhance the analysis of monetary and credit developments, as well as modifications to some existing requirements, definitions and reporting derogations where this would support better integration with other statistical datasets. Reporting under the new requirements will commence with monthly data for January 2022 and quarterly data for the first quarter of 2022.
- The ESCB's long-term approach to banks' data reporting is to increase the efficiency of data collection from banks and to reduce their reporting burden, while continuing to provide policy makers and analysts with high-quality data. This approach consists of two elements (i) the Integrated Reporting Framework (IReF)⁶ seeks to integrate the Eurosystem's statistical reporting requirements addressed to banks. (ii) the Banks Integrated Reporting Dictionary (BIRD)⁷ helps banks to efficiently organise information stored in their internal systems and to fulfil their reporting requirements. The IReF is part of the broader ESCB integrated reporting strategy which was published in September 2020 as ESCB input to the European Banking Authority (EBA) feasibility report⁸ mandated by the European Parliament and Council.
- On February 14, 2021, the list of pension funds (ref. Q3-2020) has been published on the ECB website for the first time. The list will be updated on a quarterly basis.

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

- *Euro short-term rate (€STR)*.⁹
 - The external auditor assessed €STR's compliance with IOSCO principles; the statement of compliance was published on September 30, 2020.¹⁰

⁶ https://www.ecb.europa.eu/stats/ecb_statistics/co-operation_and_standards/reporting/html/index.en.html#IReF

⁷ https://www.ecb.europa.eu/stats/ecb_statistics/co-operation_and_standards/reporting/html/index.en.html#BIRD

⁸ https://www.ecb.europa.eu/pub/pdf/other/ecb_escbinputintoebafeasibilityreport092020~eac9cf6102.en.pdf?743bc2defe61abe865e1857ab1a98337

⁹ The ECB published the €STR for the first time on October 2, 2019, according to the provisions laid down in the ECB Guideline ECB/2019/19 on €STR (July 10, 2019). Since February 2020, the ECB periodically publishes summary information on errors larger than 0.1 basis points that were detected after the standard publication and did not meet the republication criteria.

¹⁰ https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_short-term_rate/html/pwc_disclaimer.en.html

- The ECB started the publication of *compounded* €STR rates on April 15, 2021, following a public consultation and responding to market feedback in favour of having compounded rates based on the €STR published regularly by a trusted authority.
- Money Market Statistical Reporting (MMSR). The amended regulation was adopted on November 26, 2020, to ensure that branches of MMSR reporting agents located in the United Kingdom continue to report daily.
- Centralised Securities Database (CSDB). As part of its evolutive maintenance, new attributes are being gradually added to address users' requirements, e.g., on sustainable finance (identification of green bonds). The unique joint ESCB compilation of securities issues statistics directly from micro data (at t+10 days after the end of the month) is also becoming a reality in the last quarter of 2021.
- Securities holdings statistics. The data compilation has been adapted to support the ECB's Pandemic Emergency Purchase Program (PEPP), and its timeliness improved.
- Analytical credit datasets (AnaCredit Project). The second edition of the AnaCredit Reporting Manual was published in May 2019. A new set of Q&As were published due to the Covid-19 crisis.¹¹

6. The ECB, Eurostat and the OECD actively cooperate on statistics and research concerning the joint distribution of income, consumptions and wealth (ICW) as well as linking macro and micro data on household wealth.^{12, 13} The ESCB Statistics Committee's Expert Group on Distributional Financial Accounts is developing distributional results on household wealth which are consistent with the national accounts by 2022. The work will continue to support the recommendations of the G-20 Data Gaps initiative, which, in their newest version, have emphasized the development of distributional accounts as one of four main priorities. In December 2020, Eurostat published experimental results for all EU Member States regarding the distribution for income and consumption, accompanied by metadata and qualitative information.

7. Technical work by Eurostat is also ongoing towards modernizing and harmonizing public sector accounting in the context of the European Public Sector Accounting Standards (EPSAS). Ongoing technical work has focused on drafting screening reports assessing the consistency of individual International Public Sector Accounting Standards (IPSASs) with the draft EPSAS Conceptual Framework. Eurostat expects to complete this assessment by end-2021.

¹¹ https://www.ecb.europa.eu/stats/money_credit_banking/anacredit/questions/html/ecb.anag.200515.0024.en.html

¹² 3rd wave of the Household Finance and Consumption Survey (HFCS)—upon request, the micro data of the survey is available to external researchers:
<https://www.ecb.europa.eu/pub/pdf/scpsps/ecb.sps36~0245ed80c7.en.pdf?bd73411fbeb0a33928ce4c5ef2c5e872>.

¹³ <https://www.ecb.europa.eu/pub/pdf/scpsps/ecb.sps37~433920127f.en.pdf>



EURO AREA POLICIES

February 2, 2022

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES—SUPPLEMENTARY INFORMATION

Prepared By

The European Department
(in consultation with other departments)

This supplement provides information that became available after the issuance of the staff report. The thrust of the staff appraisal remains unchanged.

1. The rapid spread of the Omicron variant has led to updated near-term projections, but the medium-term outlook remains broadly unchanged (Table 1).

The recent surge in Covid-19 cases across Europe led to renewed mobility restrictions in many countries, slowing the recovery of services. In addition, elevated energy prices and supply chain disruptions continued to weigh on manufacturing. To reflect these developments, projections were revised in the [January 2022 Update](#) of the *World Economic Outlook* along the following lines:

- Euro area GDP growth in 2022 has been revised down to 3.9 percent (-0.3 p.p. relative to the staff report projections), reflecting carryover from slower growth in 2021Q4 and 2022Q1. With a gradual dissipation of headwinds to growth, economic activity is projected to bounce back in 2022Q2 and subsequent quarters, resulting in an upward revision to growth in 2023 to 2.5 percent (+0.3 p.p.). Growth over the medium term remains broadly unchanged, and so is the projected path of the output gap, which is still expected to close in 2024.
- Average headline inflation for 2022 has been revised up further to 3.0 percent (+0.4 p.p. relative to the staff report projections), as elevated energy prices and supply-side constraints are expected to persist for longer. Inflation is nevertheless expected to be on a downward trajectory through 2022 as these factors diminish, with end-of-period inflation close to target. Inflation over the medium term has also been revised up, but staff still expect headline and core inflation to remain below the ECB's new symmetric 2 percent target over the projection horizon.

2. Recent developments and data further illustrate a mix of strong demand, the impact of Omicron, and near-term inflation pressures. Preliminary data point to a significant slowdown in real GDP growth to 0.3 percent (q/q) in 2021Q4, below staff's

projection of 0.6 percent. However, with an upward revision to growth in 2021Q3 (+0.1 p.p.), the estimated 2021 growth outturn of 5.2 percent is in line with the *January 2022 WEO Update*, and 2021Q4 GDP is now higher than pre-crisis. Headline inflation reached a record high of 5.0 percent (y/y) in December 2021, driven primarily by elevated energy prices and persistent supply-side disruptions, as well as a strong rebound in demand. However, month-on-month inflation dynamics have softened, with core inflation increasing only slightly, to 2.7 percent (+0.1 p.p.). The unemployment rate declined to a record low of 7 percent in December, although total hours worked remained about 2 percent below pre-crisis levels in 2021Q3. Recent wage developments confirm the baseline view of limited second-round effects.

3. Rising tensions between Russia and Ukraine are an important new risk to the near-term outlook. While a number of countries have important trade and financial linkages with Russia, for the euro area as a whole the main exposure comes through natural gas imports, of which about $\frac{1}{3}$ comes from Russia. Natural gas is also the second most important energy source in the euro area, accounting for 20 percent of the energy mix. As a result, escalating Ukraine-Russia tensions pose a new downside risk to growth and an upside risk to inflation, through elevated food and energy prices and other channels. Much will depend on how events unfold in the coming weeks, and on any policy response from other nations and Russia. The additional uncertainty further complicates the task confronting policymakers. The impact of the 2014 hostilities in Crimea and associated measures taken in response was fairly muted, although gas and energy markets are much tighter now than they were in 2014.

4. The updated EBA leaves staff's assessment of the external position unchanged. The current account surplus declined to 2.2 percent of GDP in 2021Q3 from 2.9 percent of GDP in the first half of 2021. This reflected the rising costs of imports, particularly energy. Subsequently, the surplus increased in October and November 2021. For the 2021 as a whole, the euro area current account surplus projection has been revised up by 0.4 percentage points of GDP to 2.9 percent. This marginally widens the staff current account gap estimate from 1.4 to 1.5 percent of GDP. Accordingly, staff continues to assess the external position in 2021 as moderately stronger than the level implied by medium-term fundamentals and desirable policies (Table 2).

Table 1. Euro Area: Main Economic Indicators

	2017	2018	2019	2020	Projections 1/					
					2021	2022	2023	2024	2025	2026
Demand and Supply										
Real GDP	2.6	1.8	1.6	-6.4	5.2	3.9	2.5	1.7	1.6	1.4
Private consumption	1.8	1.5	1.3	-7.9	3.5	5.2	3.1	1.7	1.7	1.6
Public consumption	1.1	1.1	1.8	1.3	3.7	0.1	0.9	1.1	1.1	1.0
Gross fixed investment	3.9	3.1	6.7	-7.0	4.6	4.1	3.2	2.4	1.9	1.8
Final domestic demand	2.1	1.7	2.6	-5.8	3.8	3.8	2.6	1.7	1.6	1.5
Stockbuilding 2/	0.2	0.1	-0.1	-0.5	0.3	-0.1	0.0	0.0	0.0	0.0
Domestic demand	2.3	1.8	2.5	-6.2	4.0	3.7	2.6	1.7	1.6	1.5
Foreign balance 2/	0.4	0.1	-0.8	-0.3	1.3	0.4	0.0	0.1	0.0	0.0
Exports 3/	5.6	3.6	2.7	-9.1	9.9	6.2	4.6	3.8	3.4	3.2
Imports 3/	5.2	3.8	4.7	-9.1	7.7	5.9	5.0	4.0	3.7	3.5
Resource Utilization										
Potential GDP	1.5	1.4	1.4	-2.0	3.3	2.0	1.9	1.6	1.5	1.4
Output gap	-0.6	-0.1	0.1	-4.3	-2.6	-0.7	-0.1	0.0	0.1	0.1
Employment	1.6	1.6	1.3	-1.5	0.8	1.2	0.6	0.3	0.2	0.1
Unemployment rate 4/	9.1	8.2	7.6	7.9	7.8	7.5	7.3	7.2	7.1	7.0
Prices										
GDP deflator	1.1	1.5	1.7	1.6	1.7	2.3	1.8	1.8	1.8	1.8
Consumer prices	1.5	1.8	1.2	0.3	2.6	3.0	1.7	1.8	1.8	1.8
Public Finance (percent of GDP)										
Overall fiscal balance	-0.9	-0.4	-0.6	-7.2	-6.3	-3.8	-2.4	-1.9	-1.6	-1.5
Primary balance	0.8	1.2	0.8	-5.9	-5.1	-2.7	-1.4	-0.9	-0.7	-0.6
Structural balance	-0.5	-0.3	-0.5	-4.6	-4.7	-3.3	-2.3	-1.9	-1.7	-1.6
Structural primary balance	1.3	1.3	0.9	-3.3	-3.5	-2.2	-1.3	-1.0	-0.7	-0.7
Gross public debt	87.5	85.5	83.6	97.3	97.4	95.1	93.5	92.4	91.1	89.9
External Sector 5/ 6/										
Current account balance	3.2	2.9	2.3	1.9	2.9	2.8	3.0	2.9	2.8	2.8
Interest Rates (end of period) 4/										
EURIBOR 3-month offered rate	-0.3	-0.3	-0.4	-0.5	-0.6	...	...	...	...	...
10-year government benchmark bond yield	0.9	1.2	0.4	-0.1	0.3	...	...	...	...	...
Exchange Rates (end of period)										
U.S. dollar per euro	1.18	1.14	1.11	1.22	1.13	...	...	...	...	...
Nominal effective rate (2005=100)	106.1	107.8	105.7	114.6	111.0	...	...	...	...	...
Real effective rate (2005=100, ULC based)	87.3	85.5	84.0	87.3	82.0	...	...	...	...	...

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

1/ Projections are based on aggregation of January 2022 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.

Table 2. Euro Area: External Sector Assessment

<p>Overall Assessment: <i>The external position in 2021 is assessed as moderately stronger than the level implied by medium-term fundamentals and desirable policies. However, this assessment is preliminary and subject to a wide range of uncertainty arising from the preliminary nature of data and Covid-19 adjustors for 2021. The final assessment will be provided in the 2022 External Sector Report.</i> Data for the first three quarters of 2021 show an increase in the seasonally adjusted current account (CA) surplus to 2.7 percent of GDP, on the back of stronger external demand, especially for services. The CA surplus is estimated to have reached 2.9 percent of GDP for 2021 as a whole. In the medium term, the euro area's CA surplus is projected to remain broadly at the 2021 level, although the range of uncertainty around this projection is exceptionally high given the nature of this crisis. Imbalances that existed prior to the Covid-19 outbreak could remain sizable at the national level.</p> <p>Potential Policy Responses: Short-term policies should continue focusing on containing the Covid-19 outbreak and reducing scarring from the crisis. The recent initiatives both at the national and EU-levels, including NGEU, have supported these efforts and could potentially help reduce the CA surplus by supporting investment and consumption, thereby increasing imports. Going forward, monetary policy should remain accommodative until inflation has durably converged to the ECB's medium-term price stability objective while fiscal support should remain in place until the expansion phase is firmly in train, before gradually consolidating towards medium-term objectives. If imbalances in policy gaps that existed prior to Covid-19 were to persist at the national level, then countries with excess CA surpluses should continue to strengthen investment and potential growth, whereas those with weak external positions should undertake reforms to raise productivity, reduce structural and youth unemployment, and enhance competitiveness as the acute phase of the pandemic recedes. Euro area-wide initiatives to make the currency union more resilient (e.g., banking and capital markets union and fiscal capacity for macroeconomic stabilization) could further reinvigorate investment and, hence, reduce the aggregate CA surplus.</p>					
<p>Foreign Asset and Liability Position and Trajectory</p>		<p>Background. The NIIP of the euro area had fallen to about -23 percent of GDP by the end of 2009 but has since risen substantially to about -3.3 percent of GDP by mid-2021. The rise was driven by stronger CA balances and modest nominal GDP growth. Relative to 2020, the NIIP increased by 1.3 p.p. of GDP, reflecting primarily the net increase in outbound FDI and debt portfolio securities, partially offset by a milder increase in inbound portfolio equity and other investment. Gross foreign positions were about 271.2 percent of GDP for assets and 274.4 percent of GDP for liabilities as of mid-2021. Net external assets reached elevated levels in large net external creditors (e.g., Germany and the Netherlands), whereas net external liabilities remained high in some countries, including Portugal and Spain.</p> <p>Assessment. Projections of continued CA surpluses over the medium term suggest that the NIIP-to-GDP ratio will rise further, at a moderate pace. The region's overall NIIP financing vulnerabilities appear low. Despite rising CA balances over the medium term, large net external debtor countries still bear a greater risk of a sudden stop of gross inflows.</p>			
2021H1 (% GDP)	NIIP: -3.3	Gross Assets: 271.2	Debt Assets: 104.3	Gross Liab.: 274.4	Debt Liab.: 104.0
<p>Current Account</p>		<p>Background. The CA balance for the euro area is projected to increase to 2.9 percent of GDP in 2021 from 1.9 percent of GDP in 2020. The services balance has recovered especially strongly, alongside the primary income balance, while the goods balance remained somewhat constrained by supply chain disruptions. Both private and public sector saving are estimated to have increased compared to 2020, outpacing the increase in investment. Some large creditor countries, such as Germany and the Netherlands, continued to have sizable surpluses, reflecting high corporate and household saving and weak investment. At the end of the projection horizon, the CA balance will be above the pre-pandemic level, mainly driven by higher private sector savings in Italy and some smaller countries, including Ireland.</p> <p>Assessment. The EBA model estimates a CA norm of 1.0 percent of GDP, against a cyclically adjusted CA of 2.5 percent of GDP. This implies a gap of 1.5 percent of GDP. IMF staff analysis indicates a somewhat higher CA norm than estimated by the EBA model, consistent with the assessed external positions of euro area member countries. The higher CA norm considers policy commitments to reduce the large net external liability positions in some countries (e.g., Spain) and uncertainty about the demographic outlook and the impact of recent large-scale immigration (e.g., Germany). In addition, adjustments to the underlying CA were made in Ireland and the Netherlands given measurement issues. Adjustments for the transitory impact of the Covid-19 crisis on the shift in household consumption composition, medical goods, and tourism are estimated at 0.3 percent of GDP. Considering these factors and uncertainties in the estimates, including the cyclical adjustment, the IMF staff assesses the CA gap to be 1.5 percent of GDP for 2021, with a range of 0.7 to 2.3 percent of GDP. This assessment is preliminary and may change as more data for 2021 becomes available. The final assessment will be published in the 2022 ESR.</p>			

Table 2. Euro Area: External Sector Assessment (concluded)

2021 (% GDP)	CA: 2.9	Cyc. Adj.CA: 2.5	EBA Norm: 1.0	EBA Gap: 1.5	Covid-19 Adj.: 0.3	Other Adj.: -0.4	Staff Ca Gap: 1.5
Real Exchange Rate	<p>Background. The CPI-based REER appreciated by 0.5 percent in 2021 compared to 2020. This reflected a nominal appreciation of 1.7 percent, which was partially offset by weaker euro area inflation relative to its trading partners. The ULC-based REER depreciated by 2.1 percent.</p> <p>Assessment. The staff CA gap implies a projected REER gap of -4.1 percent in 2021, applying an estimated elasticity of 0.35.¹ The EBA REER index model suggests an overvaluation of 6.2 percent, and the EBA REER-level model implies an undervaluation of 0.2 percent. Consistent with the staff CA gap, staff assesses the REER gap to be in the range of -6.4 to -1.9 percent. As with the CA, the aggregate REER gap masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 12.2 percent in Ireland to an overvaluation of 5.1 percent in Belgium. The substantial differences in REER gaps within the euro area highlight the continued need for net external debtor countries to improve their external competitiveness and for net external creditor countries to boost domestic demand.</p>						
Capital and Financial Accounts: Flows and Policy Measures	<p>Background. Mirroring the CA surplus in 2020, the euro area experienced net capital outflows, largely driven by portfolio investment, which more than offset the net inflow of direct and other investment into the euro area. Net capital outflows from the euro area in 2021 were largely driven by outbound FDI and portfolio debt investment.</p> <p>Assessment. Gross external indebtedness of euro area residents increased by 0.4 percentage point of GDP in the first half of 2021 as higher external debt of deposit-taking institutions has offset a reduction in Eurosystem and nonfinancial sector liabilities.</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>						
<p>¹ The export and import elasticities are taken as the average of estimates from Consultative Group on Exchange Rate Issues (CGER)-inspired export and import equations using various types of REERs relevant for the euro area (with an ADL (2,2,2) model on quarterly data 2000–19). The trade balance elasticity is calculated using the share of exports and imports for <i>extra-EA trade</i> in GDP.</p>							

**Statement by Mika Pösö, Executive Director for the Nordic-Baltic Constituency
on behalf of the Euro Area Authorities
February 4, 2022**

In my capacity as President of EURIMF and Euro Area representative at the Board, I submit this Buff statement on the Euro Area consultation on Common Euro Area Policies. 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 to staff and the mission team led by Mr. Gerson and Mr. Balakrishnan for the open and fruitful consultations and their constructive policy advice. The authorities are in broad agreement with the findings and recommendations in the Euro Area Policies Staff Report, including on new and existing risks and the high level of uncertainty surrounding the current outlook and the need for policy to sustain the recovery. We particularly welcome the acknowledgement of the importance of action at EU and Member States level in responding to the pandemic and underpinning a strong economic rebound, while noting the call for continued agility of policy measures, with a focus on containing economic scarring, in particular through facilitating the reallocation of resources, while protecting vulnerable groups.

The authorities concur on the importance of increasing global vaccine production and ensuring equitable access to vaccines. In the short run, we agree on the need to ensure the acceleration of the delivery of vaccines, diagnostics and therapeutics for countries that are lagging behind in vaccine rollout, and re-affirm the strong commitment at EU level in this respect. The EU has been, and still is, the world's leading exporter and donator of vaccines from the beginning. Since December 2020, the EU has exported over 1.4 billion vaccine doses to more than 150 countries. As of January 25, the EU Member States have shared over 405 million vaccine doses to partner countries, of which 277 million have been already delivered to recipients. *More specifically, we have the following comments on the Staff Report:*

Economic outlook and risks

The authorities share staff's overall assessment of the euro area's economic outlook and the forecast for a sustained expansion, predicated on continued adaptation to COVID-19. Since restrictions have been eased compared to the start of 2021, the euro area economy has been rebounding from the COVID-19 pandemic recession faster than previously expected and the gap with the pre-pandemic output level has now virtually closed in the euro area. Following the disruptions to economic activity in 2020 and early 2021, the rebound in spring 2021 was supported by unprecedented policy support as well as effective vaccination campaigns. Households responded to the improving epidemiological situation and the gradual relaxation of containment measures with a strong recovery in consumption that propelled growth. The savings rate should gradually return to its pre-crisis level; however, the large additional savings accumulated during the crisis are not expected to be spent in the short term, as survey data point

to only small declines in consumers' intentions to save. In 2022, growth should be supported by an improving labour market, a further reduction in the savings rate, favourable financing conditions and the continued deployment of the Recovery and Resilience Facility (RRF). Although growth is projected to remain uneven across countries and sectors, pre-pandemic output levels have been achieved or are within reach in all Member States in 2022. According to the European Commission autumn forecast, which was finalised before the spread of the omicron variant, real GDP in the euro area is estimated to have rebounded sharply in 2021 by 5 percent and is set to continue expanding by 4.3 percent in 2022 and by 2.4 percent in 2023. By next year, real GDP is therefore expected to converge to the growth path that the economy was set to follow before the pandemic. According to the Commission autumn forecast, output gap is expected to close in 2022 and become positive in 2023.

The uncertainty surrounding the economic outlook remains high, in particular linked to the recent deterioration in the epidemiological situation, and the balance of risks remains tilted to the downside. Although the impact of the pandemic on economic activity has weakened, the recent surge in COVID-19 infections coupled with the re-imposition of some restrictions suggests that some downside risks to the economic outlook are materialising. Moreover, the euro area economy has been facing new headwinds. The supply side of the economy has struggled to accommodate the abrupt swings in the level and composition of demand. Labour and skills shortages have become a growing concern in some sectors and Member States. Surging energy prices are also weighing on the growth momentum in the short term. Although industrial production and retail trade came in strong in the beginning of the fourth quarter, survey-based indicators published after the publication of the Commission's autumn forecast have softened. However, upside risks to the economic outlook are also present. The main one is related to potential efficiency gains and durable boost to productivity. Reforms and investments supported by the RRF will be key in this respect. The authorities take note of the further risks identified by the Fund's staff. In that context, the authorities consider that the current level of potential output as well as its future developments are uncertain and they remain cautious about the timing of a closure in the output gap.

External sector policies

The authorities take note of staff's assessment of the euro area's external position, acknowledging the uncertainties and challenges in the external assessment amid the pandemic crisis. The pandemic has had an uneven impact on countries' external positions depending on their economic structure and institutional features. We take note of the staff's acknowledgment of euro area's external position in 2020 being broadly in line with fundamentals, according to its assessment methodology. The Staff Report further notes that the euro area current account surplus is projected to widen further in 2021, to a level considered as 'moderately stronger' than implied by medium-term fundamentals and desirable policies. In carrying out such an assessment, we agree with staff that given the current economic uncertainty, it is difficult to provide firm views and that a more comprehensive assessment of the euro area's external balances during 2021 can only be provided at a later stage.

Monetary policy and inflation outlook

We share the Fund’s overall assessment of recent inflation dynamics. Inflation in 2021 increased more strongly than initially assumed. This was mainly due to a surge in energy prices and strong base effects, but also because demand continued to outpace constrained supply in some sectors linked to supply-side disruptions and the re-opening of the economy. Inflation is expected to remain elevated in the near term, but to decline in the course of 2022 as energy prices are expected to stabilise and price pressures stemming from global supply bottlenecks are expected to subside. Although there is uncertainty as to how long this will take, current forecasts point towards a reduction of inflation to below the ECB’s target in late 2022. Looking ahead to 2023 and 2024, inflation is projected to remain below the ECB’s target, around levels closer to 2 percent. However, these forecasts are subject to a high degree of uncertainty. The gradual return of the economy to full capacity and further improvements in the labor market should, over time, support stronger growth in wages. Market- and survey-based measures of longer-term inflation expectations have moved closer to 2 percent in recent months. These factors will help underlying inflation to move up and bring headline inflation to the ECB’s target over the medium term. We agree with the staff’s assessment that second-round wage effects of currently elevated inflation remain contained at present, but we are closely monitoring any signs of emergence of such effects.

The ECB’s accommodative monetary policy stance and the sustained favourable financing conditions continue to provide crucial support to the economy and the inflation outlook.

The new strategy is contributing to the return of inflation to the 2 percent medium-term price stability objective. In 2021, the ECB maintained a very accommodative monetary policy stance, while it adjusted its pace of purchases to preserve favourable financing conditions. This was essential throughout 2021 for the economy to continue its recovery and to progressively offset the negative impact of the pandemic on the projected path of inflation. Following the conclusion of its strategy review in July, the Governing Council announced the adoption of a new, symmetric inflation target of 2 percent. In December, progress in the economic recovery and in the medium-term inflation outlook was judged to be sufficiently advanced to announce a step-by-step reduction in the pace of asset purchases over the course of 2022. At the same time, the Governing Council declared that in view of medium-term inflation remaining below the Governing Council’s target, sufficient monetary accommodation remained essential.

The ECB takes note of the challenges identified by IMF staff in integrating climate change considerations into the Eurosystem monetary policy operation framework, but notes that these largely stem from an imperfect understanding of the announced actions and their objectives. As outlined in the climate change action plan, the adjustment of the framework guiding the allocation of corporate bond purchases will include taking into account the alignment of issuers with, as a minimum, EU legislation implementing the Paris agreement through climate change-related metrics or commitments of the issuers to such goals: this does not imply restricting purchases to “green” corporate assets. Possible adjustments to the collateral framework would aim to enhance—rather than undermine—the ECB’s own balance sheet risk

management by ensuring that all relevant risks, including those arising from climate change, are well reflected. Finally, green TLTROs are not part of the current climate change action plan. The ECB reiterates that the action plan is in line with its obligations and independence, and that the design of the measures will be proportionate and will not in any way prejudice the price stability objective. When implementing any measure, the ECB will carefully consider all the technical and legal aspects. The ECB encourages the IMF to deepen its analysis of these issues going forward and stands ready to provide additional information on the ongoing activities.

Fiscal policy

The authorities broadly share the staff's views on fiscal policy in the euro area. The general government deficit in the euro area is expected to narrow marginally in 2021 to 7.1 percent of GDP and then set to decline considerably in 2022 to 3.9 percent of GDP, while the euro area fiscal stance, according to the Commission assessment, is projected to remain supportive in 2021 and 2022. We will continue to use and coordinate national fiscal policies to effectively underpin a sustainable and inclusive recovery and maintain a moderately supportive euro area fiscal stance in 2022, taking into account national budgets and the funding provided by the RRF. Member States with low or medium debt ratios should pursue a supportive fiscal stance in 2022, while Member States with high debt should use the RRF to finance additional investment in support of the recovery and the twin transitions, while pursuing a prudent fiscal policy. In December 2021, those high-debt Member States where the planned growth of nationally financed current expenditure was not considered sufficiently prudent, according to the Commission assessment, have been invited to take the necessary measures within their national budgetary processes to limit the growth of nationally financed current expenditure. Reflecting the degree of uncertainty, the authorities also highlight the need to keep fiscal policy agile, in order to be able to react to the evolution of the pandemic.

With the economic recovery taking hold, the focus should be on gradually pivoting fiscal measures from temporary emergency measures to targeted recovery support measures, including investments that promote a sustainable and inclusive recovery, consistent with the green and digital transitions. Due to the pandemic shock to economic activity and the ensuing fiscal response, general government debt in the euro area is estimated to have peaked at 100 percent of GDP in 2021. Recently granted state guarantees add risk to public finances from the potential materialisation of contingent liabilities in the future. Fiscal policies should be differentiated, taking into account the strength of the recovery, and should ensure fiscal sustainability and enhance investments, while bearing in mind the need to reduce divergences. A gradual, continuous and growth-friendly debt reduction will be a policy objective across a large part of the euro area. We also take note of the staff's call for medium-term consolidation plans to be submitted already now, and against this background, we highlight that the upcoming Stability Programmes will be submitted in spring 2022. In spring 2022, the European Commission will also reassess the situation and take stock of the application of the general escape clause. Based on the latest forecast, the conditions for the deactivation of the general escape clause as of 2023

are met, while country-specific situations will continue to be taken into account after the deactivation of the clause.

The authorities take note of the Fund’s call for reforming the fiscal framework, fostering sustainability while allowing adequate room for macroeconomic stabilisation and preventing counterproductive spending cuts. The authorities acknowledge staff’s views on the main features of such reformed fiscal rules, including the need for appropriate ownership and political will. While recalling that a debate is ongoing on the challenges and objectives for the review, the authorities take note of the Fund’s initial analysis and suggestions, and look forward to staff’s announced further input for the review in early 2022.

Structural policies

The authorities share the Fund’s message on the importance of the NGEU recovery package to help the recovery, facilitate reallocation, build back better, and tackle inequality. The effective and rapid implementation of the reforms and investments included in the recovery and resilience plans are key to contribute effectively to the achievement of the euro area policy priorities. The authorities concur that these policy actions will all contribute to ensuring a sustainable and inclusive recovery, sustain growth potential and enhance resilience, and they agree on the need to mitigate the risk of increasing economic divergence. The authorities recall that one of the Facility’s main innovative features is its performance-based nature, as the funds will be disbursed as Member States implement the coherent investments and reforms set out as milestones and targets in the Council Implementing Decisions. The authorities take note of the staff’s call for NGEU Funds to adhere to the highest standards of transparency and accountability.

The authorities underline how the swift and forceful policy response has been effective in mitigating the impact of the crisis on the labour market, as also recognised by the staff’s assessment. Policy support, including through short-time work schemes and other job retention measures, has supported businesses activity throughout the crisis and has limited the rise in the unemployment rate and the drop in disposable income.

We concur on the need to shift policy attention towards pandemic-induced and structural labour transition and reallocation, while protecting the most vulnerable. While noting that the use of short-time work schemes has declined in line with the improvement in economic conditions, the authorities take note of the recommendation to continue phasing out these schemes, and of the Fund’s analysis on labour market reallocation. The authorities find that there is a need to transition from emergency to recovery measures in labour markets by ensuring effective labour market policies supporting job transitions, combining measures tackling skill shortages, strengthening upskilling and re-skilling, providing targeted hiring incentives and enhancing the capacity of public employment services to address labour market mismatches. The authorities take note that policy measures that facilitate job transitions and labour market re-integration will be needed to support adjustment and mitigate social impacts especially for the

young, women, and low-skilled workers. In view of the challenges emerging from the COVID-19 crisis, and those related to the green and digital transition, it is important to develop and adapt social protection systems, while strengthening access. In this respect, the Commission has put forward a recommendation on an Effective Active Support to Employment following the COVID-19 crisis (EASE). Divergences have widened less than initially expected, but the COVID-19 crisis has nevertheless had substantial territorial, sectorial, and distributional implications, and we concur on the risks of increasing inequality and widening divergences between and within countries.

Climate Policies

EU policies have a critical role in accelerating the green transition. The authorities welcome the IMF's positive views on the Fit for 55 agenda. The Commission's proposals aim to make climate, energy, land use, buildings, transport and taxation policies fit for reducing net greenhouse gas emissions by at least 55 percent by 2030 compared to 1990 levels, an objective enshrined in the European Climate Law. So far, through the RRF,¹ the combined climate investments amount to around 40 percent of the total RRF funds allocated, above the 37 percent target set in the Regulation. The authorities acknowledge the Fund staff's concerns on Carbon Border Adjustment Mechanism compatibility with WTO rules and other international commitments, while highlighting the non-discriminatory nature of the instrument and the compatibility with WTO rules and other international obligations. We take note and appreciate the analysis by the Fund on RRFs impact on GHG emissions, and the policy recommendations at EU level. Finally, the authorities recognise that coordinated national climate policies are key, while highlighting that mitigation policies must take into account the different capacities of Member States to take action at the required pace.

Financial sector policies

Measures taken to provide support to firms have been critical and the rise in bankruptcies has remained limited so far. Many support measures lapsed or were terminated in 2021. However, the authorities recognise that the pandemic has left many firms with weaker balance sheets, which might constrain their ability to finance investment in the near term and compromise their repayment capacity. Timely withdrawal of policy support measures is a difficult balancing act. In this context, improving access to finance for companies, strengthening firms' balance sheets and enhancing the capacity and efficiency of insolvency frameworks is crucial. It will be important to continue monitoring the effectiveness of policy support packages,

¹ The expenditures reported for the RRF are based on the information on climate tracking published as part of the Commission's analyses of the national recovery and resilience plans (RRPs). The data reported cover the 22 RRFs endorsed so far, and will evolve as more plans are assessed.

while also focusing on a more targeted support for the solvency of viable firms that have come under stress, and making greater use of equity-type instruments.

Euro area banks have successfully coped with the challenges of the COVID-induced crisis.

Strong solvency and liquidity positions, in a context of massive monetary and fiscal policy support to the wider economy, have allowed them to maintain adequate financing of the economy while preserving financial stability. We are well aware of the challenges for the banks going forward, reflecting both structural factors and the continued phasing out of monetary and fiscal support measures.

The phasing out of policy support measures to address the effects of the COVID crisis is ongoing.

It will continue in an orderly fashion, taking into account the evolution of the pandemic. Prudential standards for banks, which have been adapted in response to the crisis, have already been and will be further normalised gradually and predictably. In particular, proper loss recognition remains imperative in order to preserve stability of the banks and the financial system as a whole. We agree that banks should now focus future lending on viable borrowers and that Member States should ensure that their insolvency regimes facilitate the most effective workout of non-performing loans on banks' balance sheets.

The COVID-induced crisis highlighted the need to strengthen the resilience of the non-bank financial sector.

Vulnerabilities in this sector, including potential redemption pressures and ensuing liquidity risk, warrant close monitoring. We take note of the Fund's assessment that a strengthening of the prudential framework for money market funds, investment funds and other non-banks should be implemented in a way that reflects macroprudential perspectives.

The recent acceleration in real estate prices represents a potential risk to financial stability.

In parts of the euro area, these risks may be amplified by high levels of household debt. In many euro-area Member States, macro-prudential tools have been deployed to mitigate these risks but we concur with the Staff Report that, in some cases, borrower-based macro-prudential tools could be used more effectively. In those countries where materialising real estate risks would be likely to spill over to the real economy or where cyclical risks go beyond real estate risks, an activation of the countercyclical capital buffer should also be considered. In addition, supply-side policies, such as changes in taxation and fostering rental markets and housing supply, might be warranted to stabilise real-estate prices.

The EU is working to implement global regulatory standards that will make banks more shock-resilient for the challenges ahead.

In particular, the Commission has adopted a proposal to implement the final stage of the Basel III agreement, which is now under negotiation with the Council and European Parliament. The proposal meets international commitments, while reflecting the specific features of the EU banking system. Beyond the Basel III implementation, the proposal also aims to enhance the current EU prudential framework and increase the consistency of the EU single rulebook in different areas, such as ESG risk management, Fit and Proper assessment and supervisory powers. In addition, reflections on regulatory standards

continue in close cooperation with international partners on how to ensure resilience of the EU financial sector to climate-related risk, building notably on enhanced monitoring, stress testing, and disclosures. The EU encourages the IMF to deepen its analysis of climate-change-related financial risks and related financial policies in the future Article IV reports.

Work on the Banking Union and the Capital Markets Union remains of high priority. For the Banking Union, it is focused on agreeing, on a consensual basis, on a stepwise and time-bound work plan on all outstanding elements and with the same level of ambition. The agreement amending the Treaty on the European Stability Mechanism and the early introduction of the backstop to the Single Resolution Fund will enter into force as early as possible. We will continue to deepen and integrate European capital markets in the Capital Markets Union, also on the basis of the package of proposals by the European Commission of November 2021. This package includes the creation of a European Single Access Point for corporate data, and amendments of the European Long-Term Investment Funds Regulation, the Alternative Investment Fund Managers Directive and the Markets in Financial Instruments Regulation to make EU capital markets more integrated and efficient. Further steps in deepening the EMU should take into account the lessons learnt from the Union's comprehensive economic policy response to the COVID-19 crisis.

We share the view of staff that establishing a single rulebook on anti-money laundering and countering the financing of terrorism (AML/CFT) and enhancing supervision via the creation of an EU-level AML/CFT authority can reduce fragmentation and strengthen the integrity of the financial system. To this end, the Council and European Parliament are currently negotiating on the basis of a proposal from the European Commission.

Trade Policies and Global Issues

The authorities re-affirm the EU's strong support for a rules-based multilateral trading system and the engagement on global issues. The authorities welcome staff's acknowledgment of the EU's leadership role on WTO reform and efforts to address underlying sources of global trade tensions and investment distortions. We welcome the recognition of the importance of the EU-US trade agreement on steel and aluminium, while also acknowledging the global nature of the issue. The authorities express commitment to global solutions, but re-affirm the legitimacy and proper design of WTO-consistent unilateral actions.

Globalisation has made it necessary to adjust the taxation framework to fit an increasingly digitalised economy. In this context, the authorities highlight the importance of timely implementation of the OECD/G20 Inclusive Framework on base erosion and profit shifting agreement (BEPS) and recall that all euro area Member States, and indeed all EU members of the Inclusive Framework on BEPS joined the international agreement in October 2021. The European Commission has proposed a Directive to ensure a global minimum effective tax rate of 15 percent for large groups operating in the European Union.