July 2010
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Euro Area Policies: 2010 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; 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 2010 Article IV consultation with member countries forming the euro area, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 27, 2010, with the officials at EU institutions in the context of the Article IV consultations with member countries forming the euro area. Based on information available at the time of these discussions, the staff report was completed on July 1, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of July 14, 2010 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 19, 2010 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Germany, on behalf of the euro-area Member States and the European Community.

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

Selected Issues Paper

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

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EURO AREA POLICIES

Staff Report for the 2010 Article IV Consultation with Member Countries

Prepared by the European Department

Approved by Ajai Chopra and Tamim Bayoumi

July 1, 2010

EXECUTIVE SUMMARY

The current crisis is a wake-up call for the euro area. The crisis was largely caused by unsustainable policies in some member countries, and has put the spotlight on the deficiency of area-wide mechanisms in disciplining fiscal and structural policies. The sovereign crisis erupted before the euro area's recovery could gain ground, threatening the financial system and the regional and global recovery.

Despite a strong and far-reaching policy response, market confidence will take time to restore. Facing increasing turmoil, the ECB stepped into the breach with liquidity and credit support aimed at avoiding market instability. New European financing instruments are being created to assist euro area sovereigns, and several affected member countries took additional fiscal action. While these measures should bolster confidence, further market disruptions cannot be ruled out and will call for strong national policies and use of the newly created instruments as needed.

Now, the underlying problems should be urgently addressed in a well-coordinated manner involving all euro area countries:

- Fiscal sustainability needs to be established, with ambitious medium- and long-term adjustment plans supplemented by short-term consolidation at a pace tailored to country circumstances;
- Growth needs to be boosted through swift implementation of structural reforms, which will also have a key role to play in tackling intra-euro area imbalances;
- Weak parts of the banking system need to be identified and fundamentally restructured;
- Now is also the time to establish an effective economic and monetary union by strengthening the enforcement of sound fiscal and structural policies and completing the area-wide framework for financial stability.

The authorities broadly concurred with this analysis, but the implementation is, as yet, patchy. Progress is being made on fiscal consolidation, and weak banks are beginning to be tackled, but little is being done to address long-standing structural problems, including entitlement reforms, and true coordination of policymaking remains elusive.

Staff: The team comprised Messrs. Belka (Head through May 27), Debrun, Everaert, Harjes, Valckx, Schindler, and Ms. Perez Ruiz (all EUR), Mr. Nier (MCM), and Mr. van der Mensbrugghe (EUO). The Managing Director presented the concluding statement to the Eurogroup on June 7, 2009. **The cutoff date for information presented in this report is June 16, 2010.**

Analytical work: A separate selected issues paper discusses bank lending constraints, fiscal governance, governance of structural reforms, and financial sector reform.

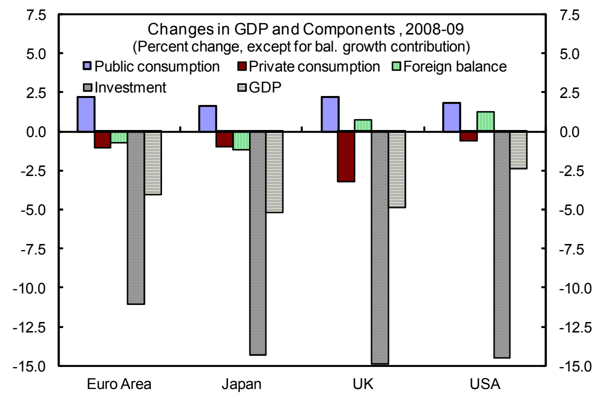
Contents

I. FROM GLOBAL TO EURO AREA CRISIS

A. Slow Recovery after the Global Crisis

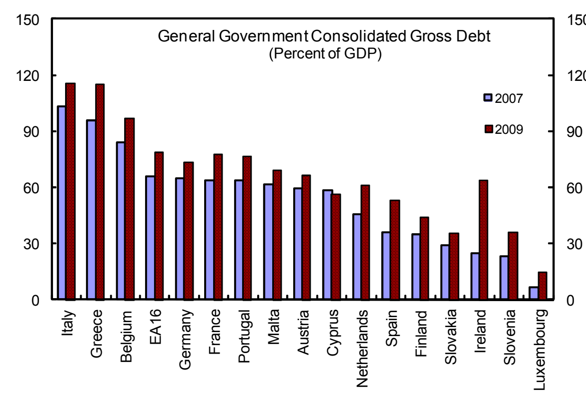
1. **Already prior to the sovereign crisis, the euro area was slow to recover.** With strong reliance on its banking system for funding, pronounced uncertainty about the strength of the financial system has been an important factor. In the staff's view, recent data suggest that financing constraints are binding on some segments of the economy, although the ECB sees demand as the key factor underlying weak credit growth (Box 1). Meanwhile, needed deleveraging of private sector balance sheets, improvements in competitiveness, and reallocation of resources to tradable sectors in some countries is taking time. Furthermore, despite employment-support measures in many countries, uncertainty about job prospects has been weighing on households.

2. **The euro area was hard hit by the global financial crisis.** Shocks to external demand and financial sector losses contributed to a sharp downturn in real activity in 2009. In the face of uncertain prospects, investment fell dramatically while consumption declined in response to rising unemployment and increased precautionary savings. Net exports fell, as in Japan, but unlike in some other advanced countries.



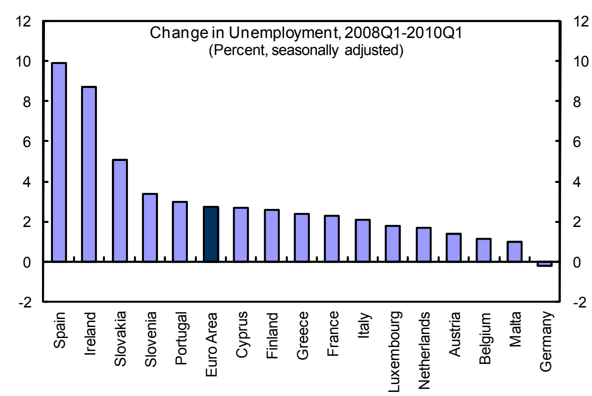
Sources: IMF, *World Economic Outlook;* and IMF staff calculations.

3. **Massive macroeconomic support stabilized demand.** In addition to substantial monetary easing by the ECB, many member countries allowed automatic stabilizers full play and implemented fiscal stimulus measures aimed at supporting private consumption, limiting increases in unemployment, and raising public investment. These policies mitigated the impact of the crisis, but together with bank support, came with a rise in average euro area government debt from about 66 percent of GDP in 2007 to nearly 80 percent in 2009.



Sources: Eurostat and IMF staff calculations.

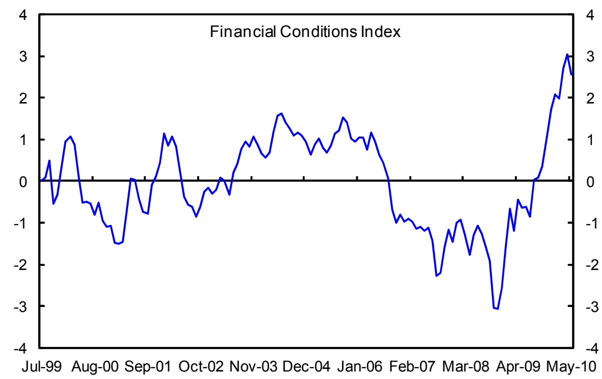
4. **Unemployment increased significantly during the global crisis, undoing previous substantial gains**. However, outcomes varied widely across countries, ranging from a dramatic increase in unemployment in some to even a modest decline in the case of Germany. These variations reflect differences in labor market



Sources: Haver Analytics; and IMF staff calculations.

policies and institutions, such as short-time work schemes that limited the rise in unemployment in several countries, but more recently also discouraged-worker effects. The counterpart of labor hoarding in the face of substantial output losses was a significant decline in productivity, suggesting that "jobless recoveries" are a likely outcome in many euro area members.

5. **After several months of improvement, financial conditions have recently deteriorated.** Financial conditions eased during most of 2009, reflecting predominantly the recovery in equity prices, lower real interest rates and a marked reduction in risk spreads. This trend recently reversed, with heightened spreads and a fall in equity values only partly compensated by the weakening of the euro. Moreover, financial conditions may be tighter than suggested by the index, reflecting non-price factors, including tighter bank credit conditions (Figure 1).

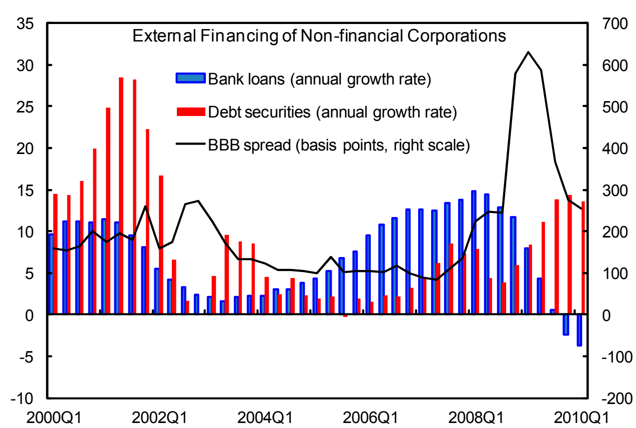


Sources: Datastream; Haver Analytics; and IMF staff calculations.

Box 1. Are Bank Loan Supply Constraints Weighing On the Euro Area Recovery?

Since the eruption of the global financial crisis, European banks have suffered heavy losses. In response, some euro-area banks have issued additional equity or other forms of capital and sharply reduced dividend payments, while profits recovered strongly, but others remain thinly capitalized especially in view of further expected write-downs.

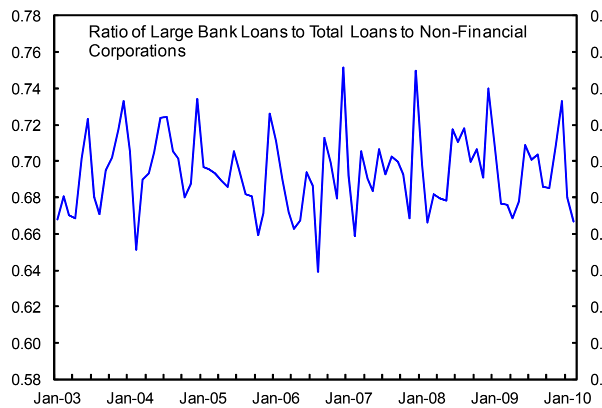
Whether possible capital constraints affected aggregate bank loan supply during the early stage of the recession is less clear. There have been pockets of credit rationing in some markets segments, but aggregate data show that the credit-to-GDP ratio continued to rise and GDP led credit through most of the euro-area recession. Therefore, it is difficult to argue that aggregate credit or bank lending constraints caused the recession.



Sources: ECB and IMF Staff Calculations.

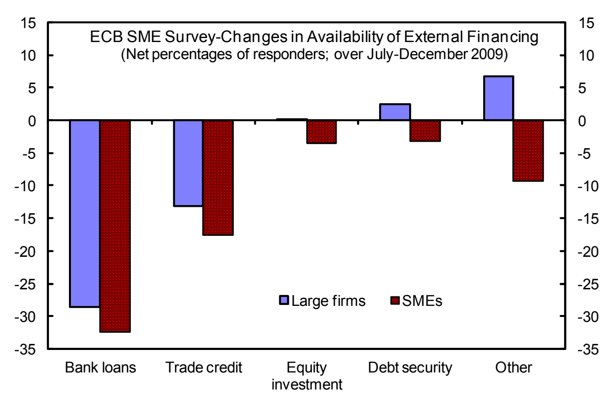
But concerns about bank lending constraints are intensifying. Over the past year, bank lending growth to nonfinancial corporations has fallen steeply and recently turned negative, while net issuance of corporate debt has soared. This shift in the composition of corporate debt from bank debt to bonds could imply binding bank lending constraints. While a shift at the aggregate level could also be caused by a shift in financing from riskier SMEs to large corporations during the downturn, credit costs and spreads for lower rated and risky bonds have declined sharply at the same time the substitution from bank debt to bonds occurred. Moreover, at individual firm level any substitution towards bonds signals constraints on bank loan supply, as the risk level is given.

Disaggregated bank lending data and survey results point to constrained bank loan supply in the euro area. A new ECB survey on the access to finance of SMEs showed that despite different risk characteristics both large corporations and SMEs had experienced a significant deterioration in the availability of bank loans. The net percentage (28 percent) of large firms reporting a deterioration was close to that for SMEs. Moreover, the stable ratio of large loans to total corporate bank loans suggest that bank loans to large corporations must have fallen as well as total loans declined and the debt mix of large corporations with similar risk profiles must have shifted significantly in favor of capital market debt.



Sources: ECB (MFI new business volume data) and IMF Staff Calculations. Calculated as unweighted average of ratios by maturity (less than 1 year, 1-5 years, more than 5 years).

Constrained bank loan supply could weigh heavily on the recovery of the euro-area economy. Bank lending remains the predominant external financing source of most corporations, in particular for SMEs. The effect on growth could be significant as SMEs account for 60 percent of value added and 70 percent of employment in the euro area and even higher in Greece, Italy, Portugal and Spain. A bank lending crunch in these countries would certainly aggravate a return to better-balanced growth within the euro area as these countries are expected to lag behind in the recovery.



Sources: European Commission/ECB Survey on the access to finance of SMEs.

B. Market Disruptions Generated a Strong Crisis Management Package

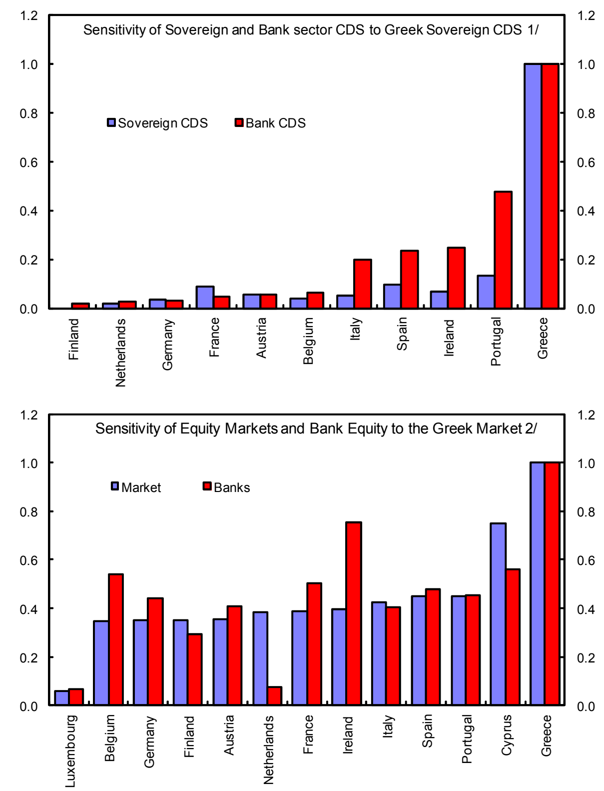
6. **Before the recovery from the global crisis became entrenched, delays in addressing fiscal sustainability concerns in Greece unsettled markets.** The sudden revelation of large fiscal imbalances in Greece prompted a crisis and strongly affected the Greek banking system, curbing its access to international and domestic funding sources. CDS spreads and other market indicators deteriorated significantly, and Greek banks raised their recourse to ECB liquidity facilities from 8 percent of total assets in January to 16 percent in April 2010 (euro 82 billion).

Bank Exposures to Selected Countries December 2009
(Billions of U.S. dollars)

	Greece	Ireland	Italy	Portugal	Spain	Total
France	79	52	508	45	211	**895**
Germany	46	184	190	47	238	**704**
UK	15	173	77	26	110	**400**
Netherlands	12	28	69	14	120	**243**
Spain	1	15	47	85	-	**148**
Ireland	9	-	46	5	32	**91**
Italy	7	17	-	7	31	**62**
Portugal	10	9	5	-	29	**53**
Switzerland	4	17	20	4	21	**66**
US	17	57	53	5	58	**190**
Other	11	55	61	7	40	**175**
Total	**199**	**552**	**1,014**	**238**	**850**	**3,027**

Source: Bank of International Settlements.
Note: Bank exposures refer to consolidated foreign claims.

7. **The Greek debt crisis spread quickly to other euro area sovereigns and banks through various channels, with ripple effects beyond the euro area.** First, bond yields rose for other euro area sovereigns with large fiscal imbalances, while the subsequent flight to quality lowered yields on German Bunds, implying a rising divergence in financial conditions across the euro area. Second, while aggregate exposures were broadly known (see table) uncertainty about individual banks' exposures to sovereigns and a strong co-dependence of banks and their sovereign resulted in heightened funding and counterparty risks, in turn pushing up bank bond spreads in several other euro area countries. Similarly, investors from outside Europe curbed lending and exposure, contributing to an increase in liquidity premiums for overnight dollar funds and a weakening of the euro. Third, concerns about sovereigns' ability to further support the financial sector aggravated the financial stability outlook. Finally, the crisis jolted risk appetite globally.



Sources: Datastream; and IMF staff calculations.
1/ Sensitivity of changes in bank and sovereign CDS spreads to movements in Greek sovereign CDS spreads, corrected for movements in the SovxWE index.
2/ Sensitivity of broad market and bank index returns to Greek market returns, corrected for movements in broad euro area market returns. Estimation period November 2009-June 2010.

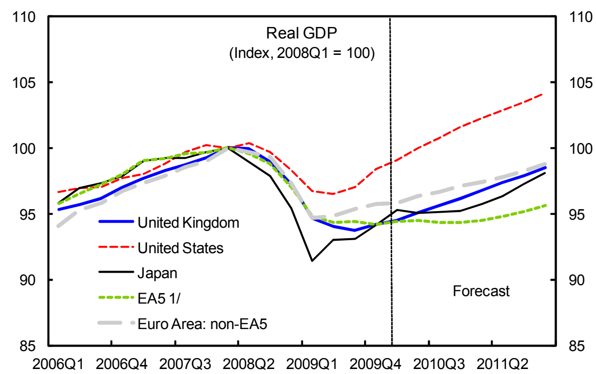
8. **Vulnerabilities to sovereign risk proved to be significant, but differed markedly across countries.** The sensitivity of euro area countries' sovereign and banking sector CDS spreads to developments in Greece was moderate on average but significant in a number of cases, while the equity market response was more broad-based. Portugal experienced the fastest increase in debt spreads since April 2010 and by early June its 5-year CDS spreads

exceeded those of Ireland, while the increase for Spain was smaller and that for Italy somewhat less again. However, nearly all countries but Germany saw some rise, and the recent inversion in the sovereign CDS curve for Spanish, Greek and Portuguese debt signals heightened investors concern. Average banking sector CDS spreads were pushed higher in Greece, Spain, and Portugal than in the aftermath of the Lehman crisis (October 2008-March 2009). Continuous measures of contagion risk among banks, such as the ECB's systemic risk indicator and the IMF's joint probability of distress, revealed a peak in May 2010, exceeding the previous peaks of September 2008.

9. **Despite the agreement on the Greek rescue package, market tensions escalated, requiring stronger measures.** Tensions rose sharply on May 7, threatening a financial meltdown. The ECB rightly stepped into the breach with a Securities Markets Program (SMP), allowing it to purchase private and public securities in secondary markets, while governments agreed to establish a European Stabilization Mechanism (ESM) to preserve financial stability. Enhanced liquidity support and currency swap lines with other central banks were also reinstated. Staff and authorities agreed that these programs were necessary to avoid a contagion-driven systemic debt crisis, but that they could not substitute for fundamental adjustment. Indeed, the ECB remains determined to keep inflation expectations well anchored and emphasized the temporary nature of its SMP which is geared at curbing volatility while not fighting fundamental trends. Consistent with this approach, the ECB has not announced volume or price targets under its SMP. It will thus be crucial for national authorities to implement corrective measures, as they committed to when the crisis measures were adopted.[1]

II. Heightened Risks Threatening Moderate Recovery

10. **It was agreed that even if sovereign and financial risks are contained the recovery is likely to be moderate and uneven.** In the baseline scenario, the crisis management measures are expected to keep the sovereign crisis in check, while fundamental measures are being put in place, which would gradually restore market confidence. Yet weakened confidence and the drag from fiscal adjustment—accelerated in some parts of the euro area—will be only partly offset by the recent depreciation of the euro, which is now broadly in line with fundamentals. Inventory restocking and strong export performance continue to drive short-term dynamics, while private consumption and investment remain weak, given uncertainty and substantial idle capacity. Hence, it was agreed that GDP growth would average about 1 percent in 2010, and rise to about 1¼ percent in 2011. Consequently,

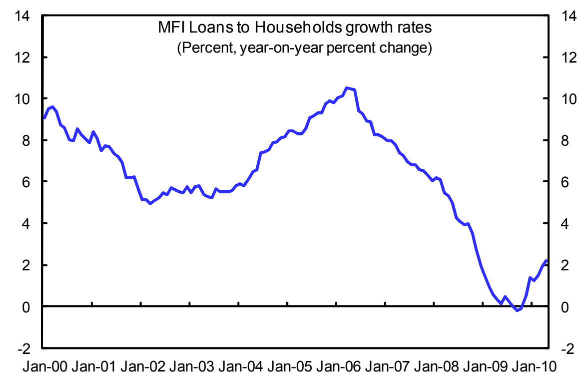


Sources: IMF, *World Economic Outlook*; and staff calculations.
1/ Greece, Ireland, Italy, Portugal and Spain

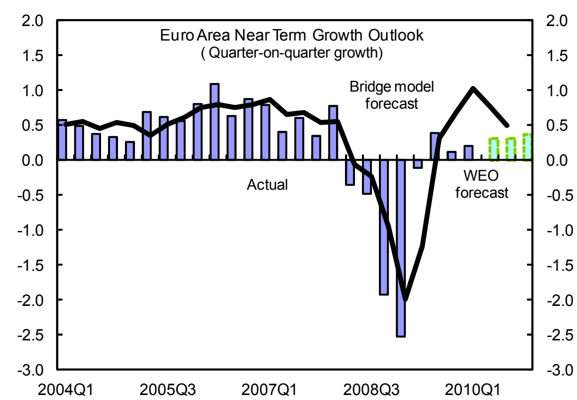
[1] ECOFIN Statement: www.consilium.europa.eu/uedocs/cms_data/docs/.../ecofin/114324.pdf.

the euro area is not contributing much to the regional and global recovery. In this environment inflation is expected to be subdued. Divergences across countries are likely to rise because of differences in financial conditions, the pace of fiscal adjustment, and labor market dynamics.

11. **Private consumption is projected to be last to recover, and fiscal consolidation will also dampen demand.** Lower household incomes due to higher unemployment or fewer hours worked and lower incomes from assets, together with continued wage moderation in many countries will weigh on consumption. Staff felt that fiscal consolidation would constitute a drag although the phasing and composition of the adjustment will be key. In countries where fiscal credibility is being questioned, frontloaded consolidation would inevitably dampen demand in the short run. Elsewhere, a more gradual approach, supported by entitlement reforms would contain the immediate drag on demand. Although difficult to quantify, confidence enhancing effects of establishing fiscal sustainability should partly offset the impact of fiscal adjustment, through a reduction in precautionary buffers from recent highs, a point stressed by the ECB. Consistent with this, household credit growth has picked up (Figure 2). On the whole it was agreed, however, that private consumption is not likely to contribute substantially to growth until late 2011.

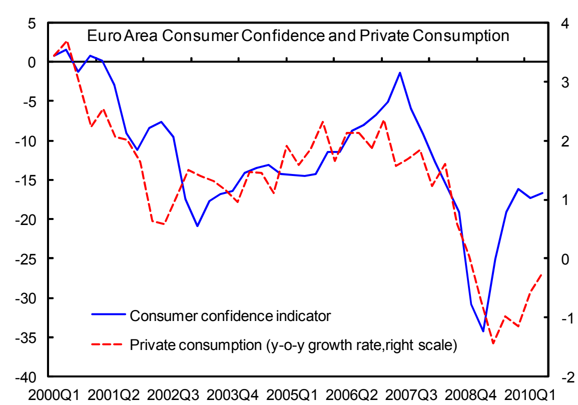


Sources:EuroStat and IMF staff calculation.



Sources: Eurostat; and IMF staff calculations.

12. **All agreed that the recent crisis had raised uncertainty considerably, creating significant downside risks**. High-frequency indicators are consistent with a relatively strong second quarter in 2010, driven by the global recovery in trade and manufacturing which could provide an upside surprise (Figure 3). Bridge model forecasts are somewhat higher than the current WEO baseline, but the sovereign crisis seems to have stalled momentum and confidence indicators weakened significantly following the heightened market tensions in May. Should this shift in confidence become entrenched, a sharp weakening of growth in the second half of 2010 would occur.



Sources: EuroStat; European Commission; and IMF staff calculation.

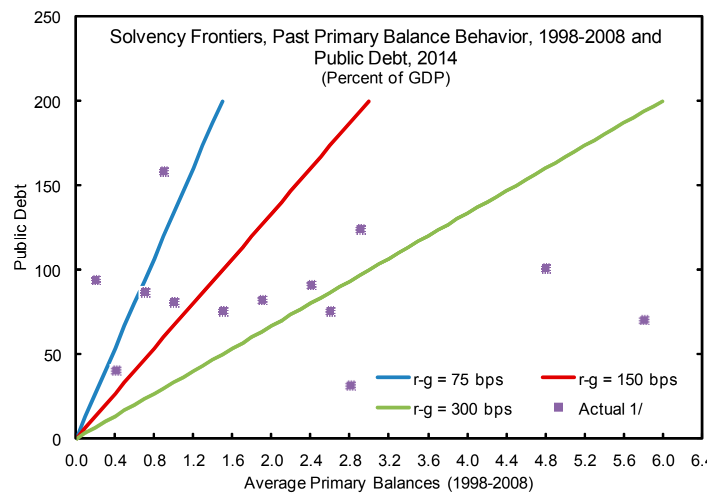
13. **Sovereign risk and its nexus with the financial system are the dominant concern (Box 2).** Indeed, since the onset of the crisis, spillovers from sovereigns to the banking system have increased market and liquidity risk. The authorities agreed that failure to meet the challenge of establishing fiscal sustainability and address counterparty risk would fuel the adverse feedback loop between the financial system and public finances, to the detriment of financial stability and the outlook for the regional and global economy. It could lead to a sharp rise in risk premiums and a disorderly depreciation of the euro. The authorities felt, however, that with the European Stability Mechanism now in place, such a disorderly scenario could be avoided. Like staff, they saw a scenario without disruptive movements, but with lackluster demand, low inflation and high public debt, leading to a prolonged period of stagnation, as a distinct possibility. This would especially be the case if competitiveness and private debt overhang problems were left unaddressed.

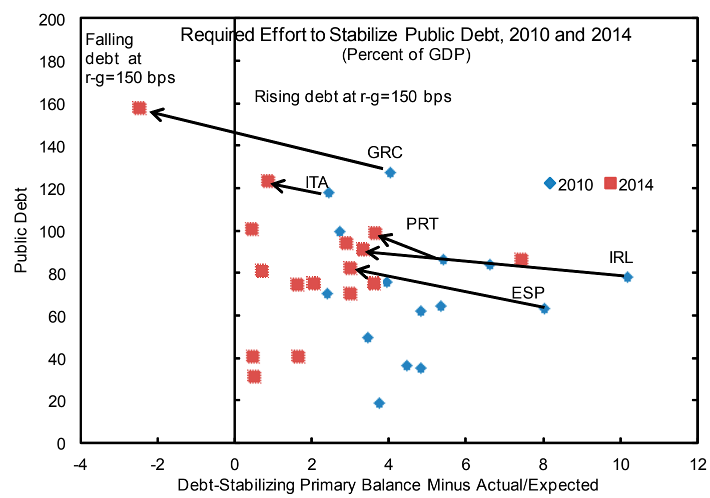
14. **The staff emphasized that weaknesses in part of the banking system also entail risks, though the authorities felt that systemic risk from within the financial system had diminished.** Profitability of banks had increased overall, but a persistent number of banks continue to underperform, posing a threat to the financial sector recovery and leading to segmentation in money and bank funding markets (Figure 4). Moreover, the performance of banks may come under further pressure from increased risk premiums, heightened market uncertainty, reduced government support, and loan-loss provisioning continuing at very high levels. The ECB noted that losses in the remainder of 2010 and 2011 would amount to euro 230 billion, with a further risk of substantial write-downs on marked-to-market debt securities. A considerable refinancing need over the same period will coincide, and could compete, with sovereign issuance. The ECB noted that risks had become more institution-specific ahead of the sovereign jitters, but acknowledged the staff's observation that the financial system could be adversely affected by the accumulation of weaknesses in a large number of smaller institutions, which calls for a broader coverage of financial institutions in macro-prudential supervision and stress testing. Indeed, since the mission, banks' CDS spreads and interbank funding strains have risen.

Box 2. Sovereign Challenges: Solvency and Liquidity

The fiscal response to the crisis, structural revenue losses, and the assumption of implicit liabilities in the banking sector have left most euro area economies with the challenges of establishing sustainability, managing liquidity risk, and dealing with the feedback between public finances and the financial system.

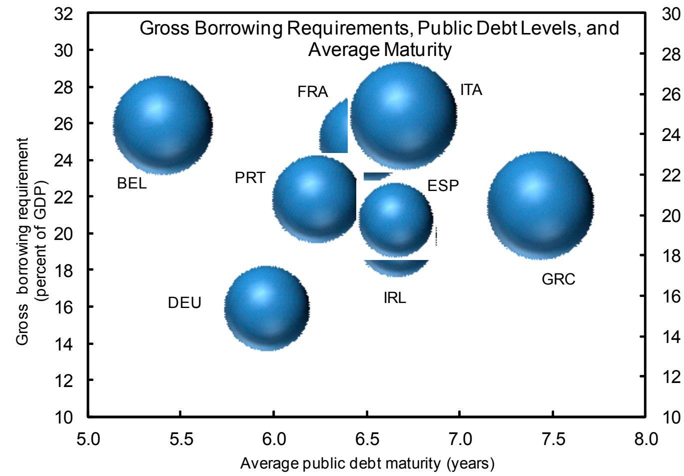
While a majority of member states have in the past managed to sustain the primary surpluses needed to reduce high public debt levels, in the present circumstances, fundamental changes in fiscal behavior will be needed for many. Indeed, primary balances needed to stabilize debt at its projected 2014 level, exceed those observed during 1998–2008 in many cases (first figure). On current intentions and using conservative assumptions about the automatic rise in the debt ratio due to the difference between nominal GDP growth and the implicit interest rate, expected improvements in primary balances should make significant progress in curbing the rise in debt ratios but would reverse or stabilize them in only a few cases (second figure). In a context where fiscal credibility is being challenged by financial markets, large refinancing needs pose a substantial risk (third figure). This is particularly relevant where average maturity has been falling. Delays in fiscal consolidation could thus trigger more widespread concerns about liquidity, sending risk premiums higher.



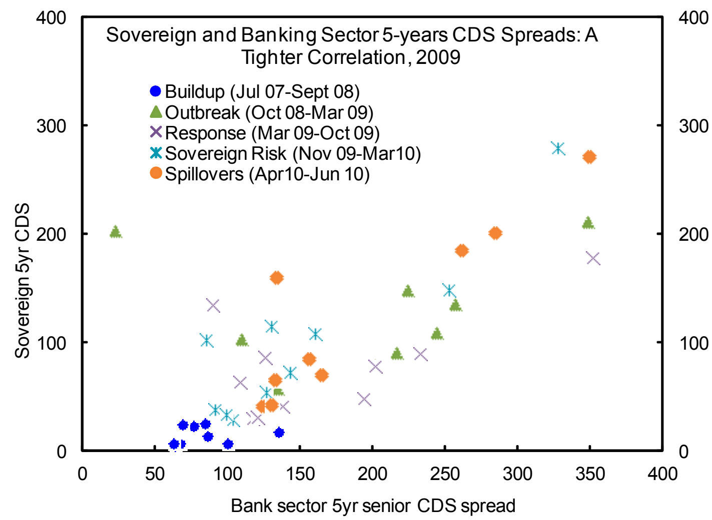


Sources: IMF, *World Economic Outlook*; and staff calculations.
1/ Frontier shows combinations of debt by 2014 and 10-year average primary balance (1998-2008)

Finally, sovereign and bank risk have become more closely interconnected as fiscal fundamentals played a greater role in market perceptions of sovereign solvency (fourth figure). The increase in sovereign spreads led to higher bank bond spreads in several vulnerable countries, reflecting direct exposure or the continued dependence of weak financial institutions on public support. Moreover, sovereign spreads affect banks' funding costs, which could reignite fears of financial instability. Conversely, difficulties in the financial system may elevate sovereign borrowing costs or require additional fiscal support.



Sources: Bloomberg and IMF staff .
Note: The size of the bubble is proportional to debt-to-GDP ratios.



Sources: Datastream; *Fiscal Monitor*, May 2010; and IMF staff calculations.

15. **Bank capitalization broadly increased but remains low in an international context and uncertainties over the adequate size and quality of capital prevail**. Capital levels improved markedly through early 2010 as banks continued to delever, retain more earnings and actively raised capital buffers through renewed and innovative equity and bond issuance as well as public interventions. However, in an international perspective, euro area banks' capital buffers remain low (see the April 2010 GFSR) and profit retention will be paramount, much like it was in 2009. The ECB, while acknowledging that the quality of capital could be improved, noted that capital buffers of large and complex banking groups had now risen to above pre-crisis levels and seemed adequate for the major euro area banks.

16. **The euro area sovereign crisis is likely to have significant spillovers, especially if downside risks materialize**. Various channels are at work: lower domestic demand and a more depreciated euro; reduced risk appetite and a diversion of capital flows; and weaker balance sheets of euro area banks. If the crisis is contained through strong policy implementation and the euro remains close to its fundamental value, spillover effects are

expected to be limited and regional, mostly affecting other EU countries and Switzerland, in the latter case initially through safe haven effects. If downside risks were to materialize, however, the consequences could be severe, threatening the global recovery, with global financial conditions tightening sharply and the euro depreciating substantially (see downside scenario in WEO Update of July 2010).

III. Overcoming The Crisis: Sustainability, Stability, and Growth

17. **The ECB and the EC strongly agreed with the staff that the crisis management measures put in place are no alternative for immediate action to secure fiscal sustainability, address weak banks, and boost growth.** While the staff stressed the need for well-coordinated and joint action across the euro area, national authorities saw more urgency for action in the countries most affected by market pressures and a greater role for national initiatives, especially in tackling banks and structural issues.

18. **While fundamental reforms should bolster confidence, the staff noted that full advantage should be taken of the establishment of the new financing facilities, especially as further market disruptions cannot be ruled out**. The authorities observed that the European Financial Stability Mechanism (EFSM), with resources up to euro 60 billion, had been available since early May to meet any EU member's financing needs. They expected the larger European Financial Stability Facility (EFSF), specifically designed for euro area members, to be fully operational in July 2010. Use of both facilities would be subject to strict conditionality and operate in conjunction with an IMF program. The staff welcomed the facilities, underscoring the need for flexibility to deal with unforeseen circumstances and the usefulness of actually activating them to enhance the credibility of the authorities' overall approach in dealing with the crisis. Accordingly, the staff suggested that use of the newly created instruments be considered also in a precautionary manner and for the resolution of difficulties in the banking system.

A. Adjusting and Consolidating Public Finances

19. **Although the nascent recovery remains dependent on policy support, sovereign market stress constrains fiscal policy.** Staff and the authorities agreed that countries facing severe financial market stress had no option but to undertake immediate fiscal adjustment, as is already underway. The ECB emphasized that in these cases, front-loading and accelerating fiscal consolidation was indispensable to limit contagion risks and prevent an adverse feedback loop between financial markets and fiscal policies. Nevertheless, the staff emphasized that countries with manageable debt dynamics can maintain their current plans in the context of credible medium-term adjustment programs. As a result, with the considerable near-term fiscal easing in Germany, the overall fiscal stance in the euro area would remain broadly neutral in 2010 (Figure 5).

20. **There was agreement that all member states need to start sustained consolidations at the latest in 2011, with the magnitude varying according to the state of public finances**. Current deficit targets imply synchronized consolidations leading to deficits below the SGP limit by 2013 in most cases. With all but one euro area countries now under the Excessive Deficit Procedure (EDP), the corrective arm of the Stability and Growth Pact—that member states have agreed to significantly strengthen, including through a wider use of sanctions and enhanced peer pressure—should prompt effective actions and serve as a medium-term anchor. However, additional efforts will be needed to stabilize debt dynamics over the long term.

21. **While compliance with the deficit targets set out in EDPs is a top priority, the staff emphasized the need to maximize confidence in long-term sustainability and limit the short-term impact on growth.** In the authorities' view, the adverse confidence effect of allowing some countries to deviate from the agreed adjustment path would outweigh the benefits of fine-tuning the short-term impact of consolidation on economic activity. Staff welcomed the already substantial differentiation across member states of the pace of deficit reduction under EDPs, but with the still patchy and uncertain recovery emphasized that the composition of the adjustment should be mindful of minimizing immediate damage to demand, while maximizing confidence effects.

22. **To this effect, fiscal adjustment plans need to be strengthened considerably.** They should focus structural expenditure cuts on distortive and ineffective programs, such as the elimination of certain price and production subsidies, and a shift from universal to targeted social transfers which would preserve spending by low income earners, while boosting confidence in the return to sustainable spending patterns. Ambitious entitlement reforms—such as measures aimed at increasing the effective retirement age—are essential to deliver large credibility gains at a lesser cost in terms of short-term growth. In contrast, across-the-board cuts in public investment programs should be avoided. In some countries, comprehensive tax reforms should aim at broadening the tax base, reducing distortions and improving compliance. In this respect, the coordinated introduction of a Financial Activities Tax would be helpful.[2]

23. **Staff and the authorities agreed that fiscal risks will best be managed through a resolute implementation of recently announced measures and detailed medium-term action plans.** The authorities expressed concerns about slippage in attaining medium-term targets, which often reflect optimistic growth forecasts and suffer from a lack of specifics on the underlying measures. Staff and the authorities agreed on the urgency for national governments to lift these uncertainties by laying out detailed medium-term action plans backed by concrete and credible measures.

[2] See IMF 2010: A Fair and Substantial Contribution by the Financial Sector, Interim Report for the G20.

B. Addressing Weaknesses in Banks

24. **Problems in banking segments that continue to perform poorly must be tackled.** Decisive actions are already underway in some countries (e.g., Ireland and Spain), but voluntary measures are unlikely to be sufficient and in some countries (e.g., Germany) long-standing problems are yet to be addressed. Furthermore, a number of banks, including some mid-size, remains heavily reliant on ECB financing facilities or on government support. Staff suggested several possible avenues, ranging from forcing those banks to raise additional capital and more decisively clean-up their balance sheets, to restructuring and resolution where viable business models cannot be established. Staff agreed that some blanket financial support measures may need to be extended, but cautioned that care be taken that the urgency to restructure is not put off and competition not distorted. It advocated a stronger role for EU institutions and mechanisms, given the cross-border dimension and the limited fiscal capacity of some member states.

25. **Euro area authorities agreed with the need to address weak banks, but noted limits to their capacity to act.** The ECB had to reverse its gradual phasing out of non-standard measures due to the sovereign crisis. It had previously urged national authorities and supervisors to address market access of the "persistent bidders," but with little success, complicating the ECB's exit strategy. The EC can only intervene based on state-aid rules and competition grounds, which means that the initiative often rests with national authorities. As a result, problem cases come to the EC's attention at a fairly late stage, often after adverse spillovers are already felt. The EC clarified that government guarantee schemes on bank debt may be extended beyond the review date of June 30, 2010, but—in an effort to wean banks off state support—would become more expensive over time, linked to banks' credit rating and a viability review if the amount of guarantees breached certain thresholds.[3] While the current crisis management mechanisms were not designed to deal directly with banks, the authorities agreed that, should they be used, resources could be set aside to support banks as was done in the case of Greece.

26. **The staff emphasized that stress tests should be used more effectively in conjunction with remedial action to help improve the financial system.** Currently stress tests are being overseen by national supervisors and coordinated by CEBS aimed at testing the resilience of large banks to corporate and household sector credit losses and assessing the effect of continued reliance on government support. To reduce aggregate uncertainty and induce a greater willingness to tackle troubled banks, staff called for a more detailed disclosure of inputs and outcomes, possibly at the institution-level, together with announcements of remedial actions by weak institutions to mitigate capital shortfalls, a view shared by the EC. The staff also called for broadening the transparent use of stress tests beyond the largest institutions covered in the CEBS tests. With sovereign risk predominant, staff agreed that communication would need to be handled carefully. Supervisors felt that disclosure of individual bank results could prove too market-sensitive and some national authorities noted legal impediments to publication.

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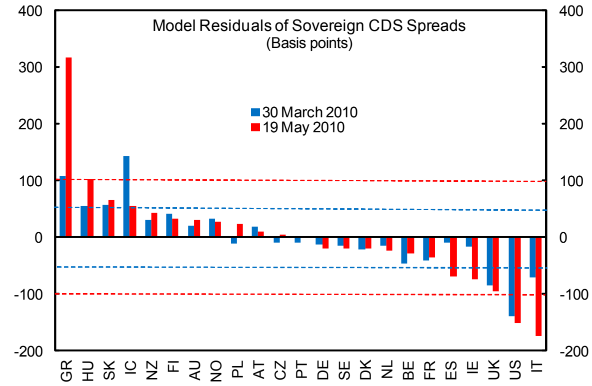
[3] See http://ec.europa.eu/competition/state_aid/studies_reports/phase_out_bank_guarantees.pdf

27. **Bans on short selling cannot alter fundamentals and may reduce confidence.** Germany's unilateral ban on selected short selling does not appear well-founded in the absence of proven market abuse. Analysis shows that variations in sovereign CDS spreads are well explained by fundamentals, i.e., deficit and debt ratios and EMU membership (with a discount for peripheral countries and Italy), in most countries, including Germany.



Sources:Datastream; and IMF staff estimations.
Note: The model estimated for 23 advanced countries is CDSi = c0+c1DEFi+c2DEBTi +c3EMU+c4GIIPS, where DEF is the country's debt-GDP ratio, DEBT the debt-GDP ratio, EMU and GIIPS are dummies for EMU membership and GIIPS countries. Horizontal lines indicate one-standard deviation bands.

C. Reinvigorating Growth

28. **Reinvigorating growth in the euro area will be crucial**. It was agreed that growth-enhancing reforms are essential to achieve fiscal sustainability. Raising growth potential will require preventing increases in structural unemployment and tackling bottlenecks. Reducing the work disincentives embedded in tax and benefits systems would raise fiscal revenues already in the short run. And regulatory reforms should generate substantial government revenues as soon as employment rates recover. Policy action is not only necessary in member countries suffering from excessive fiscal and external imbalances, but throughout the euro area to generate confidence, display cohesion, and improve overall investment and growth prospects.

29. **The staff argued that the current crisis provides a not-to-be-missed opportunity to move ahead with difficult reforms.** Structural reforms often need to overcome the interests of large and powerful insiders. However, with a sense of urgency spreading among the electorate and the markets, some euro area countries are moving ahead, hopefully setting a precedent. The EC and ECB have also stepped up their call for rapid progress.

30. **The authorities and staff agreed on the key reform priorities, which are country specific (Table 3)**. Labor market models perform very differently across euro area countries, both in terms of efficiency and equity. Most Mediterranean countries fare poorly and need to address labor market segmentation, inadequate wage flexibility and skill mismatches. They should also upgrade education systems and foster capital deepening and innovation. Most other countries still need to ease stringent employment protection rules and take measures to improve job matching. For all, further liberalization of product and services markets under the Single Market program will strengthen the employment effects of labor market reform. The staff called for measures to generally reduce public ownership and involvement in business operations, especially in the banking sector; lower barriers to competition still present in network industries, retail trade and liberal professions; and remove administrative barriers on start-ups. It argued that reform in bankruptcy proceedings, most clearly in Southern countries, will help facilitate firm turnover and entrepreneurship, and that potential growth would profit from a deficit-neutral shift in taxes from labor to consumption (e.g., VAT), preferably coordinated across the euro area.

31. **Policies need to be readjusted to limit the risk of a permanent reduction in potential output.** There is broad consensus that, thanks to past reforms, the impact of the crisis on structural unemployment is expected to be more moderate than in previous severe downturns in the majority of euro area countries. It was agreed that the temporary extension of benefits in response to the crisis will need to be reversed, incentives to early retirement removed and unemployment benefits conditioned on tightened activation and effective training. The staff called for further trade liberalization, the unwinding of sectoral subsidies and the end to disguised forms of protectionism.

IV. Inflation and the Role of Monetary Policy

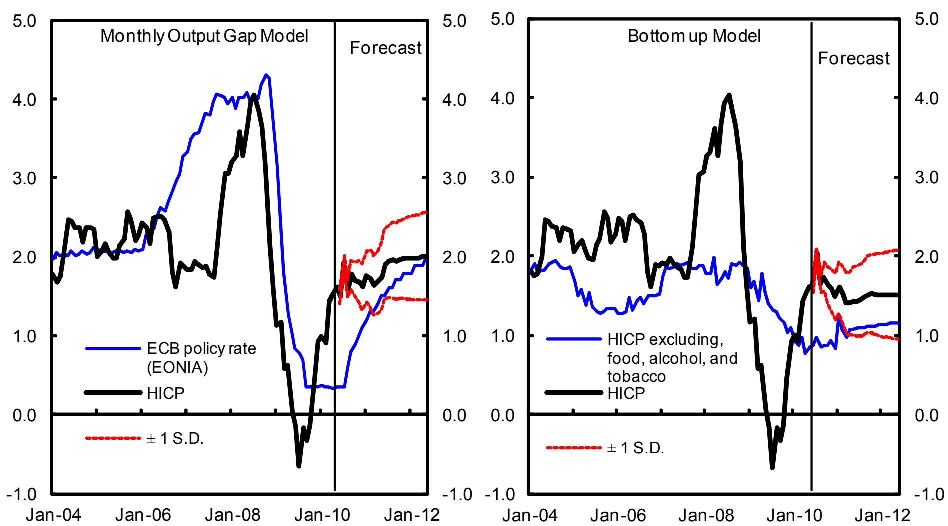
32. **Disinflationary pressure persists in the face of weak domestic demand.** The rebound in energy prices pushed headline inflation back into positive territory (1.6 percent in May) but core inflation excluding volatile food and energy prices and other measures of underlying inflation, such as trimmed means, have gradually fallen below 1 percent, reflecting a steady downward trend in services and industrial goods price inflation (Figure 6). Prices have dropped sharply for items that tend to respond very elastically to weak economic conditions and income uncertainty. Goods prices weakened significantly with the fall in global demand and have not yet responded much to the recent euro depreciation. This also holds for the non-energy components of producer prices on account of low input and operating costs and weak demand for industrial products. Regional dispersion of inflation has increased and underlying inflation has dipped into negative territory in a few countries.

Euro Area Inflation Outlook
(Annual average percent change)

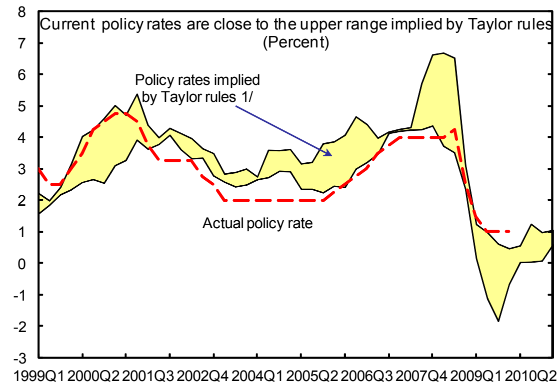
	Vintage	2010	2011
		Projections	
WEO	April	1.1	1.3
ECB	June	1.4-1.6	1.0-2.2
EC	May	1.5	1.7
Consensus	June	1.4	1.5

Sources: EC, ECB, and IMF.

Euro Area: Model Inflation Forecasts
(Year-on-year, percent, forecasts start in June 2010)



Sources: Eurostat and IMF staff estimates.



Sources: ECB; Eurostat; IMF; and staff calculations.
1/ Range based on various Taylor rules calculated using standard coefficients, headline or core inflation, and actual or expected inflation deviations from target.

33. **There was consensus that inflation will remain subdued over the forecast horizon.** Large output gaps are shrinking only gradually and low capacity utilization and wage moderation are set to last for some time. The growth in employee compensation has slowed markedly, especially in the service and construction sectors, and recent wage negotiations portend some further decline. Model-based forecasts suggest that inflation will stay low over the forecast horizon. The bottom-up, components-based forecast shows inflation at about 1.5 percent at the end of 2011, largely reflecting subdued service and non-energy goods price inflation. In contrast to the WEO and other forecasts, and influenced by estimates of a more typical cycle, the monthly New Keynesian DSGE inflation model predicts the output gap to shrink rapidly and therefore inflation to return to about 2 percent within the forecast horizon that ends in February 2012.

34. **It was agreed that long-term inflation expectations remain well anchored and risks to inflation are broadly balanced.** While the ECB agreed that deflationary periods could occur in countries that face significant pressure to reduce large fiscal and current account deficits, it did not see a significant risk of overall deflation owing to price rigidities and the strong anchoring of expectations. Moreover, breakeven inflation rates have rebounded following the slump in 2009 and are close to 2 percent, but unsettled liquidity conditions make the measure somewhat volatile (Figure 7). Survey-based measures of long-term inflation expectations are around 2 percent and generally tend to move very little. Uncertainty about future inflation measured as the dispersion of expectations in surveys or extracted from inflation derivatives, remains elevated, however. This seems to reflect concerns that a weak financial sector and a heavy public debt burden could prevent a sufficient policy tightening once the recovery gains traction and ultimately cause inflation to exceed its target. The ECB further noted that increases in indirect taxation and administered prices and energy-price and exchange rate fluctuations could produce occasional spikes in inflation.

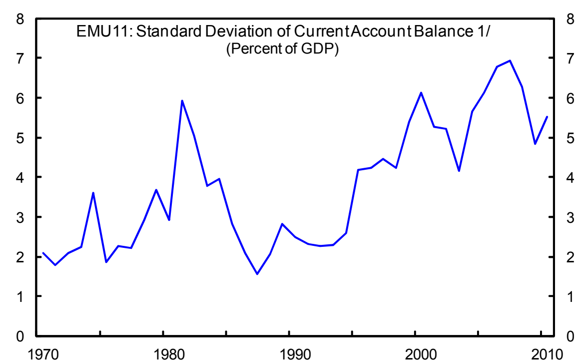
35. **The ECB and the staff agreed that the monetary policy stance can remain very supportive.** With the policy rate at 1 percent and the ECB deposit rate at 25 basis points, overnight rates have mostly hovered in the range of 35–45 basis points. Ample liquidity, especially injected through longer-term operations, has lowered the volume of overnight money market operations but without excessively reducing activity in interbank markets (Figure 8). The pass-through of lower policy rates to market and bank lending rates had been complete and term and risk premiums in money, bank lending and corporate debt markets had receded significantly as well. However, recent tensions in euro area sovereign debt markets caused some sovereign spreads to rise sharply and led to a widening in money and

credit market spreads (Figures 9, 10). Moreover, even if these tensions subside, capital constraints may weigh on corporate bank credit supply and render low policy rates less effective. A variety of models suggest that policy rates can remain low, but differ somewhat in the timing of when they should start rising.

36. **There was agreement that the ECB could resume gradual exit from its non-standard policy support once systemic liquidity conditions ease.** Non-standard support measures have been essential in meeting high systemic liquidity needs, but are also distorting market mechanisms and reducing incentives for weak banks to restructure. The experience with the unwinding of long-term refinancing operations suggests that the same criteria to begin to exit can be used as in the past. Tightening collateral requirements will be difficult and should wait until the euro area crisis is resolved. Beyond the near term, the collateral framework may need to be revisited to address concerns about the quality of the ECB balance sheet.

V. Addressing Intra-Euro area imbalances

37. **The significant increase in individual euro area member current account deficits and surpluses and their persistence since the advent of EMU has been partly reversed by the recent crisis.** It was agreed that equilibrium phenomena, such as different demographics and long-term growth dynamics justify some imbalances. Weak domestic demand, notably low corporate investment in Germany also played a role, but the major drivers were to be found in the deficit countries, facilitated by easy financing by foreign investors. Domestic imbalances linked to unsustainable credit and construction booms, a lack of fiscal restraint, and unsustainable wage developments all contributed significantly. As a result, unsustainable asset and demand booms emerged in some places, and a common monetary policy became increasingly ill-suited for individual parts of the region, creating destabilizing real interest and exchange rate dynamics (Figure 11). The exchange rate being well above fundamentals for an extended period before the crisis aggravated these dynamics: it hurt deficit countries more than surplus countries, reflecting diverging wage developments and specialization patterns. In the end, without signals from exchange rates, political economy incentives to use national tools to correct these dynamics were weak.



Sources: Bundesbank; IMF, *World Economic Outlook;* and staff calculations.
1/ 2010 data is based on IMF, *World Economic Outlook, April 2010* forecast.

38. There was agreement that resolution of euro area imbalances will require a multi-pronged approach, with both surplus and deficit countries contributing:

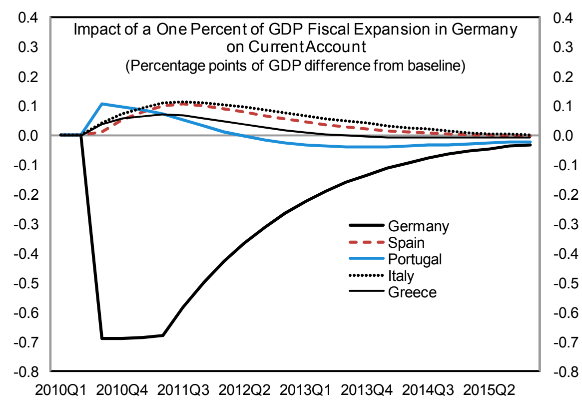
- In surplus countries, fiscal policy is providing short-term relief, e.g., with Germany's headline deficit set to double in 2010. But the effect of this policy is indirect and very small, reflecting the small size of trade flows: for example, exports to Germany from Greece, Italy, Portugal, and Spain averaged only about 2 percent of their GDP during the pre-crisis years. Staff simulations with NIGEM, suggest that a one percent of GDP fiscal expansion by Germany, improves the current account of Southern European countries by no more than 0.1 percentage point of GDP. Given these limitations and constraints on fiscal space, structural policies in surplus countries will be crucial. In Germany, for example, service and financial sector reforms, combined with lower employment protection, would create investment opportunities and boost domestic demand.

Trade Shares, 2004-08 Average

	Exports to Germany as a Share of Total Exports	Trade Openness 1/
GIPS		
Greece	11.8	51.7
Italy	13.1	54.8
Portugal	12.8	70.6
Spain	11.1	58.3
Other euro area countries		
Germany	n.a.	81.8
France	15.3	54.1
Netherlands	25.1	129.5
Slovak Republic	24.8	163.8
Slovenia	18.8	130.6

Sources: IMF, *World Economic Outlook*; *Direction of Trades*; and staff calculations.
1/ Ratio of exports and imports to GDP.

- Deficit countries will need to play a key role in resolving the imbalances. In addition to appropriately strong fiscal consolidation, increasing product market competition (Figure 12), improving nominal wage flexibility (following the example of Ireland), and adjusting labor market models would go a long way in addressing the structural and competitiveness issues behind much of the intra-euro area imbalances (Figures 13, 14).



Source: IMF staff simulation.

- Resolving intra-euro area imbalances is also linked to avoiding global imbalances (Figure 15). A euro remaining in line with its fundamentals—consistent with a small euro area current account surplus—would facilitate adjustment in several large deficit countries for which price competitiveness is key, though effects of euro depreciation differ markedly across countries (e.g., for Italy and Spain they would be larger than the euro area average, while for Greece and Portugal they would be smaller). Reforms in other countries would strengthen overall growth in the euro area with positive effects globally.

VI. Reforming Policy Frameworks

A. Strengthening Fiscal Policy Surveillance and the Stability and Growth Pact

39. **Fundamental gaps in the euro area's fiscal framework increased fiscal vulnerability during the crisis and urgently need to be addressed**. Staff and the authorities broadly agreed that three long-standing weaknesses had been exposed by the crisis. First, the SGP has failed to encourage the buildup of sufficient buffers in good times, and lower debt to prudent levels, limiting room for maneuver in bad times. Second, weak governance has aggravated structural flaws. Specifically, fiscal surveillance has been narrowly focused on procedural aspects and formal deficit limits, while EDP enforcement suffered from the Council's reluctance to use binding legal instruments to mandate policy corrections. The result was insufficient scope for sound economic judgment to shape policy recommendations, constraining an effective use of preventive legal instruments. Third, the fiscal framework has been lacking centralized crisis management and resolution capacities, a gap now temporarily being filled by the European Stabilization Mechanism.

40. **Staff welcomed the authorities' initiative to launch a broad debate on improving fiscal governance, but emphasized that ambitious reforms were needed to foster compliance with the rules**. The EC has issued a consistent set of recommendations to address key issues in the operation of the SGP.[4] The President's Task Force on economic governance initiated its own discussions by exploring ways to enhance sanctions against countries violating the common fiscal rules, taking the EC's proposal as a basis for discussion. Staff argued that more fundamental steps were needed. In particular, the flawed enforcement procedure of the SGP needs repair to make sure that binding provisions of the EDP—including sanctions—are enforced when violations of the rules are patent.

41. **Staff discussed various options to enhance the enforcement of corrective provisions in the EDP and expand their applicability to key preventive aspects of the SGP.** Two broad classes of proposals were discussed.

a. **A shift of policy authority to the center** that would either curtail member states' discretion in areas of common interest—for example by issuing binding deficit limits—or enhance individual incentives to comply with existing rules—for instance through access to a common Euro bond issuance—was debated.

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[4] The May 12, 2010, EC communication proposes to reinforce policy coordination in the EU in general and the euro area in particular. All proposals are based on the Treaty and only require changes in secondary legislation and codes of conduct. The communication features: (i) a strengthening of the SGP mainly by stepping up sanctions (including in the preventive arm) and activating the EDP using the debt criterion, (ii) a more intrusive surveillance of external imbalances in the euro area (involving early warnings and recommendations in a wide array of policies), (iii) stronger ex-ante coordination through a "European semester" (involving peer review of budget proposals and policy guidance from the EC and the Council before submission to national parliaments), and (iv) a permanent framework of crisis management along the lines of the European Stabilization Mechanism (ESM).

However, these options require Treaty changes around which consensus may take time to build. Also, the ECB was concerned by the moral hazard implications of pooling debt issuance. Nonetheless, staff felt that in the long run a shift in policy authority to the euro area level would be essential.

b. **It was agreed that greater ownership of the common rules at the national level could facilitate enforcement.** Euro-area member states could be mandated to transpose in their national fiscal frameworks the common standards of fiscal responsibility, based on Article 136 of the Treaty. Regardless of the process, the harmonization of national frameworks should be guided by two principles: (i) rules in line with the spirit of the SGP, that is a structural balance close to balance or in surplus, and (ii) a credible national enforcement procedure which would be adapted to the particular context of each member state in terms of decentralization, form of government, and legal tradition. The authorities expressed interest in that approach as a way to ameliorate the enforcement problem.

B. Improving Governance over Structural Reforms

42. **Weak governance is regarded as an important element underlying the Lisbon Strategy's poor effectiveness, even though the strategy is useful in setting the agenda for growth-oriented structural reforms in the euro area.** The EC's diagnosis is strong, but the authorities agreed that implementation was lagging. Progress had been uneven across areas, with key labor market reforms missing. The EC felt that ownership of the strategy had remained weak, with infrequent debates held by the European Council and rare decisive policy action.

43. **Staff emphasized three key challenges for Europe 2020 to become a central element of the EU's response to the crisis**. First, the strategy should to be focused on the delivery of a narrower set of policy goals, as currently envisaged, but perhaps with even more emphasis on employment rates and education. Second, surveillance over structural bottlenecks, competitiveness and imbalances needs to be integrated with fiscal surveillance. Third, a sustained commitment of the European Council and the Eurogroup on structural reforms will be key. While the EU is fully committed to make fast progress along these lines, close integration within the policy debate of the President's Task force on economic governance will be essential.

44. **The Eurogroup will need to play a pivotal role in the peer review of key structural policies**. By aligning surveillance over fiscal and key related structural policies (labor taxation, social benefits, employment protection and wage bargaining) greater account can be taken of policy interactions and the prevention and correction of intra-euro imbalances. The upgrading of the peer review in fundamental structural reforms foreseen in the EC's May 12 Communication anticipates the Eurogroup to act as a collective body, notably by providing systematic assessments and by communicating openly the benefits of reforms for fiscal consolidation and the correction of external imbalances. When non-

compliance with the Council's recommendations leads to significant cross-country spillovers in EMU, the EC should address a policy warning to the Member States concerned, followed by a public statement by the Council. Staff welcomes the EC's suggestion that conditionality could be enhanced by twinning EU budget expenditures to Council's recommendations, either by redirecting Structural Funds to remedy Member States' major structural weaknesses and competitiveness challenges or by suspending EU payments for non-compliers.

C. Rising to the Challenge of Financial Sector Reform

45. **In the wake of the global financial crisis, financial sector reform poses particular challenges for the EU.** The objective of establishing and maintaining an integrated market for financial services across the euro area and wider EU needs to be underpinned with a set of pan-European institutions to deal with regulation, supervision and resolution (including deposit insurance). It also requires stronger capital and liquidity requirements, to be agreed globally, to ensure greater resilience against stresses and avoid systemic disruptions from the failure of individual institutions in the EU.

46. **The recent ("sovereign") phase of the crisis has made this agenda all the more pressing, in the staff's view.** It has underscored the potential for financial contagion to cross European borders, reinforcing the need for robust regulation and a strong European element in supervision and resolution. Recent crisis measures also showed, once again, the strength of the inclination on the part of national authorities to act unilaterally, rather than in a coordinated fashion, which added to uncertainty and confusion in financial markets.

47. **The ECOFIN Council's agreement last December to establish a new European supervisory structure represents an important milestone for the EU.** The Parliament's Committee on Economic and Monetary Affairs has since issued a set of proposals to further strengthen the overall framework. The authorities are aware that reconciliation needs to avoid slippage in the establishment of the European Supervisory Authorities (ESAs) and European Systemic Risk Board (ESRB).

48. **All agreed that a strong role of the ESAs in supervision and rulemaking was desirable.** However, the EC cautioned that direct supervisory powers for the European Banking Authority (EBA) over the largest institutions, as proposed by Parliament, may not be feasible, if the timeline for its establishment is to be kept. Both the EC and ECB pointed to legal difficulties[5] and argued that entrusting the EBA with more direct supervisory responsibility may best be discussed in the context of the planned 2014 review of the new arrangements, when the EBA would have established a track record. In the staff's view a useful immediate step would be a strong role for the EBA in the supervisory colleges for cross-border groups. The outcome of negotiations should in addition ensure maximum

[5] According to the EC and ECB, the Meroni judgment of 13 June 1958 constrained the sphere of discretion that the EBA could be vested with under the Treaty, potentially affecting its ability to issue supervisory decisions.

information sharing and efficient rule-making procedures so as to advance the establishment of a single rule-book across the EU.

49. **The ESRB can play a useful coordinating role in crisis prevention and some aspects of crisis management.** The EC agreed with staff that, without prejudice to the setting of global standards by the Basel Committee, the ESRB should use its recommendations to guide the calibration of preventive macro-prudential measures, including to address the build-up of credit and liquidity risks from capital flows across the EU. The EC explained that, contrary to a parliamentary proposal, the ESRB could not, for legal reasons, be given immediate power to declare an emergency—and thus activate emergency powers on the part of the ESAs. However, the staff suggested that it could nonetheless be consulted before an emergency is declared and use the power of its recommendations to achieve greater coordination of crisis measures across all sectors (banking, insurance and securities). The staff also underscored that the ESRB would need to have effective access to all relevant information.

50. **The introduction of stronger and harmonized early intervention and resolution capabilities across the EU remains pressing.** All agreed that European legislation should establish a core set of early intervention and resolution tools and remove legal constraints on their effective use. Staff also supports a risk-based levy on the banking system, as currently proposed by the EC and Parliament, so as to establish financial stability funds, which will also require a fiscal backstop. While some jurisdictions appear to prefer for levies to contribute to the general budget, it makes no difference to the public sector's financial position whether a levy accrues to the general revenues or to a fund that invests in government assets.[6] Against this, a key advantage of a dedicated fund is that it can be mobilized quickly to reduce systemic risks. A fund can aid the resolution of systemic institutions—by providing funding to a bridge bank and assisting in the sale of the institution to a third party—and enable early intervention, e.g., to force the sale of bad assets, including those arising from cross-border exposures.

51. **A pan-European Financial Stability Fund can further strengthen financial stability.** Staff argued that such a Fund could be particularly useful as long as individual countries are fiscally constrained. Moreover, even when national funds are "networked", as proposed by the EC, the need for strong guidance on burden sharing remains and might need to be addressed through legislation. Recent proposals by an EFC working group to set up crisis management groups for each individual cross-border institution and to require institutions to prepare Recovery and Resolution Plans are further useful elements. So as to have a neutral voice at the table, staff suggested for the EBAs to be represented in these groups, with a mandate to mediate and monitor adherence to agreed crisis management principles.

[6] See IMF, 2010, "A fair and substantial contribution by the financial sector—interim report for the G-20", Washington, D.C.

52. **The staff expressed concern that appetite for fundamental reform of capital and liquidity requirements appeared to be waning in some countries.** The EC and CEBS explained that difficulties in calibration arose where there was substantial heterogeneity across firms and differences in starting points across countries, e.g. as regards the definition of capital. Against this, the staff argued that a robust calibration of measures currently being debated at the global level remained important, so as to strengthen the resilience of the European banking system to future shocks. The staff welcomed the EU's work to ensure robust arrangements for the clearing of derivatives. It should take full advantage of the capital framework to create incentives and be advanced in a manner that allows the emergence of a globally consistent approach.

VII. Staff Appraisal

53. **The euro area is facing a severe crisis, requiring decisive action to deal with the crisis and to complete the project of European Economic and Monetary Union.** The current crisis results from unsustainable policies in some countries, delayed repair of the financial system, insufficient progress in establishing the discipline and flexibility needed for a smooth functioning of the monetary union, and deficient governance of the euro area. Consequently, divergences in economic performance have been allowed to fester, building up imbalances and leading to the recent dramatic wake-up call from markets. The immediate crisis response has been strong and far-reaching, demonstrating the euro-area's capability to act together when pressured. But while the newly created crisis management tools should be used as needed, they should not be considered an alternative to the necessary corrective policy actions and fundamental reforms.

54. **Heightened downside risks threaten a moderate and uneven recovery**. The nascent recovery, driven mainly by external demand, is likely to be slowed in the near term by market tensions related to sovereign risks. Over the medium term, the need for fiscal consolidation and structural rigidities will weigh on it, leading to persistent unemployment and subdued investment. The depreciation of the euro, which is now broadly consistent with fundamentals, will provide some relief. The sovereign crisis has created significant downside risks. Since its onset, spillovers to the banking system have increased market and credit risk, and could fuel the adverse feedback loop between the banking system and public finances. Competitiveness problems and private debt overhang also loom large in some member countries.

55. **Immediate action is needed to establish fiscal sustainability.** Credible fiscal adjustment must be at the core of the response. Countries facing market pressures have no option but to adjust forcefully and meet their deficit targets. For all countries, additional efforts must be made to turn around unfavorable debt dynamics over the medium term. The pace of consolidation should however be differentiated across countries. The aggregate fiscal stance of the euro area is correctly envisaged to be neutral in 2010, while consolidation will start everywhere at the latest in 2011. The quality and composition of fiscal consolidation

will be important to support the recovery as much as possible, with entitlement reforms featuring prominently.

56. **The long-standing problem of anemic growth in the euro area must now be addressed.** High growth is not only important for its own sake, but essential to secure fiscal sustainability, facilitate the resolution of intra-euro area imbalances, and keep the global recovery on track. Reform priorities have been well identified in the Lisbon strategy, but it is now crucial to implement a set of country-specific structural reforms throughout the euro area.

57. **The resilience of the banking system must be improved and its stability assured**. Banks overly reliant on liquidity or other government support should be forced to recapitalize, restructure, of face resolution, a process that can be helped by effective use of appropriately transparent stress tests, applied to a broad set of financial institutions. Blanket financial support measures may need to be reinstated or extended, though care should be taken that they do not put off the urgency to restructure. Rapid clarification of new capital and liquidity requirements, set at sufficiently high levels to increase the banking system's resilience to future shocks, and properly phased in, will be important.

58. **The ECB has remained an anchor of stability throughout the crisis.** Faced with a sharp tightening of financial conditions in countries affected by the sovereign crisis, the ECB rightly undertook strong action through its Securities Market Program and the reinstatement of other non-standard measures to secure the effective transmission of its monetary stance. Reflecting the ECB's excellent track record, long-term inflation expectations remain well anchored, keeping risks to price stability at bay. With inflationary pressures subdued, the policy rate should remain low. Distortions related to protracted low rates need to be monitored and addressed with macro-prudential tools.

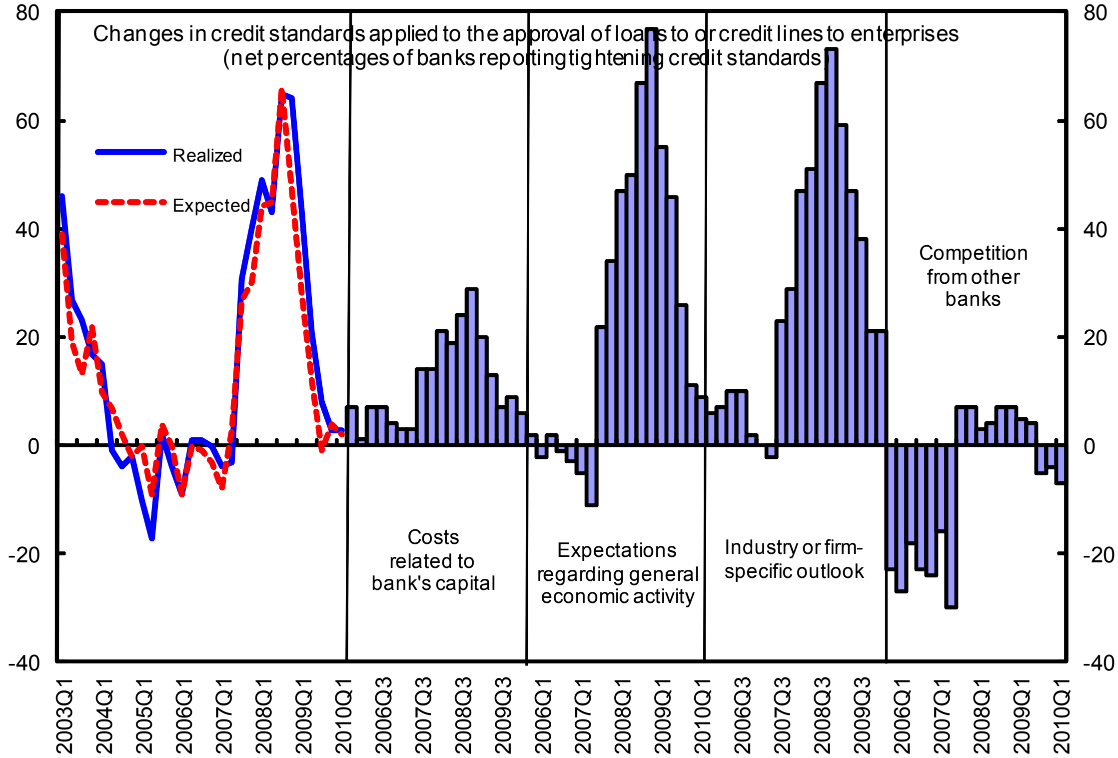
59. **Economic governance of EMU needs to be strengthened to deliver the collective responsibility necessary for a well-functioning economic and monetary union.** While the Commission's proposals and early deliberations by the President's Task Force are welcome, focus should be on enforcing budgetary discipline, helped by fundamental legislative reform, including at the national level. Key structural reforms to address macroeconomic imbalances should be included in any new governance arrangements. Swift progress in this area will enhance confidence.

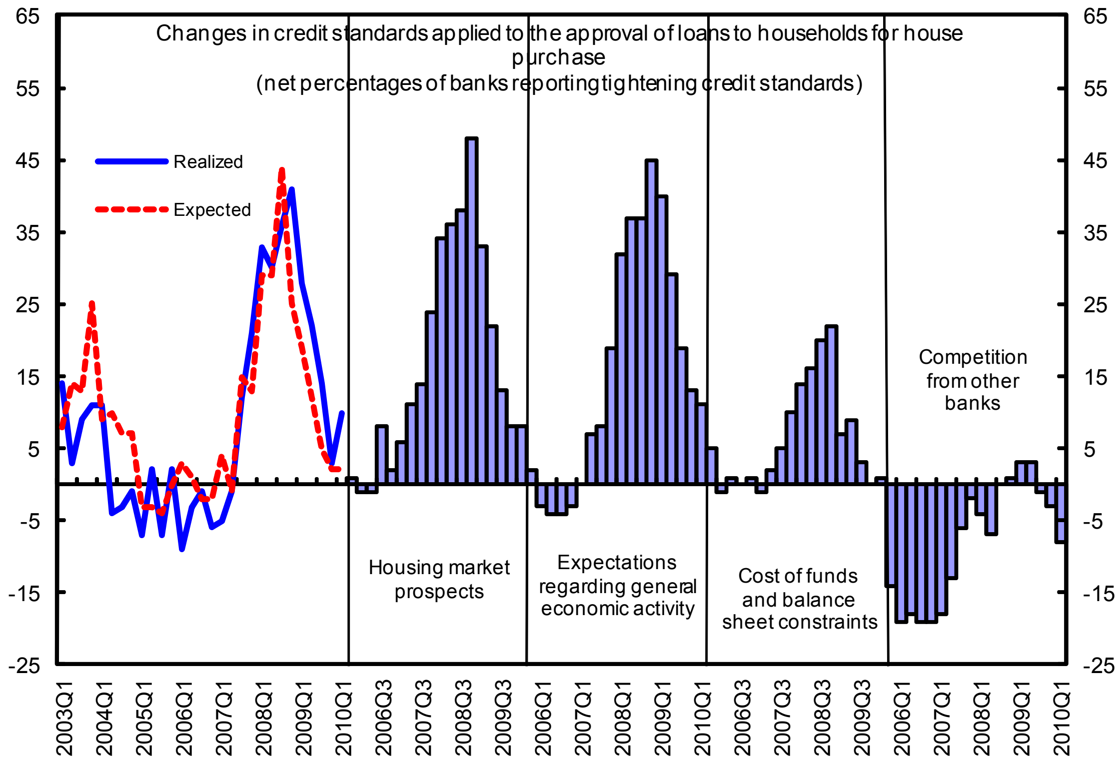
60. **Progress in building the EU's financial stability architecture should be pursued.** The establishment of more harmonized regulation and supervision of the EU financial system is highly welcome and should be extended to the areas of crisis management and resolution. The European Systemic Risk Board and European Supervisory Authorities need to be granted a sufficiently strong mandate, including in crisis management and supervision of cross-border institutions. A core set of effective resolution tools needs to be established to raise the scope for coordination in the resolution of cross-border institutions, eventually including a European Resolution Authority. The proposed risk-based levy on the banking

system deserves support. Consideration should be given to establishing financial stability funds, with a role in resolution.

61. **The staff proposes that the next consultation on euro area policies in the context of the Article IV obligations of member countries follow the standard 12-month cycle.**

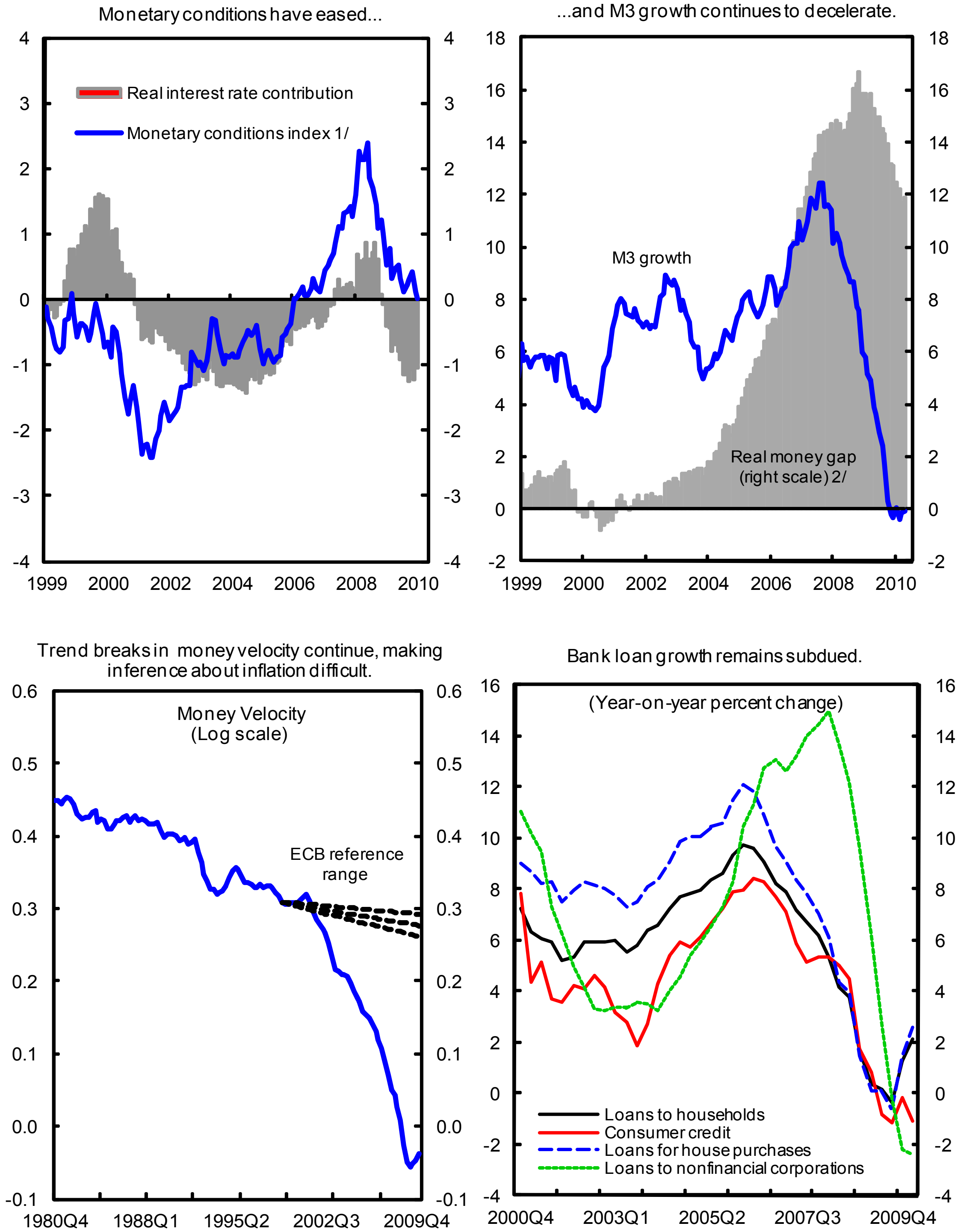
Figure 1. Euro area: Changes in Credit Standards to Enterprises and Households, 2005-10





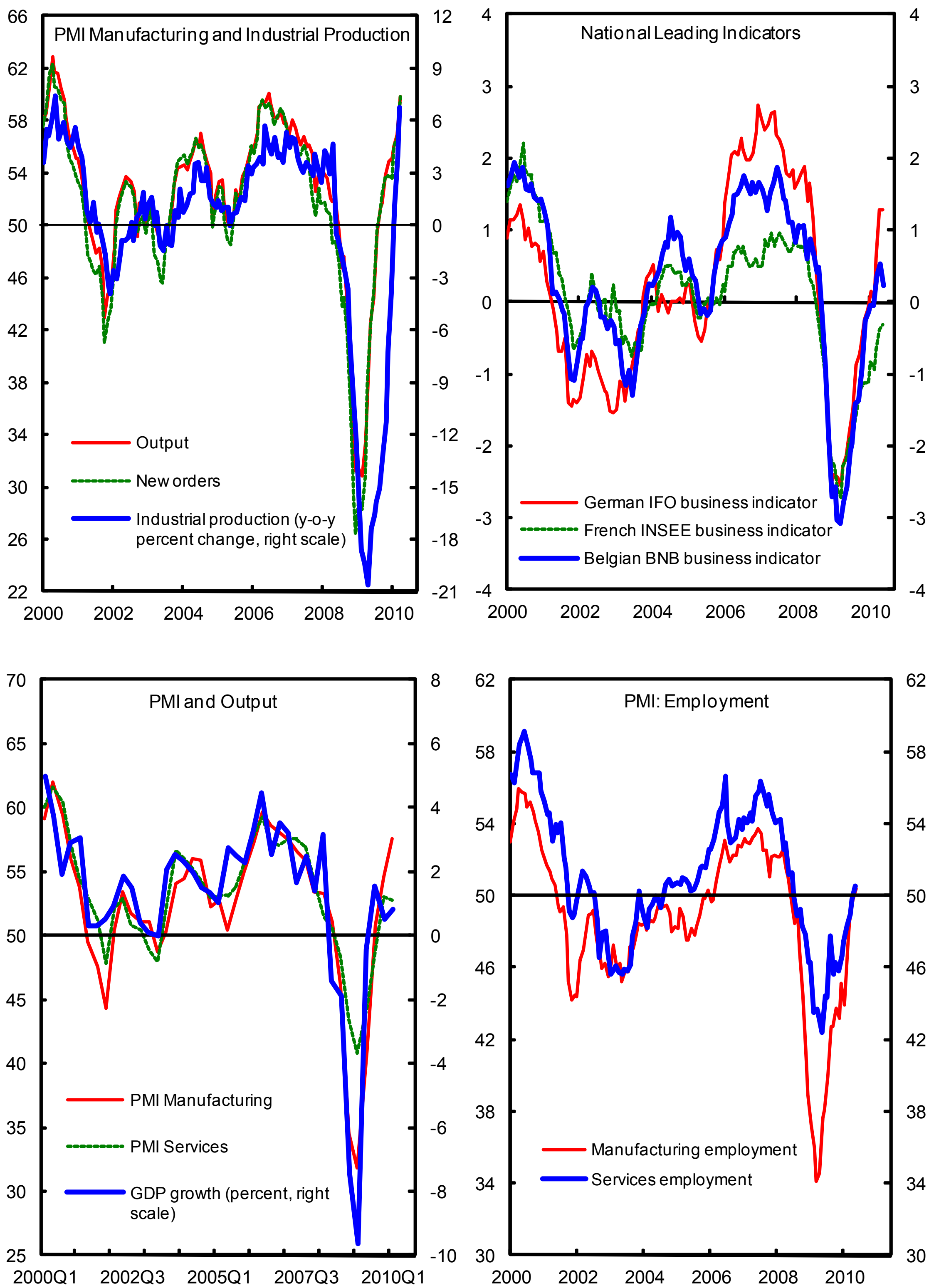
Source: European Central Bank.

Figure 2. Euro Area: Money and Credit, 1980-2010
(Percent, unless otherwise specified)



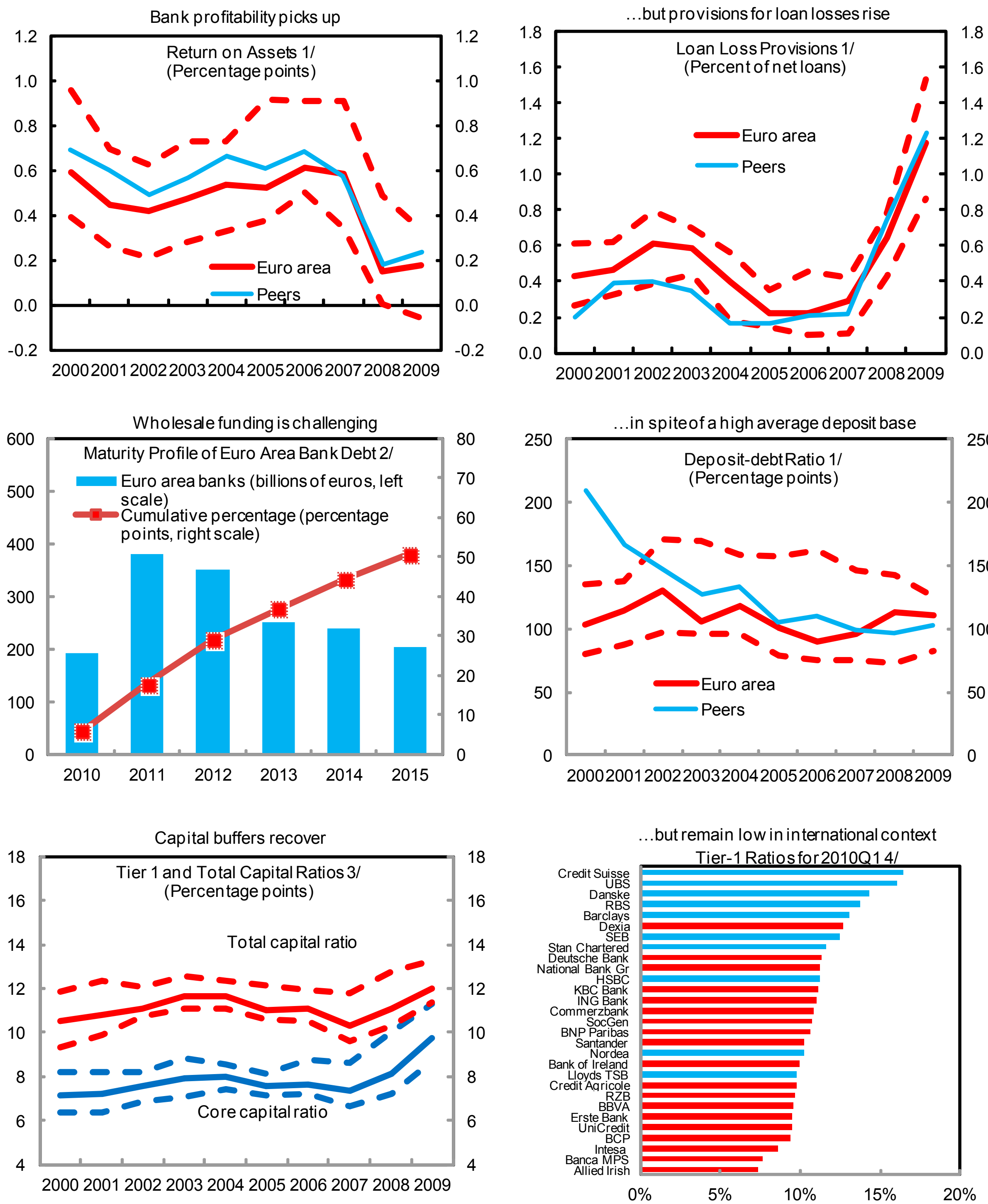
Sources: ECB; Datastream; Bloomberg; and IMF staff calculations.
1/ Deviations from 1993–2006 mean.
2/ Based on M3 corrected for the estimated impact of portfolio shifts. Deviation (in percent of the actual real stock, deflated by HICP) from an estimate of the long-run real stock that would have resulted from constant nominal M3 growth at its reference value of 4.5 percent and HICP inflation in line with the ECB's definition of price stability, taking December 1998 as the base period.

Figure 3. Euro Area: Leading Indicators



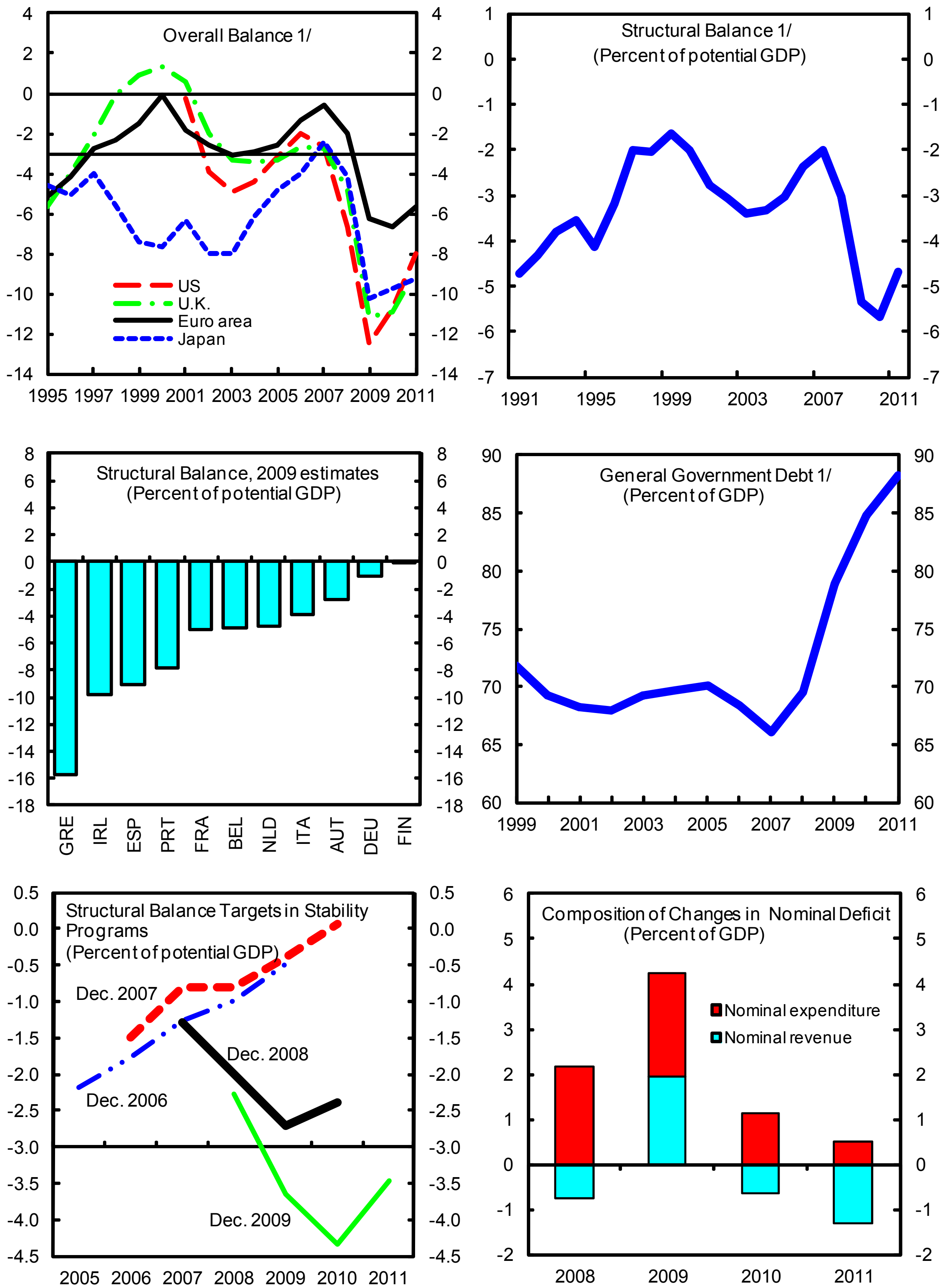
Sources: Eurostat; Reuters; IFO; INSEE; National Bank of Belgium; and staff calculations.

Figure 4. Euro Area: Banking Sector Indicators, 2000-10



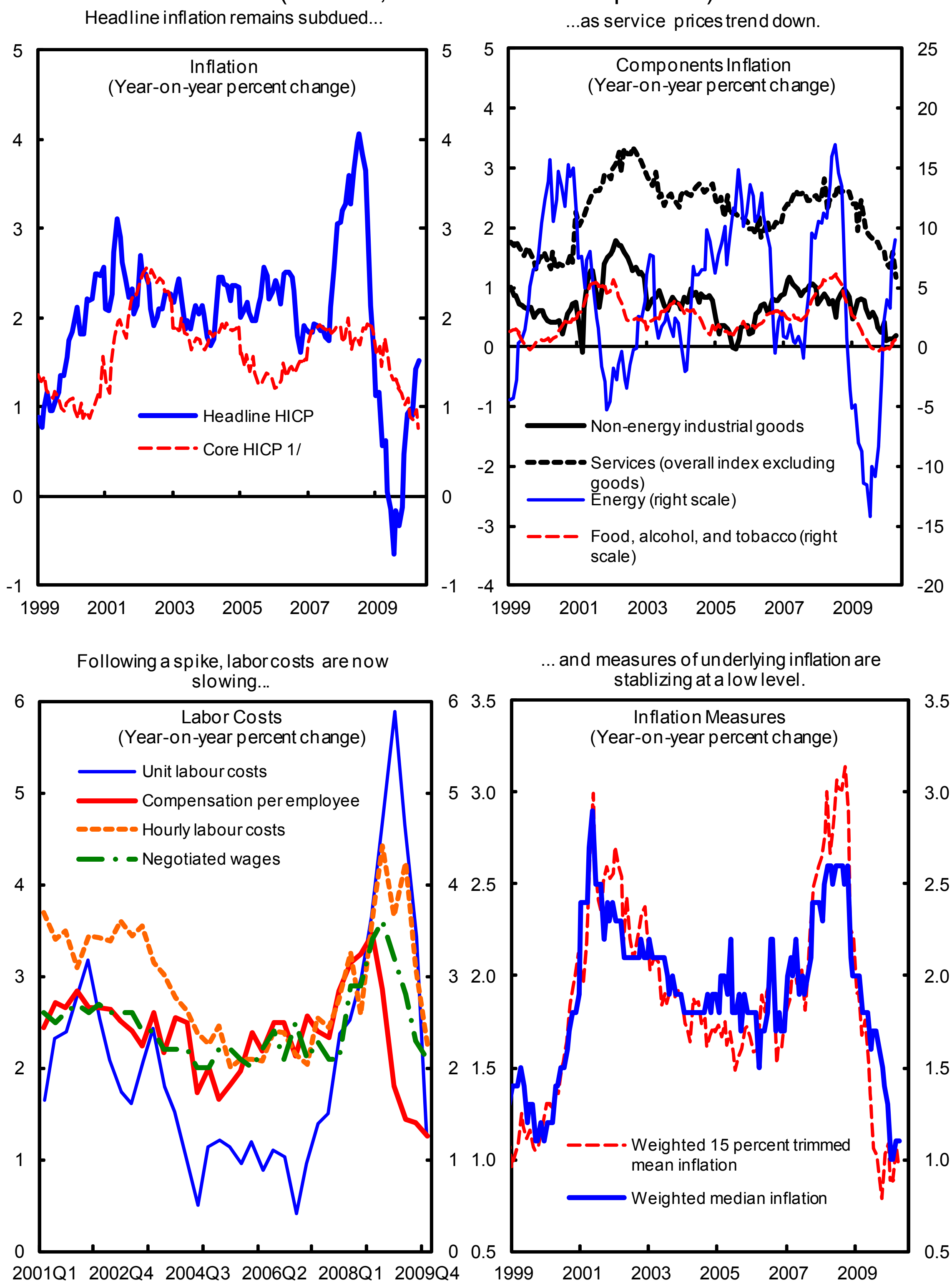
Sources: Datastream; Bloomberg; Dealogic; Individual Bank Reports; and IMF staff calculations.
Note: The peer group consists of a set of 10 large UK, Swiss and Scandinavian banks.
1/ Full lines are the median euro area (red) and median peer (blue) group's indicator. Dashed lines indicate the lower and upper quartile for the euro area banks' sample.
2/ 2010 date refer to second half of the year only.
3/ Median Tier 1 ratio (full line) and quartiles (dashed lines) in blue. Median total capital ratio (full line) and quartiles (dashed lines) in red.
4/ Sample excludes Natixis, Credit Agricole and Landesbank Berlin (missing data).

Figure 5. Euro Area: Fiscal Developments
(Percent of GDP, unless otherwise noted)



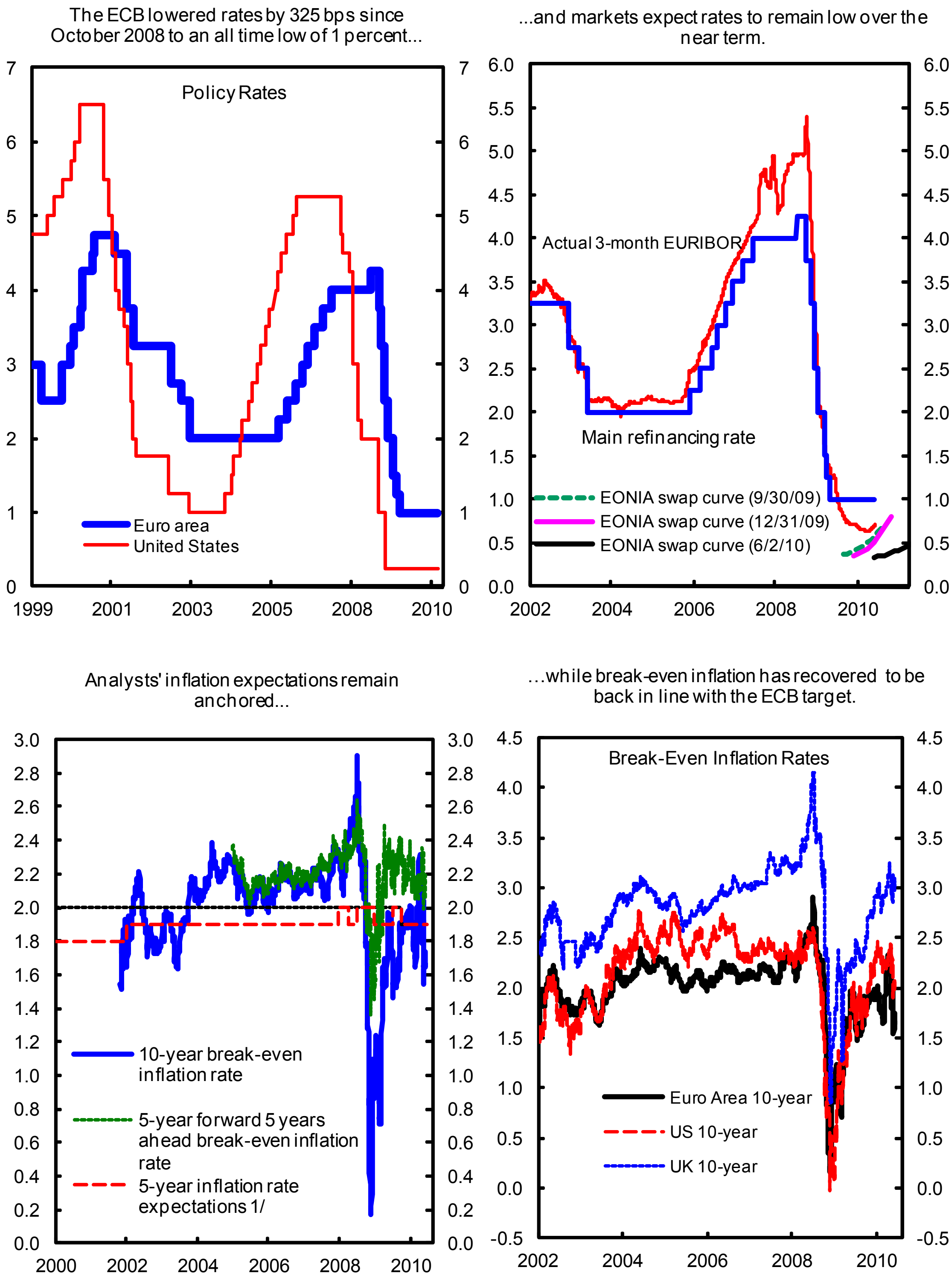
Sources: European Commission; IMF, *World Economic Outlook;* and IMF staff calculations.
1/ 2010 and 2011 data are based on latest IMF, *World Economic Outlook* projections.

Figure 6. Euro Area: Inflation and Labor Costs, 1999–2010
(Percent, unless otherwise specified)



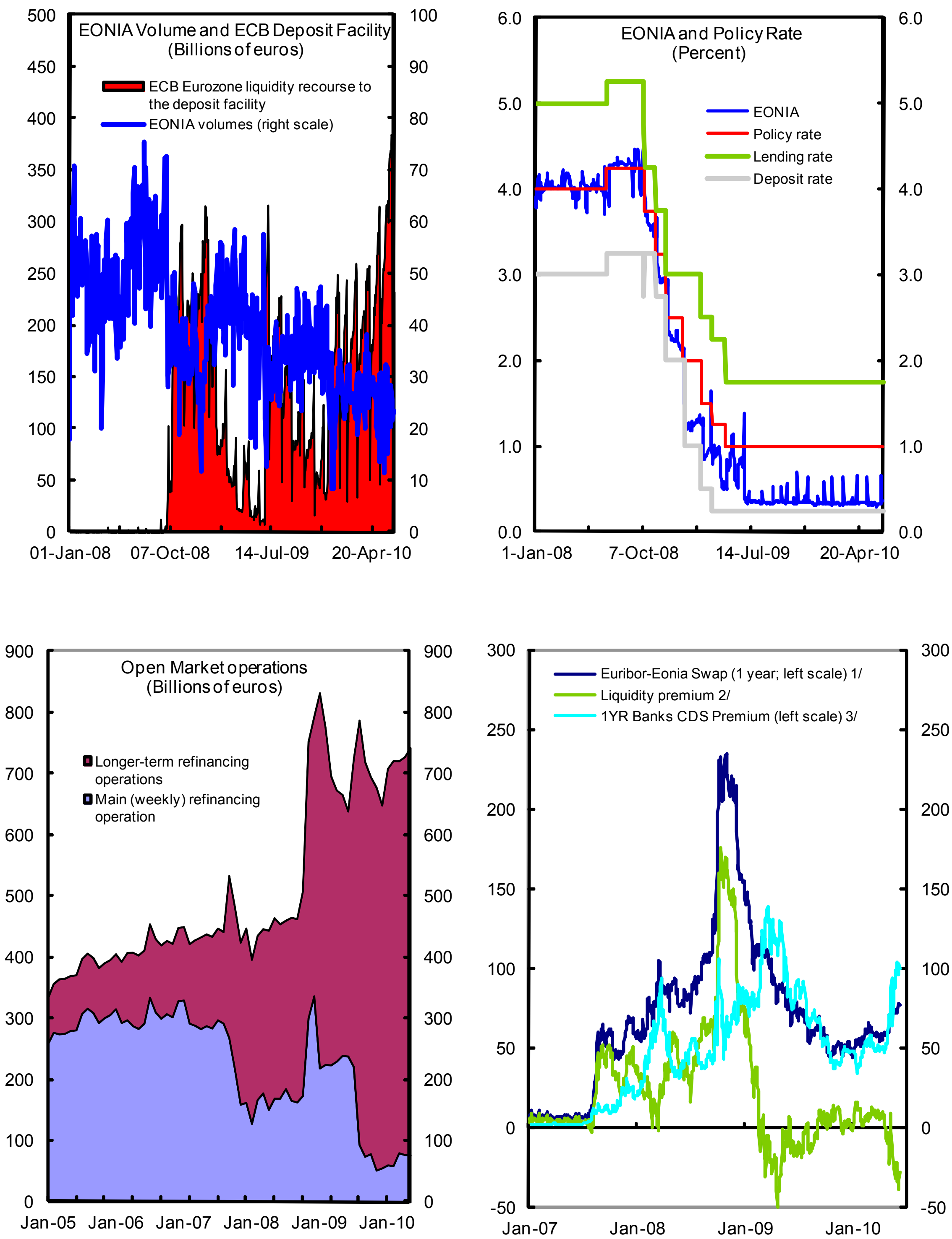
Sources: Eurostat; ECB; and Haver Analytics.
1/ Excludes energy, food, alcohol, and tobacco.

Figure 7. Euro Area: Monetary Policy and Market Expectations
(Percent, unless otherwise specified)



Sources: Bloomberg; Datastream; ECB; Eurostat; and IMF staff calculations.
1/ Survey of Professional Forecasters.

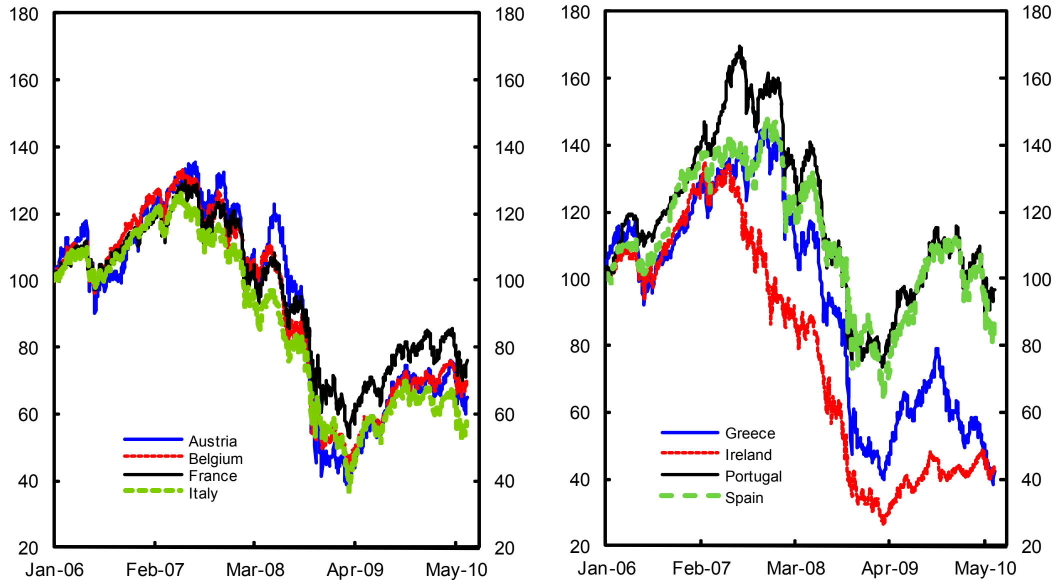
Figure 8. Euro Area: Recent Developments of the ECB's Liquidity Operations



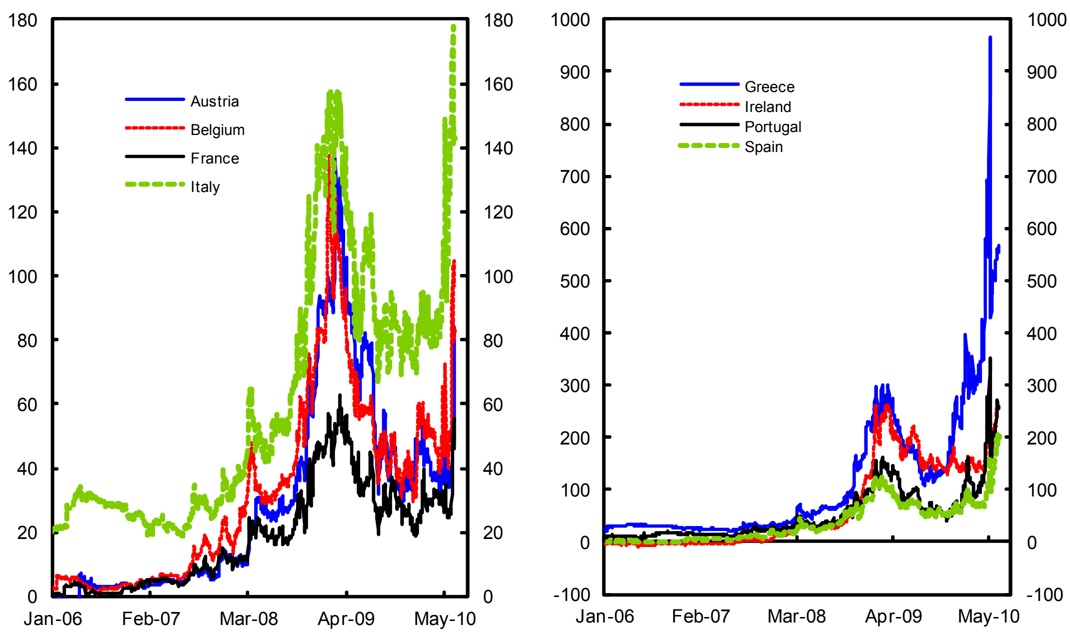
Sources: DataStream; and Bloomberg.
1/ Euribor refers to "the best price between the best banks" provided by Euribor panel members.
2/ The liquidity premium is the difference between the Euribor - Eonia Swap spread and the CDS premium.
3/ The one-year banks CDS premium is the average of premia for the "best" five Euribor panel banks out of 24 with the lowest premium.

Figure 9. Financial Indicators in Selected Euro-area Member States

Stock Markets
(Jan.1,2006=100)

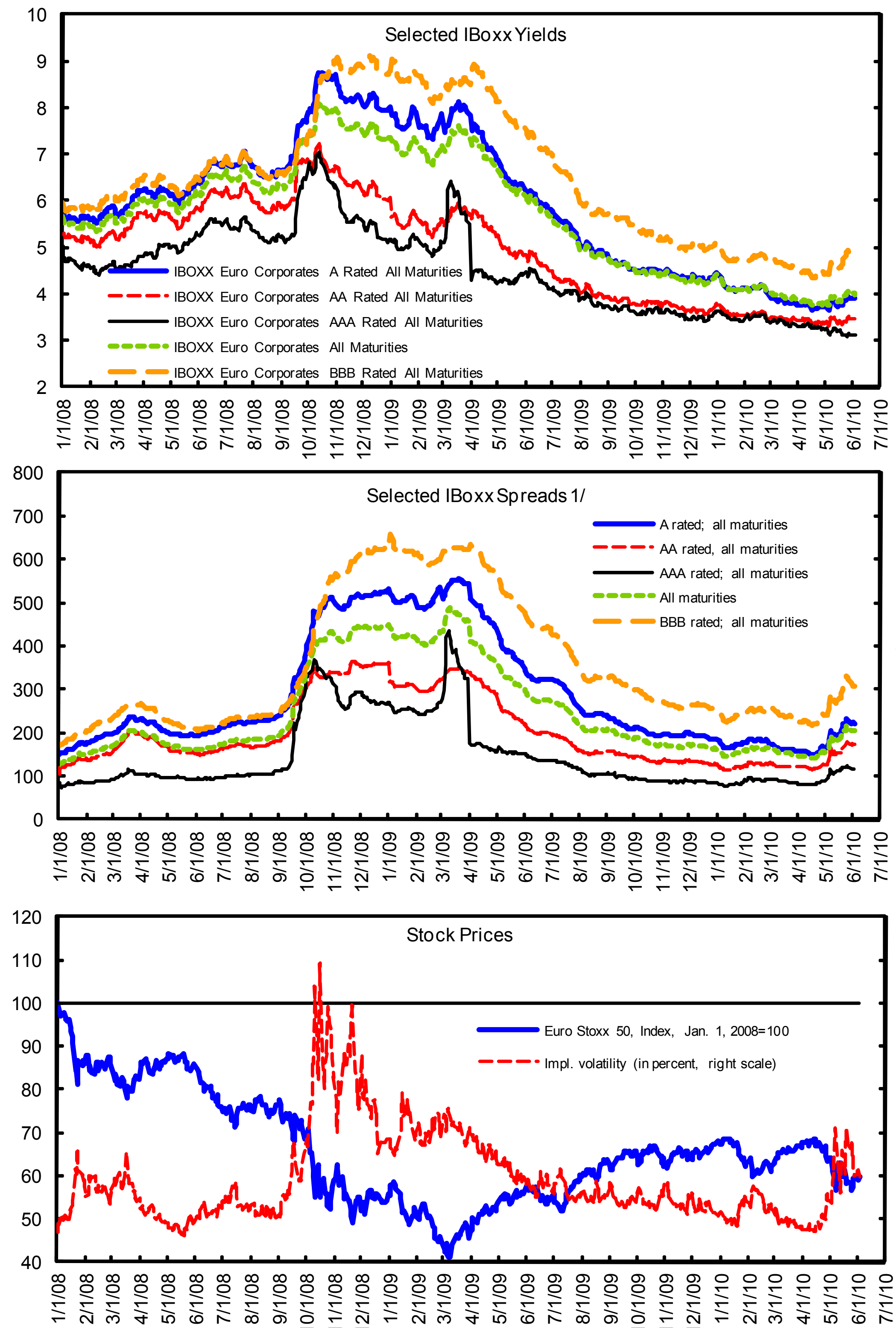


10-year spreads with German Bund
(Basis points)



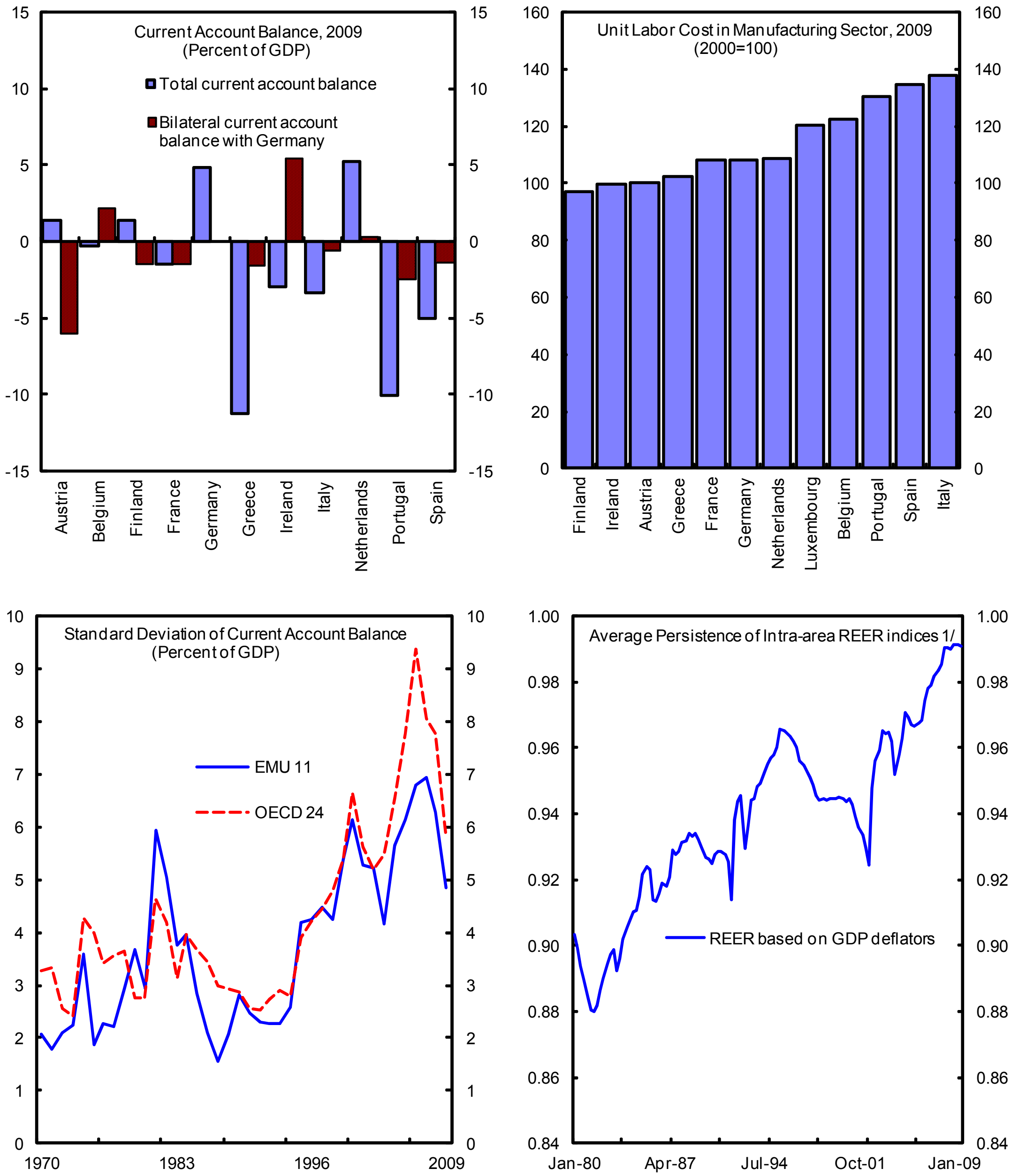
Sources: Bloomberg, Datastream and IMF staff calculations.

Figure 10. Euro Area Financial Indicators: Corporate Bond Rates and Equities
(Yields in percent, spreads in basis points)



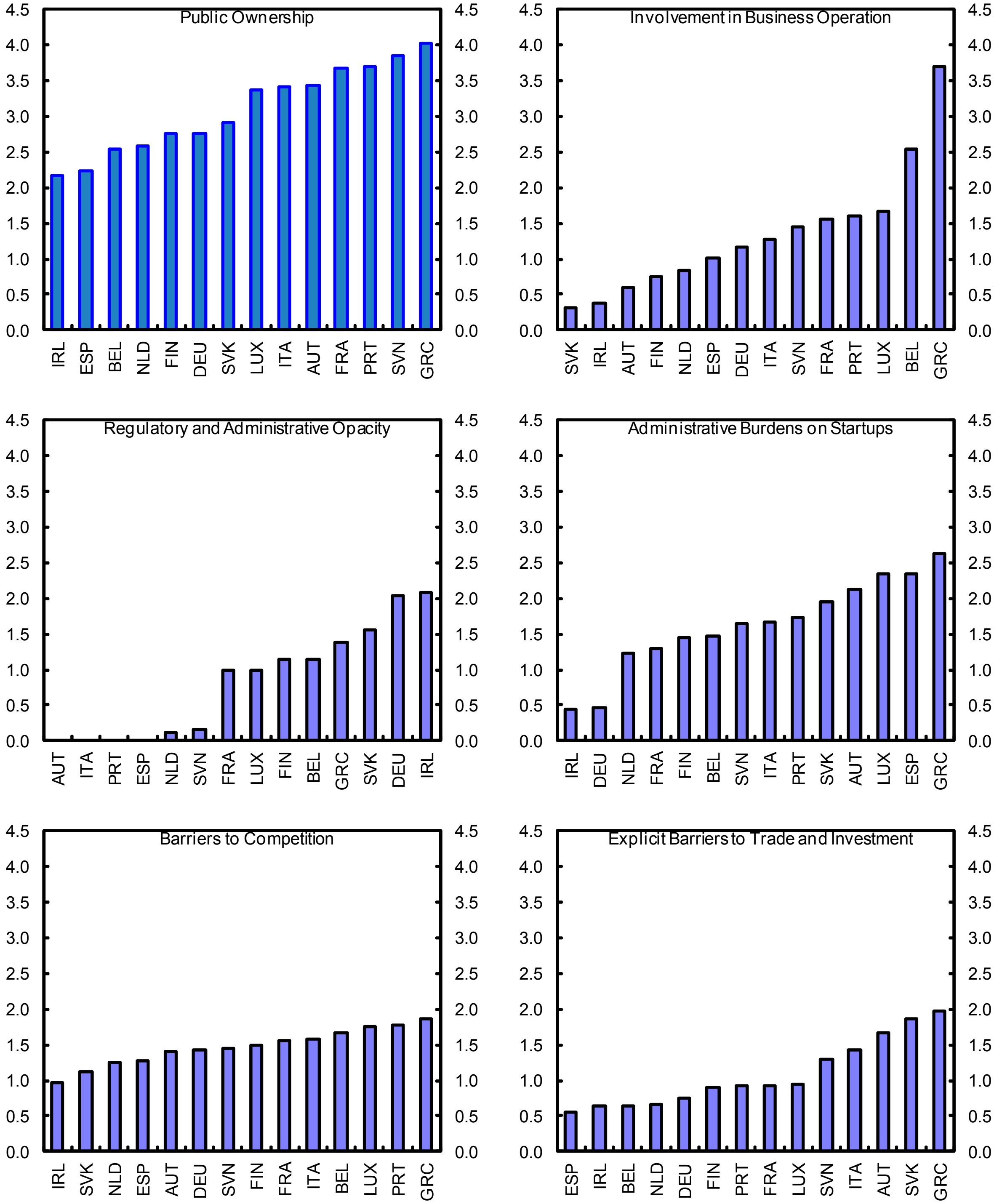
Sources: DataStream; and Bloomberg.
1/ IBoxx corporate bond rates over German benchmark bond yields.

Figure 11. Intra Euro Area Imbalances



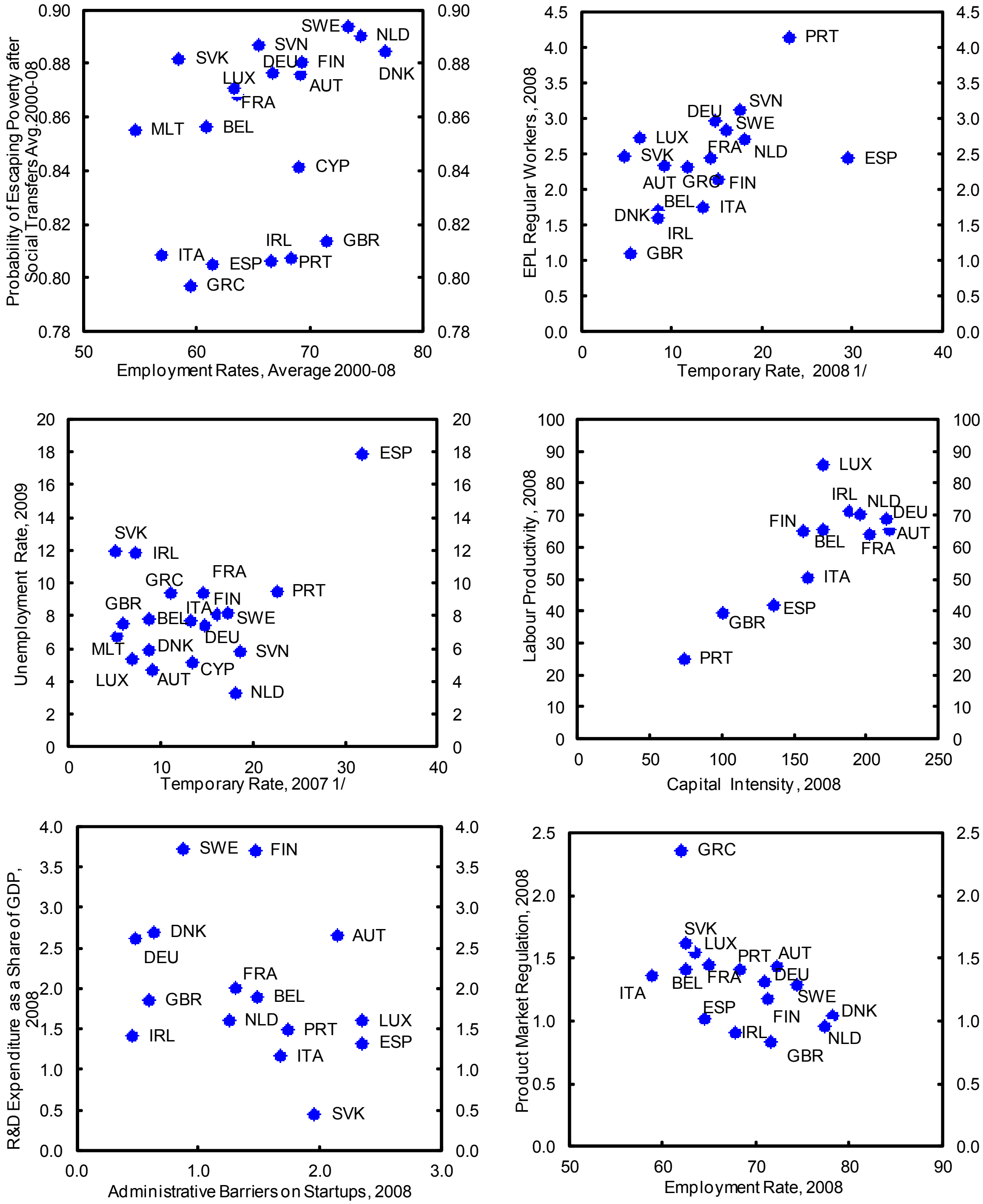
Sources: Bundesbank; Price and cost competitiveness indicators; European Commission; DG ECFIN; IMF, *World Economic Outlook* and staff calculations.
1/ The average persistence of intra-area REER indices is calculated as the average across member states of first-order autocorrelation coefficients of intra-area REER indices based on GDP deflators.

Figure 12. Euro Area Countries: Components of the Product Market Regulation Indicator



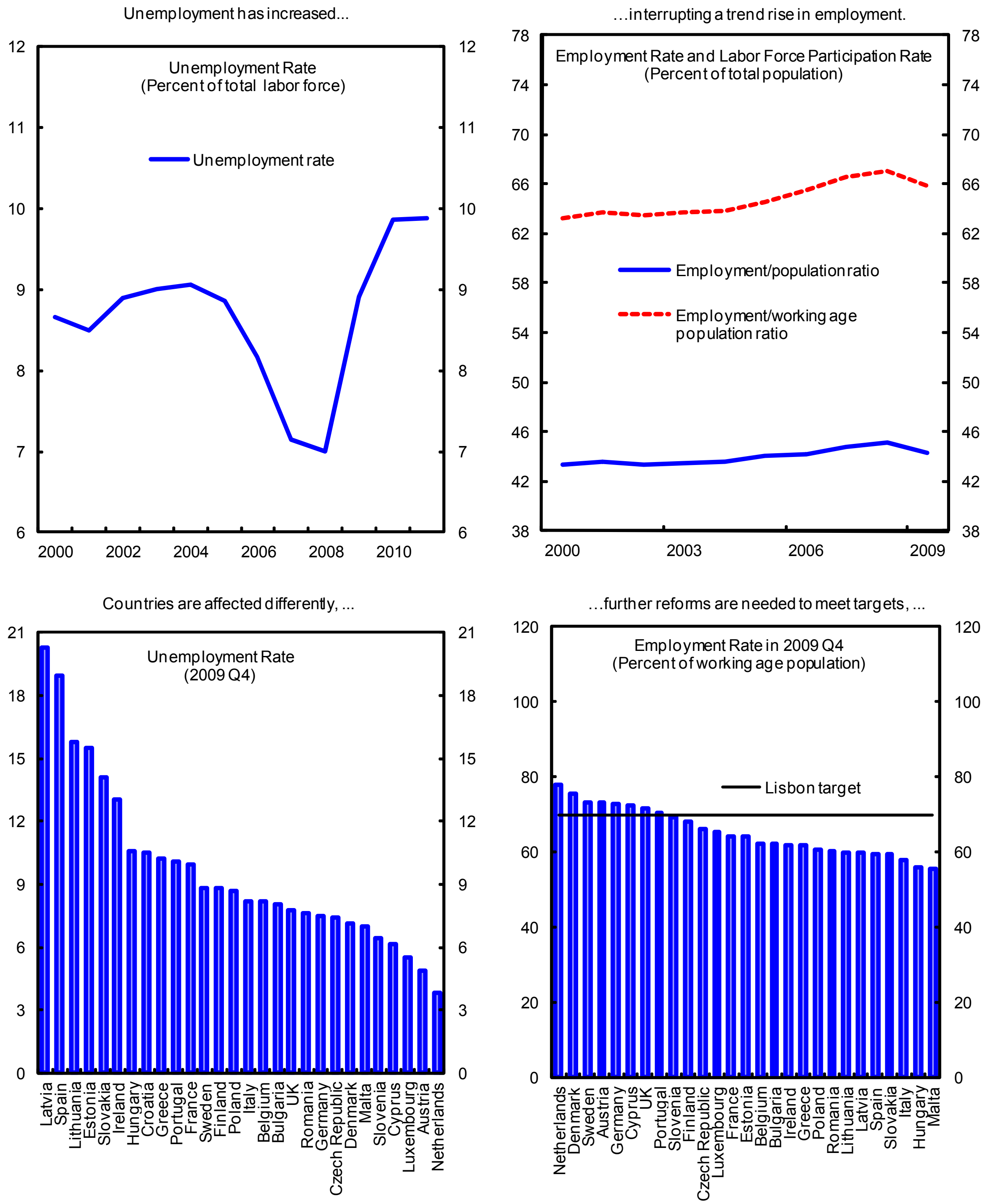
Source: OECD, Product Market Regulation Indicators, Intermediate Subdomains.

Figure 13. Euro Area Countries: Structural Indicators



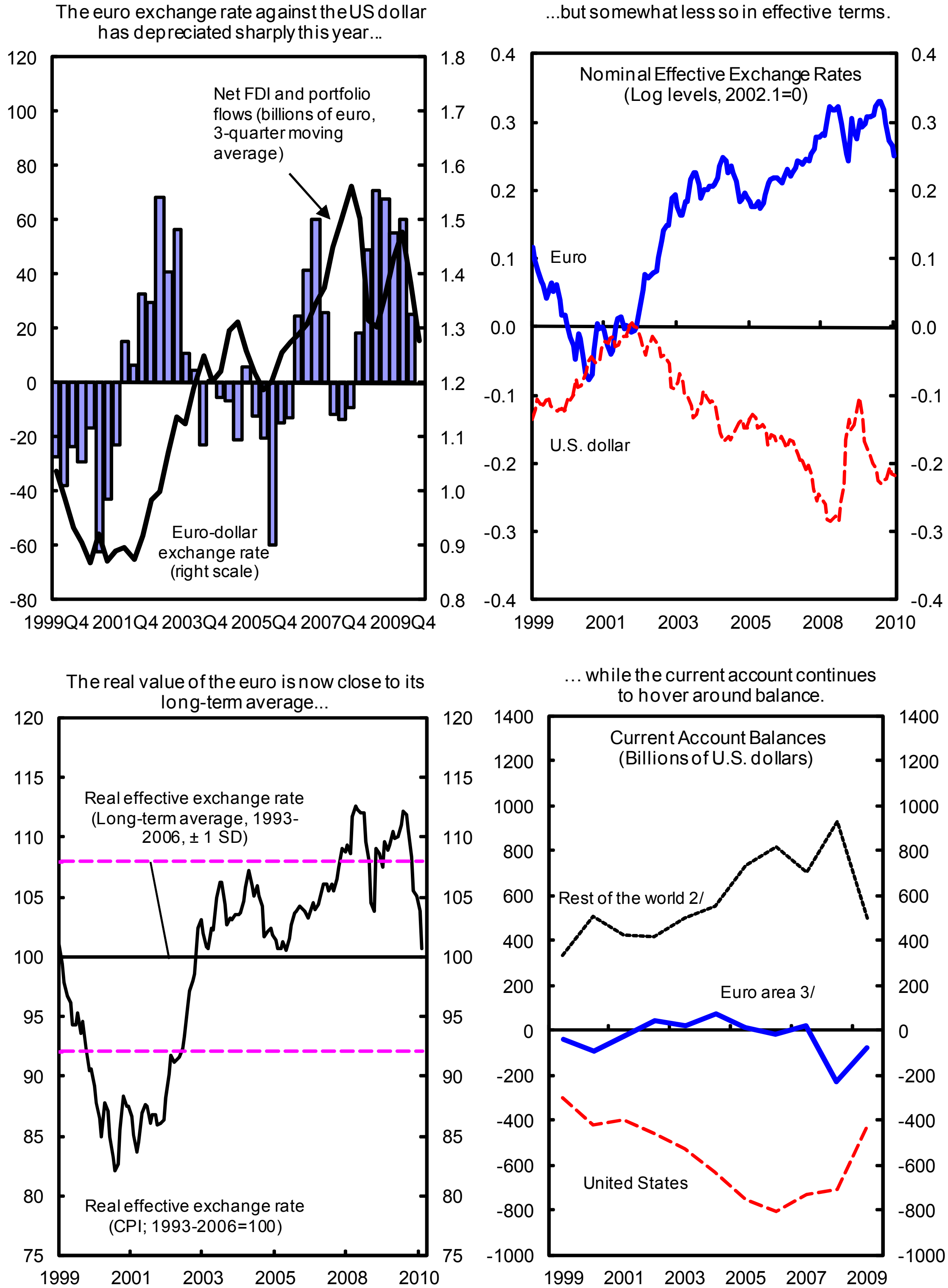
Sources: EuroStat, AMECO, ECD and IMF staff calculations
1/ Temporary rate is the share of temporary workers in total employment.

Figure 14. European Union: Labor Markets and Structural Reform



Sources: OECD; Eurostat; Fraser Institute; Haver; and IMF staff calculations.

Figure 15. Euro Area: External Developments



Sources: ECB; Haver Analytics; and IMF, *World Economic Outlook*.

1/ Staff estimate, based on a time series estimate with stochastic trend, a macroeconomic balance approach, and an external sustainability assessment.

2/ Rest of the world calculated as residual (excludes global discrepancy).

3/ Excludes intra-area trade (ECB data).

Table 1. Euro Area: Main Economic Indicators
(Percent change)

	2005	2006	2007	2008	2009	2010	2011	2012
						Staff projections		
Demand and Supply								
Real GDP	1.7	3.0	2.8	0.6	-4.1	1.0	1.3	1.8
Private consumption	1.8	2.0	1.6	0.3	-1.2	0.0	0.7	1.3
Public consumption	1.6	2.1	2.3	2.2	2.6	1.0	0.1	0.3
Gross fixed investment	3.2	5.4	4.7	-0.6	-10.9	-2.1	1.2	2.9
Final domestic demand	2.1	2.8	2.4	0.5	-2.6	-0.3	0.7	1.4
Stockbuilding 1/	-0.2	0.1	0.0	0.1	-0.9	0.7	0.2	0.0
Domestic Demand	1.9	2.9	2.4	0.6	-3.4	0.3	0.8	1.4
Foreign balance 1/	-0.2	0.1	0.4	0.0	-0.7	0.6	0.6	0.4
Exports 2/	5.1	8.5	6.3	1.0	-13.3	6.4	3.7	4.1
Imports 2/	5.8	8.5	5.5	1.0	-12.0	5.0	2.4	3.3
Resource Utilization								
Potential GDP	1.7	1.7	1.6	1.4	0.3	0.7	0.8	0.9
Output gap	-0.4	0.8	2.0	1.1	-3.3	-3.1	-2.6	-1.8
Employment	1.0	1.6	1.7	0.7	-1.9	-1.1	-0.2	0.6
Unemployment rate 3/	9.0	8.4	7.5	7.6	9.4	10.2	10.4	10.1
Prices								
GDP deflator	2.0	2.0	2.4	2.3	1.0	0.8	1.2	1.5
Consumer prices	2.2	2.2	2.1	3.3	0.3	1.2	1.3	1.5
Public Finance 4/								
General government balance	-2.5	-1.3	-0.6	-2.0	-6.3	-6.6	-5.7	-5.1
General government structural balance	-2.7	-2.1	-1.7	-2.6	-4.4	-4.7	-3.8	-3.6
General government gross debt	70.1	68.3	66.0	69.5	79.0	84.7	88.2	90.3
Interest Rates 3/ 5/								
EURIBOR 3-month offered rate	2.2	3.1	4.3	4.6	1.2	0.7	…	…
10-year government benchmark bond yield	3.4	3.9	4.3	4.4	4.0	3.7	…	…
Exchange Rates 5/								
U.S. dollar per euro	1.24	1.26	1.37	1.47	1.39	1.26	…	…
Nominal effective rate (2000=100)	126.6	127.0	132.3	138.8	140.6	128.0	…	…
Real effective rate (2000=100) 6/	121.3	120.6	124.2	128.2	128.9	115.8	…	…
External Sector 4/ 7/								
Current account balance	0.1	-0.1	0.2	-1.7	-0.6	0.2	0.4	0.4

Sources: IMF, *World Economic Outlook;* Global Data Source; DataStream; Eurostat; and ECB Monthly Bulletin.

1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ Latest available data for 2010.
6/ CPI based.
7/ Based on ECB data, which excludes intra-euro area flows.

Table 2. Euro Area: Balance of Payments

	2002	2003	2004	2005	2006	2007	2008	2009
				(Billions of euros)				
Current account	46.0	20.9	61.6	11.7	-10.0	13.6	-153.8	-55.9
Goods	121.8	98.7	95.6	43.6	10.7	47.8	-19.0	39.6
Services	16.9	22.5	32.1	38.7	41.7	49.5	41.3	31.2
Income	-43.7	-44.8	-6.3	2.5	17.2	3.0	-76.6	-38.0
Current transfers	-49.1	-56.1	-59.5	-73.4	-79.7	-87.0	-99.5	-88.5
Capital account	10.9	12.2	16.6	11.7	8.9	5.1	9.8	7.9
Financial account	-13.4	-14.1	-80.6	-37.6	-9.6	-10.7	163.3	45.5
Direct investment	22.6	-9.7	-79.6	-205.7	-160.3	-73.8	-198.6	-95.7
Portfolio investment	138.0	54.4	44.0	108.5	188.8	151.6	344.2	317.8
Equity	46.2	32.8	-2.3	105.0	90.6	103.5	-3.0	93.3
Debt instruments	91.9	21.4	46.6	3.5	98.1	48.3	347.3	224.6
Financial derivatives	-12.2	-13.7	-8.2	-17.3	-0.7	-63.8	-62.4	40.0
Other investment	-159.3	-72.8	-49.0	59.5	-36.0	-19.6	83.6	-221.2
Reserve assets	-2.5	28.0	12.6	18.2	-1.1	-4.9	-3.4	4.6
Errors and omissions	-43.5	-18.9	2.5	14.1	10.5	-8.1	-19.2	2.7
				(Percent of GDP)				
Current account	0.6	0.3	0.8	0.1	-0.1	0.2	-1.7	-0.6
Goods	1.7	1.3	1.2	0.5	0.1	0.5	-0.2	0.4
Services	0.2	0.3	0.4	0.5	0.5	0.5	0.4	0.3
Income	-0.6	-0.6	-0.1	0.0	0.2	0.0	-0.8	-0.4
Current transfers	-0.7	-0.7	-0.8	-0.9	-0.9	-1.0	-1.1	-1.0
Capital account	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Financial account	-0.2	-0.2	-1.0	-0.5	-0.1	-0.1	1.8	0.5
Direct investment	0.3	-0.1	-1.0	-2.5	-1.9	-0.8	-2.1	-1.1
Portfolio investment	1.9	0.7	0.6	1.3	2.2	1.7	3.7	3.5
Equity	0.6	0.4	0.0	1.3	1.1	1.1	0.0	1.0
Debt instruments	1.3	0.3	0.6	0.0	1.1	0.5	3.7	2.5
Financial derivatives	-0.2	-0.2	-0.1	-0.2	0.0	-0.7	-0.7	0.4
Other investment	-2.2	-1.0	-0.6	0.7	-0.4	-0.2	0.9	-2.5
Reserve assets	0.0	0.4	0.2	0.2	0.0	-0.1	0.0	0.1
Errors and omissions	-0.6	-0.3	0.0	0.2	0.1	-0.1	-0.2	0.0
Memorandum items:								
GDP (billions of euros)	7,324.5	7,546.3	7,855.4	8,146.2	8,553.6	9,002.0	9,264.8	8,986.9
Reserves of the eurosystem 1/ (billions of euros)	366.1	306.7	281	320.1	325.8	347.2	374.2	462.4

Source: ECB.

1/ End of period stocks.

Table 3. Labor and Product Market Reform Country-Specific Reform Priorities

Country	Recommendations
Genaral recommendations to all euro-area members	Reduce disincentives to work at older ages
Belgium	Reduce the tax burden on labor (financed by lowering government spending and tax expenditures); reduce replacement rates (especially for the long-term employed) and improve enforcement of job-search requirements for the unemployed; mprove competition in services (gas and electricity markets, ease regulation in the retail sector).
Germany	Improve competition in services (improve public procurement procedures, facilitate entry into network industries, abolish the compulsory membership in associations for liberal professions); relax regular EPL; strengthen the conditionality of unemployment benefits on willingness to take up work.
Spain	Reduce labor market dualism: reduce the gap in protection between permanent and temporary workers. Lower severance payments for permanent contracts and incentivize the transition from fixed-term to open-ended contracts by increasing dismissal costs gradually with tenure length; allow firm level agreements to prevail upon collectively bargained wages at higher levels and eliminate indexation; encourage job search by removing the permanent increase in unemployment benefit duration adopted in 2009; further reduce restrictions on retail trade , professional services and the rental market.
France	Ease regular EPL (simplify firing laws); reduce minimum wages; improve competition in the retail sector; undo the permanent increase in the duration of unemployment benefits adopted during the crisis.
Italy	Reduce the tax wedge on labor income (financed by improved tax enforcement); reduce state involvement in business by accelerating privatization and abolishing golden shares, especially in electricity, gas, post and transport, and enterprises that provide local services; decentralize wage bargaining taking into account regional differences in productivity; enhance the efficiency of public services (cut red-tape at all levels of Government).
Netherlands	Increase participation of second earners (remove the right for non working partners in single-earner couples to transfer their general tax credit to the primary earner) and working time of women; increase participation of older workers; promote competition in retail distribution services; ease EPL for regular
Ireland	Increase competition in the utilities and services sectors; reduce replacement rates for the long-term employed.
Austria	Lower marginal tax rates on labor income (financed by broadening the tax base and reducing tax allowances); remove barriers to competition in professional services and retail trade; further reduce
Finland	Reduce high marginal tax rates on labor across the income distribution (financied by switching from labor to property taxes); reduce replacement rates for the long-term unemployed, use stricter activation requirements to taper benefits over the unemployment spell; reform the wage setting system so that wages are better aligned with productivity performance in non-tradables.
Portugal	EPL reforms undertaken in 2008 (must be fully enforced; simplify the administration of the tax system, broaden the tax bases and reduce tax expenditures; reduce unemployment benefits' replacement rates; reduce barriers to competition in network industries (telecommunications, electricity and transport).
Luxembourg	Ease EPL by simplifying dismissal rules; reduce barriers to competition in professional services by easing conduct regulation and lowering licencing and education requirements; improve job-search incentives by tightening eligibility conditions for unemployment benefits and reducing replacement rates; eliminate automatic backward-looking wage indexation over time.

Source: IMF staff based on European Commission, OECD, and IMF recommendations.

Note: The policy priorities for Greece are spelled out under the structural conditionality included in the request for the stand-by agreement. The structural recommendations addressed by international organizations to the recent EMU joiners of Cyprus, Malta, Slovenia and the Slovak Republic are not included in the table, as they were found to be less systematic than for the remaining euro-area countries.

APPENDIX I—STATISTICAL ISSUES

Statistics for the euro area (and the EU-27) are produced by Eurostat,1 in conjunction with national statistical agencies within the European Statistical System (ESS), and the ECB, working with national central banks within the Eurosystem/ESCB.[2] These statistics are of sufficient quality, scope, and timeliness to allow effective macroeconomic surveillance, thanks to major progress made since the introduction of the euro. However, the financial crisis has generated a number of challenges for official statistics. Recent ongoing developments and desirable improvements include:

- *ESS governance:* The new statistical governance structure for the ESS was put in place in 2009. The Regulation on European Statistics[3] strengthens the European Statistical System Committee (ESSC), which acts as an umbrella committee of the ESS, the European Statistical Advisory Committee (ESAC), and the European Statistical Governance Advisory Board (ESGAB). The new regulation strengthens Eurotat's role as a coordinator of statistical activities at EU level and National Statistical Institutes at national level.

- *Impact of the crisis on official statistics:* In addition to statistics related to the financial crisis at national and EU level, the Interagency Group on Economic and Financial Statistics with the participation of the IMF, BIS, Eurostat, ECB, World Bank, and UNSC has started the process of setting up a set of *global indicators* building on the European concept of PEEIs (Principal European Economic Indicators). Discussions at the international level center on the extension of the PEEIs, the improvement of techniques to identify turning points and the development of an integrated view of business cycles, growth cycles and acceleration cycles. At EU level, an ESS Action Plan on the accounting consequences of the financial crisis was created to ensure the consistency across time and countries of the statistical treatment of bank and other support operations in full respect of the ESA95 rules.

- *Public finance statistics–actions to tackle statistical and governance issues in Greece:* Efforts focus on the improvement of fiscal and other public sector reporting by Greece. Working closely with Eurostat, the government has started to take

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[1] Eurostat has introduced a new, more user-friendly website. See: http://epp.eurostat.ec.europa.eu/. The ECB has maintained a statistical data warehouse for euro area and related national statistics. See http://sdw.ecb.europa.eu/. The division of tasks between both statistical systems has been spelled out in a Memorandum of Understanding (http://www.ecb.europa.eu/ecb/legal/pdf/en_mou_with_eurostat1.pdf).

[2] Notably in the field of national accounts and government finance statistics, a consensus was reached on Eurostat decisions thanks to the work done in common with national statisticians on a regular basis through task forces, working groups and committees (National Accounts Working group, Financial Accounts Working Group, Committee on Monetary, Financial and Balance of Payments statistics, and GNI Committee).

[3] Regulation No. 223/2009 of the European Parliament and of the Council, published in the Official Journal of the European Union on March 31, 2009.

measures to prevent the recurrence of under- and misreporting problems and designed jointly with the European Commission an action plan to address outstanding statistical issues. Full independence has been granted to the Greek Statistical Office and its resources increased to improve statistical systems and seek appropriate technical assistance to ensure rapid progress. To that end, the measures in the joint Greek government and European Commission Statistical Action Plan will be fully implemented. Since January 2010, timely monthly central government budget reports on a cash basis have been published. The General Accounting Office (GAO) will also start publishing monthly data on expenditures pending payments, including arrears. Efforts will also be intensified to improve the collection and processing of general government data compiled according to ESA.

- *Public finance statistics–Audit powers by Eurostat over EDP-related statistics:* The problems faced in Greece go well beyond what can be tackled using only the statistical monitoring tools available to the Commission, which according to the Council Regulation 479/2009 does not have audit powers[4]. To remedy this, the ECOFIN Council agreed legislation to give Eurostat audit powers over Member States' national finances. In specific cases where significant risks or problems with the quality of data have been clearly identified, Eurostat officials will have the right to see data from every level of government on execution of national budgets and the accounts of corporations, non-profit institutions and other bodies that are part of the general government sector. It is now essential that Member States take all necessary measures to facilitate the Eurostat officials' work.

- *Public finance statistics–statistical consequences of the European Financial Stabilization Mechanism (EFSM)*: From a statistical perspective, it will be important to analyze the treatment of the special purpose vehicle that will be at the center of this mechanism, in light of the international methodologies. The potential impact of the activity of the EFSM on the fiscal data of both the Member States and the European Aggregates (EU-27 and Euro Area) should also be assessed.

- *Public finance statistics–stock-flow adjustment (SFA):* the main factors contributing to changes in government debt other than government deficits are being closely monitored by Eurostat in the context of regular quality checks of the EDP data. A considerable increase of SFAs was observed in the EU in 2008 and 2009, reflecting the reactions of Member States governments to the financial crisis. However, in Eurostat's view, SFAs have generally legitimate explanations and the fears that

[4] Following the "Greek case" in 2004, and a request by the Council to strengthen the monitoring of the quality of the reported fiscal data, the Commission proposed amendments to the existing framework for the quality of EDP data, in particular, the establishment of in-depth monitoring visits and the requirement for Member States to promptly provide Eurostat with access to the information required to assess data quality of the EDP-related statistics. Council Regulations 2103/2005 and 479/2009 granted Eurostat strengthened control powers, though more limited than initially requested by the Commission.

governments may have an incentive in underreporting their deficits to comply with the EDP by reporting transactions under the SFA, seem unjustified. Moreover, the deficit revisions that would result from a reclassification of operations on financial derivatives would be limited.

- *Long-term sustainability and quality of public finances:* Member States and Eurostat should further step their efforts in the provision and dissemination of detailed data on government expenditure by function (COFOG level II data), especially in those areas relevant to the analysis of the quality of public finances and the allocation of Structural Funds. In the area of pension schemes, one novelty of the 2008-SNA concerns the comprehensive recording of pension entitlements accrued by households. A revision of ESA to include a specific chapter on social insurance systems is underway that will show the pension entitlements and the related transactions for all pension schemes including for social security contributions schemes. In the absence of legal regulations, a fully-fledged release of data is only targeted by 2014. Regarding demographic projections, as requested by the ECOFIN Council, comparable population projections should be available by autumn 2012, as requested by the ECOFIN Council. These projections will be used by the Economic Policy Committee (EPC) to estimate the budgetary implications of ageing.

- *Labor market statistics:* A major quality review of the European LFS was conducted in 2008-09 resulting in improvement recommendations. It is now important that Member States follow up on this work; implementation plans are being discussed with them.

    - While the relevance of the ILO concept is confirmed, there is agreement on the need for supplementary indicators of underemployment and labor potential outside the labor force to supplement the ILO unemployment rate.

    - The timeliness of the EU-LFS survey can be improved. This would further enhance its relevance for short-term economic analysis. For this purpose, it is essential that the twelve-week deadline in the Regulation (Council Regulation 1897/2000) is considered to apply for the final data transmission.

    - Regarding the coherence between LFS and national accounts employment estimates, the key priority in this regard is to distinguish between differences in coverage, scope and definitions from inconsistencies that can be ascribed to the accuracy of the different statistics. For this purpose the Task Force recommended the use of reconciliation tables between LFS and National Accounts estimates.

    - The PEEIs of the labor market include monthly unemployment, the Labor Cost Index (LCI), quarterly employment (National Accounts) and quarterly job vacancy statistics. Member States are encouraged by Eurostat to explore options to derive monthly unemployment estimates exclusively from the LFS, as well as to move to quarterly rotational designs in the LFS with a view to facilitating the release of information on transition processes. Although a version of the LCI without bonuses would be welcome this is not conceived as a priority for the time being.

- *Productivity data:* the EU KLEMS project is meant to evolve from a research driven project to an ESS project. Eurostat has set up actions (grants) to co-finance projects for the implementation of statistical modules for EU KLEMS in Member States. At the same time, Eurostat has started to explore the possible synergies between national accounts, labor market statistics and productivity data. For instance, additional resources are being devoted to the compilation of Input/Output tables for the euro area. Furthermore, in line with the greener and sustainable objective established in the Europe 2020 strategy, avenues to reorient the project to a broad multifactor productivity perspective with an environmental dimension are being explored. Member States should continue to enhance their efforts to improve the statistical basis for multifactor productivity analysis.

- *Short-term business statistics (STS):* the changeover to NACE rev. 2 is proceeding as planned. The adoption of the new classification will nevertheless result in shorter series for services activities for which data are not available at the required level of disaggregation. Efforts are being stepped up to coordinate the release calendar for STS to improve the stability of EU aggregates. Concerns remain about the application of conventional seasonal adjustment techniques at turning points. Regarding the Service Producer Price Indices (SPPI), only 12 out of the required 17 series are available for EA16 at this stage, with some big euro-area members being behind schedule. Timeliness of STS statistics improved in the last years, in particular for PEEIs-related STS. Nevertheless some releases still lag US dissemination dates.

- *Housing indicators:* the crisis has shown that the need to develop housing indicators. Pilot projects with the National Statistical Institutes currently underway should provide the necessary data for a possible inclusion of owner-occupied housing into the HICP and harmonized house price index data at the European level. Eurostat is preparing a legal act to insure the continuation of the project beyond its pilot phase and lead to the inclusion of quarterly House Price Indices in the list of PEEIs.

- *International trade statistics:* The new Intrastat Regulations reduce the reporting burden for traders, strengthen quality requirements and introduce new statistics by business characteristics. The revised Extrastat Regulations adapt the compilation of external trade statistics to the new Customs environment and introduce new data elements (e.g. nature of transaction, Member States of destination/actual exports, currency of transaction with countries outside the euro area, etc.). A new concept of "economic ownership" will bring in line External Trade statistics with Balance of

Payments and National Accounts and improve the recording of specific goods and movements.

- *Europe 2020:* Eurostat is involved in the methodological work around the EU headline targets of the Europe 2020 strategy (employment rate, R&D investment, climate and energy, education and social inclusion). Ongoing discussions center on the choice of relevant indicators to measure social inclusion–by combining indicators of relative and absolute poverty and the measurement of innovation to complement the R&D indicator under Europe 2020.

- *Cross-cutting issues:* The implementation of the revised ESA based on the System of National Accounts 2008-SNA is planned for 2014, requiring a Commission proposal covering methodological issues and a Transmission Program this year. The required improvements include the effective transmission of (financial and non-financial) balance-sheet data and data on pension schemes and R&D. In terms of timeliness, Eurostat is moving toward a "30-60-90" approach: publishing flash data after 30 days, European aggregates and the main income, expenditure and output components after 60 days; and the sectoral and financial sector accounts after 90 days.

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

Staff Report for the 2010 Article IV Consultation with Member Countries

Supplementary Information

Prepared by the European Department

Approved by Ajai Chopra and Martin Muhleisen

July 14, 2010

1. This supplement provides an update of economic and policy developments since the release of the staff report (7/1/10). The thrust of the staff appraisal remains unchanged. Also attached is a draft background section of the Public Information Notice (PIN).

2. **Recent data confirm a continuing recovery with heightened downside risks.** Real activity has so far weathered the financial tensions in the euro area, with production and orders data improving and the rise of unemployment decelerating (Figure 1). Developments have been mixed across countries, however, and average gains in production have recently moderated. Business and consumer confidence indices deteriorated markedly in May. Annual inflation fell to 1.4 percent in June, after 1.6 percent in May.

3. **After falling sharply against major currencies, the euro exchange rate has appreciated in recent weeks, but remains more volatile than usual.** Improved investor sentiment has helped the euro move up from its trough of early June. In real effective terms, the euro is close, if marginally above its long-term average. The external current account is near balance, not far from an expected small surplus in the medium term. In the current environment, assessing the fundamental value of the euro is subject to unusually high uncertainty. With that caveat, the euro exchange rate as of July 13 appears to be close to, if still slightly above its fundamental value as corroborated by recent CGER assessments (see table).

Euro Area Estimates of Euro Overvaluation
(In percent)

Methodology	Overvaluation
Macroeconomic balance	2
Equilibrium exchange rate	8
External Stability	1

Source: Fund Staff estimates

4. **Financial conditions are beginning to stabilize, though tensions remain.** Over the past weeks, financial stocks recovered somewhat from the lows reached in June and credit default spreads of euro-area banks and sovereigns have slightly receded but remain at elevated levels (Figure 2). Greece has managed to issue 6-month T-bills at a yield of 4.65 percent, though long-term rates remain prohibitive. Other countries affected by market tensions have succeeded to issue across the maturity spectrum at acceptable, if somewhat elevated yields.

5. **The redemption of the ECB's first one-year refinancing operation went well and purchases under the SMP have been diminishing.** While the majority of banks did not reapply for

ECB refinancing on July 1, a significant number remain heavily reliant on ECB financing facilities. At its policy meeting on July 8, the ECB reiterated its expectation of moderate inflation in 2011 and left the policy rate unchanged. The total outstanding purchases under the SMP amounted to euro 60 billion on July 9. President Trichet, emphasizing that the ECB remained vigilant, noted that the need for interventions under the SMP seemed to have diminished in view of improved functioning of secondary markets.

6. **The EFSF is set to be fully operational by end July 2010.** The EFSF framework agreement is in force as two thirds of member states have signed off. However, completing the legal procedure for issuing guarantee commitments for at least 90 percent of the total will take until end July, at which point the EFSF will have the authority to issue bonds.

7. **CEBS announced that results of ongoing EU bank stress tests will be released on July 23, 2010.** In line with staff recommendations, the exercise now covers a wider range of institutions than initially envisaged, up from 25 to 91 banks representing 65 percent of the EU banking sector. For now, markets have taken a favorable view of these stress tests, as suggested by the shrinking premium of bank over corporate CDS spreads and a modest reduction in counterparty and liquidity risk indicators (Figure 2). Nevertheless, some uncertainty regarding the stringency of the tests is likely to remain. In another welcome development, several member states extended their bank debt guarantee and recapitalization schemes and some are expected to do so in the coming days.

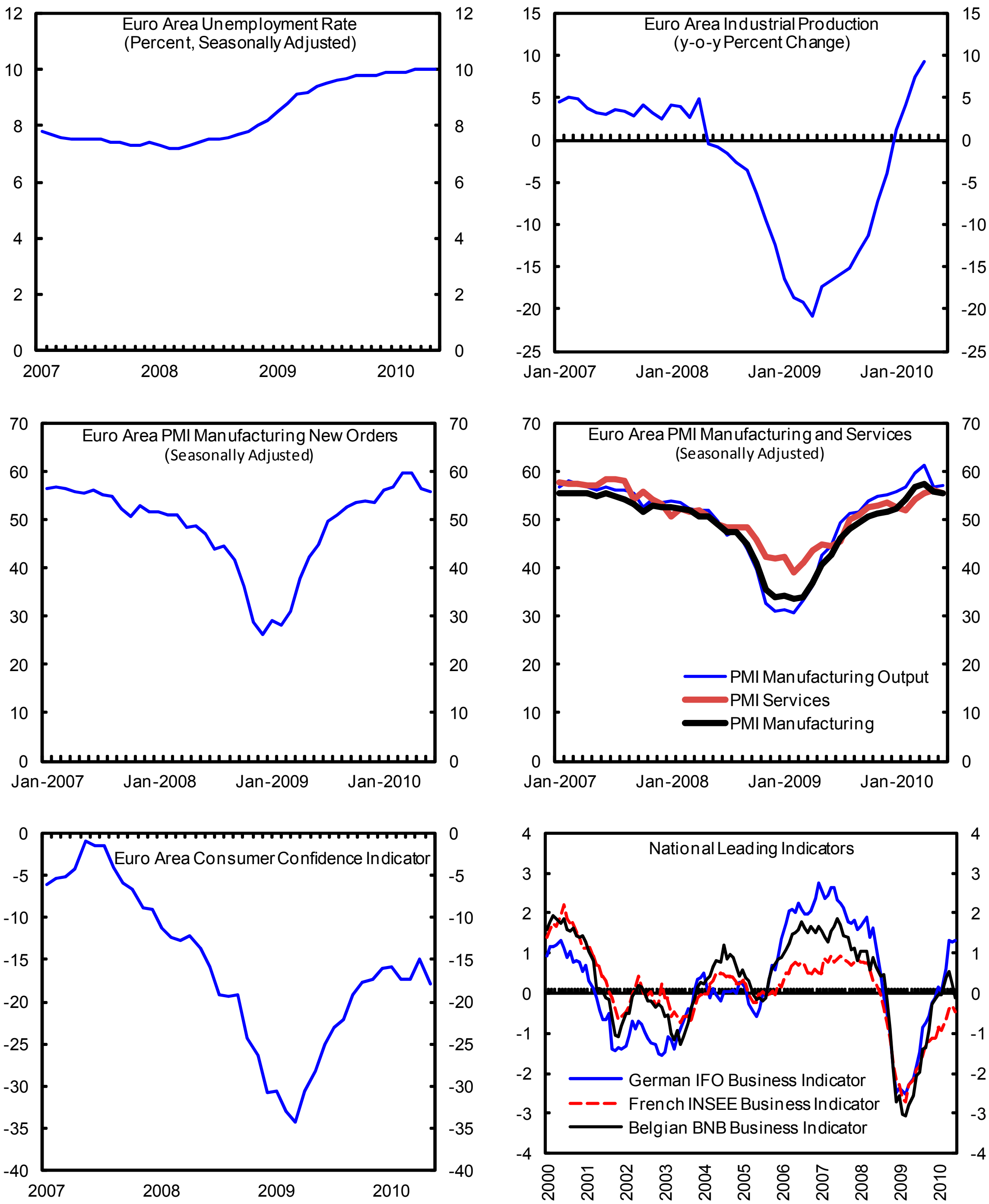
8. **Over the past few weeks, the Commission and the ECB made further contributions to the ongoing debate on the reform of economic governance:**

- The ECB governance proposals, released on June 10, emphasize the quasi-automaticity of sanctions to bolster enforcement of the Stability and Growth Pact, more intrusive ex-ante surveillance of macroeconomic policies, a mechanism modeled after the Excessive (budget) Deficit Procedure to monitor and eventually correct internal (current account) imbalances in the euro area, and a permanent crisis resolution mechanism.

- The Commission Communication of June 30 fleshed out the proposals described in the Staff Report. Most notably, it joins the ECB in proposing binding instruments to correct internal imbalances; and, in line with staff advice, envisages binding minimum benchmarks for national fiscal frameworks, including enforceable rules and better statistics. It also proposes to expand the use of financial sanctions as an enforcement mechanism, including through the suspension of certain *commitments* from the EU budget (e.g. transfers from cohesion funds or CAP reimbursements to national budgets) in case of excessive deficit and an immediate suspension of the related *payments* in case of non-compliance. The July 12 meeting of the Council task force endorsed this approach. The Communication also provides a detailed time line for the early peer review of budget plans and reform programs, on which the ECOFIN Council of July 13, 2010 requested specific implementation proposals.

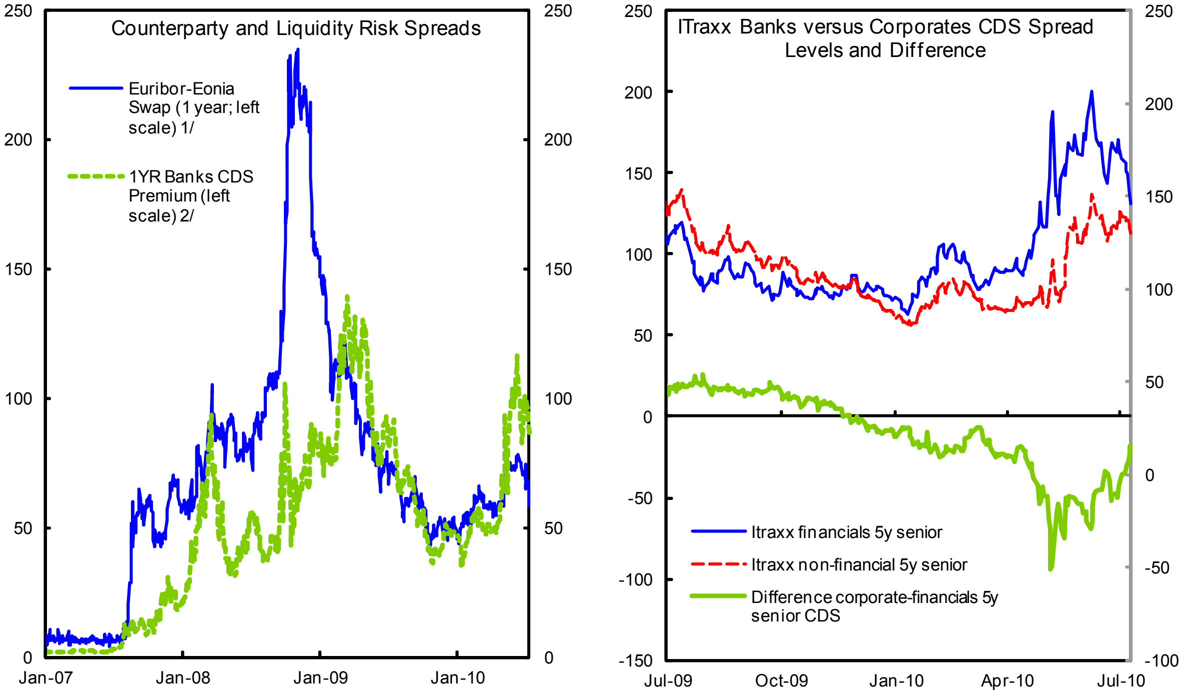
- **Next step.** The Commission will transpose these proposals into draft amendments to secondary legislation by end-September, based on existing Treaty provisions mandating economic policy coordination (Article 121) and authorizing the Council to create new instruments of enhanced coordination in the euro area (Article 136).

Figure 1. Euro Area: Short-term Indicators of Economic Activity

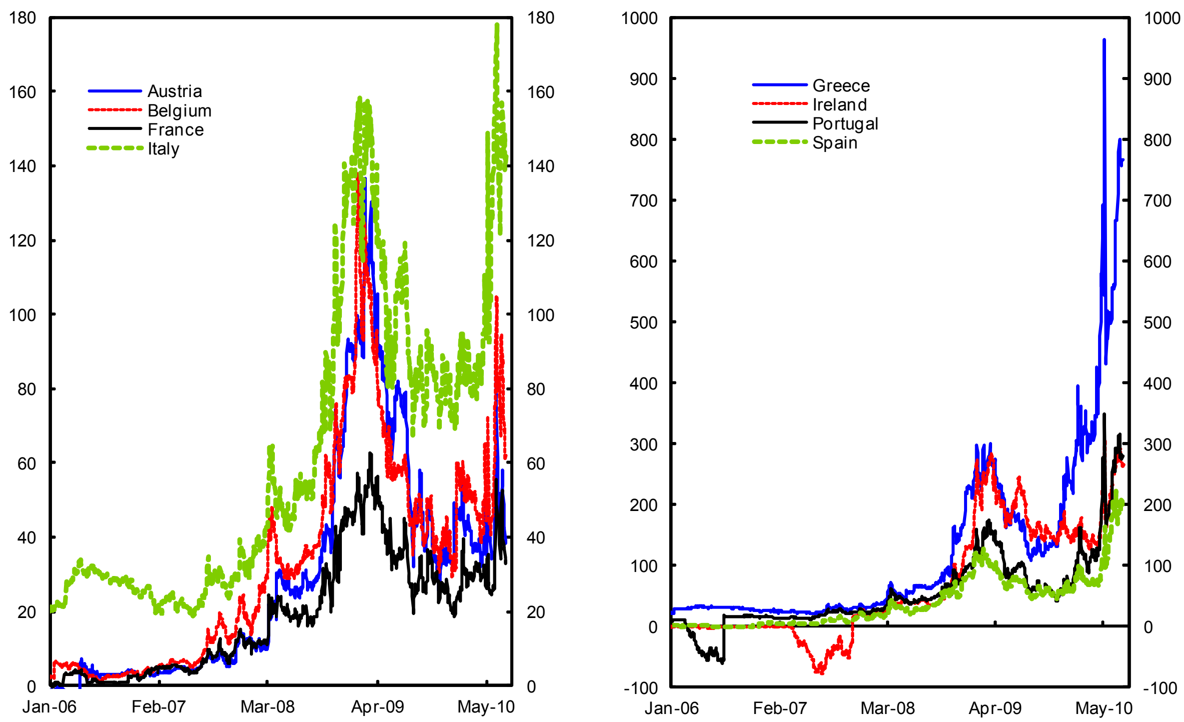


Source: Haver Analytics and Datastream

Figure 2. Euro Area: Financial Indicators



10-year spreads with German Bund
(Basis points)



Sources:DataStream; and Bloomberg.
1/Euribor refers to "the best price between the best banks" provided by Euribor panel members.
2/ The one-year banks CDS premium is the average of premia for the "best" five Euribor panel banks out of 24 with the lowest premium.

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FOR IMMEDIATE RELEASE
July 21, 2010

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

IMF Executive Board Concludes 2010 Article IV Consultation on Euro Area Policies

On July 19, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation on Euro Area Policies.[1]

Background

The euro area's sovereign crisis was largely caused by unsustainable policies in some member countries, which came to a head in early May 2010. Facing increasing turmoil, the ECB stepped up liquidity and credit support aimed at avoiding market instability. New European financing instruments were created to assist EU members facing difficulties in accessing capital markets, but have thus far not been used.

Already prior to the sovereign crisis, the staff expected the euro area to be slow to recover, with headwinds from uncertainty about the strength of the financial system, ongoing deleveraging of private sector balance sheets, and time needed to improve competitiveness, and reallocate resources to tradable sectors in some countries. Furthermore, despite employment-support measures in many countries, uncertainty about job prospects has been weighing on household demand. High-frequency indicators are consistent with a relatively strong second quarter in 2010, driven by the global recovery in trade and manufacturing, and some slowing of momentum during the second half of 2010. Disinflationary pressures persist in the face of weak domestic demand, with the sizeable output gap shrinking only gradually. Staff projects inflation to remain well below 2 percent over the relevant policy horizon.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

The aggregate fiscal position of the euro area has deteriorated sharply in 2009. Many member countries allowed automatic stabilizers full play and implemented fiscal stimulus measures aimed at supporting private consumption, limiting increases in unemployment, and raising public investment. These policies mitigated the impact of the crisis, but together with bank support came with a rise in average euro area government debt. Current deficit targets imply a neutral aggregate fiscal stance in 2010 and synchronized consolidations, gradually leading to deficits below the SGP limit by 2013 in most cases. However, additional efforts will be needed to stabilize debt dynamics over the long term.

Amid considerable volatility interbank bank CDS spreads remain somewhat elevated and some banks persistently rely on liquidity and other government support. Stress tests are underway with the aim to assess the resilience of the euro area's financial system, increase transparency to reduce counterparty risks, and identify banks with capital needs.

Individual euro area member current account deficits and surpluses and their persistence since the advent of EMU has been partly reversed by the recent crisis, but remain significant. Equilibrium phenomena, such as different demographics and long-term growth dynamics justify some imbalance, but the major drivers were to be found in unsustainable credit and construction booms, a lack of fiscal restraint, and unsustainable wage developments.

The current crisis has triggered a debate about how to close the fundamental gaps in the euro area's governance framework. The authorities have tabled several proposals to strengthen fiscal surveillance, focusing on more intrusive ex-ante surveillance, more effective sanctions, and minimum benchmarks for national frameworks. They have also proposed similar procedures to strengthen surveillance over internal imbalances. Meanwhile, member states are in the process of building up the EU's financial stability architecture, focused on establishing new European supervisory institutions, including a systemic risk board, and harmonizing the approach to resolution.

Executive Board Assessment

Directors agreed with the thrust of the staff appraisal. Noting that the euro area is being affected by a sovereign debt crisis with repercussions well beyond its borders, Directors emphasized the need for strong policy implementation across fiscal, financial, and structural policy areas to support the recovery and limit adverse spillovers. They welcomed the far-reaching crisis response and underscored that, while the newly created tools should be used as needed, they should not be considered an alternative to the necessary policy corrections and structural reforms.

Directors observed that the heightened sovereign risks have imparted further downside risks to an already moderate and uneven recovery. Over the medium term, Directors saw fiscal consolidation and structural rigidities weighing on the recovery, only partly offset by the recent depreciation of the exchange rate to a level that is now close to its fundamental value. Directors welcomed the measures currently being undertaken and the heightened intent to tackle structural issues. They saw three essential areas for policy actions to help establish a durable recovery:

- First, weaknesses in the banking system, with some banks overly reliant on liquidity or other government support, need to be addressed. Directors welcomed the authorities' intention to use transparent stress tests with an expanded coverage in terms of institutions and risks to help restore confidence in the financial system. They underscored the need to make resources available to recapitalize viable institutions lacking market access and restructure others. A clarification of new capital and liquidity requirements for banks, consistent across countries and appropriately phased in, would be important.

- Second, Directors agreed that fiscal consolidation is essential, with its speed and scope tailored to each country's circumstances. They highlighted the importance of the quality and composition of fiscal consolidation and noted that entitlement reforms will be particularly effective in helping ensure medium-term fiscal sustainability.

- Third, Directors encouraged the timely implementation of structural reforms, especially in the labor and product markets, to lift the euro area's tepid growth potential.

Directors welcomed the ECB's Securities Market Program and the reinstatement of some other non-standard measures to secure effective transmission of the monetary policy stance. Directors saw long-term inflation expectations well anchored, keeping risks to price stability at bay. Hence, they noted that the policy rate remains appropriately low.

Directors encouraged the authorities to strengthen economic governance of EMU to deliver the collective responsibility necessary for a well-functioning economic and monetary union, which would help prevent future crises. They welcomed the recent proposals by the authorities in areas including budgetary policies and competitiveness. Directors pointed to the need for better enforcement of budgetary discipline and the extension of effective surveillance over key structural reforms.

Directors encouraged further progress in building the EU's financial stability architecture. They welcomed the steps taken toward a more harmonized regulation and supervision of the EU financial system. The establishment of a core set of effective resolution tools would raise the scope for coordination in the resolution of cross-border institutions.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Euro Area is also available.

Euro Area: Main Economic Indicators
(Percent change)

	2005	2006	2007	2008	2009	2010	2011	2012
						Staff Projections		
Demand and Supply								
Real GDP	1.7	3.0	2.8	0.6	-4.1	1.0	1.3	1.8
Private consumption	1.8	2.0	1.6	0.3	-1.2	0.0	0.7	1.3
Public consumption	1.6	2.1	2.3	2.2	2.6	1.0	0.1	0.3
Gross fixed investment	3.2	5.4	4.7	-0.6	-10.9	-2.1	1.2	2.9
Final domestic demand	2.1	2.8	2.4	0.5	-2.6	-0.3	0.7	1.4
Stockbuilding 1/	-0.2	0.1	0.0	0.1	-0.9	0.7	0.2	0.0
Domestic Demand	1.9	2.9	2.4	0.6	-3.4	0.3	0.8	1.4
Foreign balance 1/	-0.2	0.1	0.4	0.0	-0.7	0.6	0.6	0.4
Exports 2/	5.1	8.5	6.3	1.0	-13.3	6.4	3.7	4.1
Imports 2/	5.8	8.5	5.5	1.0	-12.0	5.0	2.4	3.3
Resource Utilization								
Potential GDP	1.7	1.7	1.6	1.4	0.3	0.7	0.8	0.9
Output gap	-0.4	0.8	2.0	1.1	-3.3	-3.1	-2.6	-1.8
Employment	1.0	1.6	1.7	0.7	-1.9	-1.1	-0.2	0.6
Unemployment rate 3/	9.0	8.4	7.5	7.6	9.4	10.2	10.4	10.1
Prices								
GDP deflator	2.0	2.0	2.4	2.3	1.0	0.8	1.2	1.5
Consumer prices	2.2	2.2	2.1	3.3	0.3	1.2	1.3	1.5
Public Finance 4/								
General government balance	-2.5	-1.3	-0.6	-2.0	-6.3	-6.6	-5.7	-5.1
General government structural balance	-2.7	-2.1	-1.7	-2.6	-4.4	-4.7	-3.8	-3.6
General government gross debt	70.1	68.3	66.0	69.5	79.0	84.7	88.2	90.3
Interest Rates 3/ 5/								
EURIBOR 3-month offered rate	2.2	3.1	4.3	4.6	1.2	0.7	…	…
10-year government benchmark bond yield	3.4	3.9	4.3	4.4	4.0	3.7	…	…
Exchange Rates 5/								
U.S. dollar per euro	1.24	1.26	1.37	1.47	1.39	1.26	…	…
Nominal effective rate (2000=100)	126.6	127.0	132.3	138.8	140.6	128.0	…	…
Real effective rate (2000=100) 6/	121.3	120.6	124.2	128.2	128.9	115.8	…	…
External Sector 4/ 7/								
Current account balance	0.1	-0.1	0.2	-1.7	-0.6	0.2	0.4	0.4

Sources: IMF, World Economic Outlook; Global Data Source; DataStream; Eurostat; and ECB Monthly Bulletin.
1/ Contribution to growth.
2/ Includes intra-euro area trade.
3/ In percent.
4/ In percent of GDP.
5/ Latest available data for 2010.
6/ CPI based.
7/ Based on ECB data, which excludes intra-euro area flows.

Statement by Klaus Stein, Executive Director for Germany,
on behalf of the Euro Area Authorities,
July 19, 2010

In my capacity as President of EURIMF, I submit this Buff statement on the Article IV consultation with the euro area. It reflects the common view of the Member States of the euro area and the European Union in their respective fields of competence. The authorities of the euro area Member States are grateful for open and fruitful consultations with the Fund staff and for their constructive policy advice. The authorities broadly concur with the staff's findings. However we are astonished how reluctant the report is in recognizing achievements compared to reports on other major economic areas.

Short-term economic outlook

A gradual recovery is in progress in the euro area after the deep economic recession came to an end in the third quarter of last year. The turnaround was driven in large part by the exceptional crisis measures put in place by authorities in the euro area, in the EU and outside.

The normalization of the financial situation in the euro area was interrupted by a severe sovereign debt crisis caused by an exceptional combination of adverse economic and policy factors in Greece. In response, Member States agreed on a package of bold measures to preserve financial stability in Europe: the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The practical arrangements concerning the establishment of the European Financial Stability Facility are well on track and the Facility is expected to be fully operational by the end of July. In parallel with the creation of the financial instruments, the Member States experiencing particular market stress committed to accelerate fiscal consolidation and structural reforms, while the European Central Bank introduced the Securities Market Program.

Turning to the real economy, the euro area is benefiting from a strong external environment and inventory restocking, whereas weak domestic demand components continue to restrain the recovery. Investment is held back by the still relatively low level of capacity utilization, deleveraging and heightened risk aversion. Consumption growth is primarily constrained by weak wage and employment growth. The smaller-than-expected impact of the economic crisis on the euro area labor market is explained by past measures taken to enhance market flexibility combined with the use of short-term measures and, in some Member States, by labor hoarding. The remaining slack in the economy keeps wage growth and inflation in check. The speed of recovery is varying across euro area Member States, reflecting their individual circumstances and the policies they pursue.

Looking ahead, the authorities broadly concur with the forecast presented by the staff and expect the euro-area economy to grow by about 1% in 2010 and 1½% in 2011. The authorities see the risks broadly balanced, though the probability of downside risks has increased compared to the Commission's Spring Forecast.

Monetary policy and the outlook for price stability

The euro area annual HICP inflation stood at 1.4% in June, but is expected to display further volatility in the next few months, with a tendency to somewhat higher rates later this year. The inflation rates in 2011 should remain moderate, benefiting from low domestic price pressure. Risks to the outlook for inflation are broadly balanced. The underlying pace of monetary expansion is moderate, as annual growth rate of bank loans to the private sector is still weak, with positive growth in loans to households and negative growth to non-financial corporations. Against this background, the current key ECB interest rates remain appropriate.

As regards ECB's non-standard measures, with bond market tensions intensifying in April and especially in the early days of May this year in some euro area countries, and spreading to other markets and countries, on May 10, 2010, the ECB re-introduced some non-standard measures that had been withdrawn, such as six-month refinancing operation with full allotment. Furthermore, a Securities Markets Program (SMP) was introduced, implying Eurosystem interventions in private and public bond markets. Its aim is to address the malfunctioning of some securities markets, and restore an appropriate monetary policy transmission mechanism. Following the introduction of the program, bond spreads of euro area countries generally have declined, though still standing at elevated levels. All non-standard measures, including the SMP, are by construction temporary in nature.

Turning to money markets, the maturing of the first 1-year Long-Term Refinancing Operation (EUR 442 bn) at the end of June went smoothly, as banks had been given the opportunity to refinance themselves in other operations with full allotment. With banks choosing to refinance less than the maturing amount, excess liquidity in the money market decreased somewhat, causing short-term interest rates such as the overnight interest rate (EONIA) to rise slightly, though still standing close to the interest rate on the ECB deposit facility.

Fiscal policy

The euro area authorities share the staff assessment on the broad neutrality of the fiscal stance in the euro area in 2010 and the need for the stance to become clearly restrictive as from 2011. However, in some countries the challenges regarding sustainability were exacerbated by financial market tensions, requiring strengthened consolidation efforts already in 2010, despite the prospects of only moderate recovery, in order to secure fiscal sustainability and to limit contagion effects.

The euro area authorities agree with the staff that the overall objective should be for fiscal consolidation efforts to be supportive of the economic recovery. As underlined by the staff, this can be made possible by focusing on structural expenditure reduction as well as improved streamlining of public expenditure programs. Pension reforms would also strengthen long-term commitment to sound public finances. However, the euro area authorities note that fiscal adjustment plans also need to be tailored to country-specific situations as indicated in the *Orientations for fiscal policies in the euro area Member*

States issued on June 7, 2010 by euro-area Finance Ministers. A coordinated differentiation in the speed of consolidation is warranted by frontloading consolidation in a number of Member States in order to avoid adverse debt dynamics, also taking in to account macro-financial stability considerations. Additional measures should be implemented in 2011 and beyond, where and when necessary, in order to ensure the achievement of the budgetary targets and to underpin the credibility of consolidation strategies. For the credibility of fiscal consolidation in all Member States it is essential that the measures adopted are of a permanent nature and embedded in a comprehensive strategy of structural reforms. Concerning the composition of adjustment, the magnitude of the required corrections means that it is likely that a combination of spending and tax measures will be necessary. While expenditure-based consolidations are in general preferable in order to limit medium to long-term adverse effects on growth and to reinforce credibility, tax increases may also assist in achieving structural fiscal adjustment objectives.

State of the banking sector

The sovereign crisis in the euro area led to renewed stress in the banking sector, as many banks are exposed to sovereign risks and market participants started questioning the solvency of some segments of the euro-area banking system. Although most of the euro area's large banking groups returned to modest profitability in 2009 and their capital positions increased to above pre-crisis levels, credit risk is still considered to be the most important risk for the banking sector in most of the Member States. The increasing tension was quickly mirrored in tightening money market conditions and higher funding costs. These developments signal that trust among banks remains fragile as long as there are doubts about the solvency of the potential counterparts.

Since the outbreak of the financial crisis the EU has taken significant measures to support the banking sector, including:

- guarantee schemes – the approximate volume of guarantees authorized by the Commission until 31 March 2010 under schemes amounts to € 2 747 billion and ad hoc guarantees to a total of € 402.8 billion;

- recapitalization schemes – the total volume of approved recapitalization measures (both schemes and ad hoc cases) by the end of March 2010 stood at € 503.1 billion, which corresponds to around 4% of EU GDP, whereas the amount effectively used was € 241.6 billion or 2% of EU GDP;

- impaired asset measures – the nominal amount of total assets covered by the asset relief interventions reached € 376 billion;

- restructuring plans.

As the staff noted, keeping support to the financial sector at current levels in place for too long would allow banks with structural problems to unduly postpone the necessary restructuring and could lead to growing competition distortions. The return to normal market conditions is important for a sustained recovery. It is essential, therefore, that banks accelerate balance sheet repair to minimize the need for government intervention. In this respect, transparency in the existing quality of bank balances would encourage the distressed institutions to restructure and would help to lift doubts about the soundness of the financial system as a whole.

The staff is right to emphasize the role of stress tests in this context. The authorities consider that the extended coverage as well as the planned publication of the CEBS stress test will be a crucial step. The objective of this extended exercise is to assess the overall resilience of the EU banking sector and the banks' ability to absorb further possible shocks on credit and market risks, including sovereign risks, and to assess the current dependence on public support. The exercise is being conducted on a bank-by-bank basis, using commonly agreed macro-economic scenarios for 2010 and 2011.

The macro-economic scenarios, which include a set of key macro-economic variables, envisage adverse conditions in financial markets and a shock on interest rates to capture an increase in risk premia linked to a deterioration in the EU government bond markets. The scope of the stress testing exercise has been extended to include key domestic credit institutions in Europe, in addition to the major EU cross-border banking groups. In each EU Member State at least 50% of the national banking sector, in terms of total assets, is covered. Banking groups have been tested on a consolidated level. This means that subsidiaries and branches of an EU cross-border banking group have been included in the exercise as a part of the test of the group as a whole. For the EU, the 91 banks covered represent 65% of the EU banking sector.

Financial regulation

The European Commission and the EU governments initiated numerous regulatory reforms in the financial sector, which have been an integral part of the responses to the crisis. The Commission's communication on "Regulating Financial Services for sustainable growth" of June 2, 2010 takes stock of the ongoing initiatives and lists the initiatives to be undertaken and completed before the end of 2011. The initiatives cover the issues highlighted by the staff and largely go in the indicated directions.

In particular, on July 8, the European Parliament approved amendments to the Capital Requirements Directive ("CRD 3") as regards capital requirements for trading book and for securitization, and the supervisory review of remuneration policies. Further possible changes to the Capital Requirement Directive ("CRD 4") are underway. The proposed amendments relate to liquidity standards, definition of capital, leverage ratio, counterparty credit risk, counter-cyclical measures including through-the-cycle provisioning for expected credit losses, systematically important financial institutions and single rule book in banking. This legislative proposal will be presented by the Commission this autumn and will mirror the revisions proposed under Basel III. Following on the regulation on credit rating agencies adopted in 2009, the Commission proposed on June 2, 2010 a draft regulation amending this legislation and setting up a direct and a centralized EU oversight of the rating agencies by the future European Securities and Markets Authority (ESMA), planned to be established in 2011. The Commission also intends to propose by next fall additional measures to strengthen competition in the credit rating market and to reduce excessive regulatory reliance on credit rating in the financial system. The EU is also currently working on a complete set of tools on crisis prevention and management. In October 2010, the Commission will publish an action plan on crisis management, leading to legislative proposals for a complete set of tools for prevention, management and resolution of failing banks. Discussions continue on the new supervisory framework in the EU. It is expected that the legislative process in the European Parliament and the Council will be concluded in September and the new institutions will become operational at the beginning of 2011.

Structural reform and growth

The authorities concur with the staff that a key challenge is to promote policy strategies that create growth and employment, restore sustainability of public finances and at the same time address the long-term challenges of globalization, ageing and climate change. This is the objective of the Europe 2020 strategy, on which a political agreement was reached by the European Council of June 2010. The strategy is designed to promote reforms in various areas, such as employment-boosting reforms of the labor market, reforms of the research and education systems, measures to promote "green" growth, and product market reforms. The strategy also encompasses reforms directly aimed at improving quality of government expenditure that can have immediate and longer-term positive fiscal impact (for example, raising effective retirement ages and reform of age-related expenditure, such as healthcare) as well as boosting revenues. As to the short term focus of the Europe 2020 strategy, priority should be given to frontloading reforms that bolster jobs and growth but have no or positive budgetary impact (e.g. regulatory measures) or which strengthen fiscal sustainability over the long run (e.g. pension reforms). Credible commitments now to implement growth-enhancing reforms in the medium term could also boost confidence, and through expectations of stronger fiscal positions translate into lower risk premia.

The June ECOFIN Council endorsed a report identifying the main bottlenecks to sustainable growth, which specifies areas in each Member State where structural reforms are necessary to remove the bottlenecks that constrain sustainable growth. Proposals on the enhanced governance arrangements are being elaborated, providing for a more comprehensive, integrated and effective approach to economic policy co-ordination. Also, improving the effectiveness and efficiency of the EU budget through stronger prioritization and better alignment of EU expenditure with Europe 2020 goals will be discussed in the context of the upcoming EU budget review and the next multi-annual financial framework. The Commission is going to outline concrete proposals in autumn.

Intra-euro-area imbalances

The authorities recognize that competitiveness divergences and underlying imbalances are a matter of common importance for euro area Member States and warrant appropriate and timely policy measures. In March 2010, the Eurogroup committed to address the issue of competitiveness divergences and macroeconomic imbalances swiftly and effectively and to put in place an ambitious and comprehensive policy response covering appropriate measures in four broad areas: budgetary and wage policies, labor markets, goods and services markets and the financial sector. Moreover, the Ministers committed to make sure that the agreed policy response is coordinated in the euro area, designed to address the specific vulnerabilities and needs of each country and facilitates the smooth functioning of the EMU.

As rightly pointed out by the staff, action is required in all euro area Member States, but the nature, importance and urgency of the policy challenges differ significantly depending on the countries considered. Given vulnerabilities and the magnitude of the adjustment required, the need for policy action is particularly pressing in Member States showing persistently large current-account deficits and large competitiveness losses.

Economic governance

The global economic crisis has shown that the current mechanisms of economic policy coordination and surveillance need to be strengthened. The authorities have therefore embarked on a comprehensive debate on the improvement of economic policy coordination in the euro area and in the EU as a whole. In line with proposals by the Commission, the European Council of June 17, 2010 endorsed a first set of orientations as regards budgetary and broader macroeconomic surveillance. The European Council also invited the Task Force on economic governance chaired by the President of the European Council and the Commission to rapidly develop further these orientations and make them operational.

Surveillance under the new framework will incorporate areas such as macro-economic imbalances that were hitherto not systematically part of surveillance. Also, surveillance will henceforth be conducted in an integrated fashion, meaning that the reporting on fiscal policy under the Stability and Growth Pact on the one hand and the reporting on macroeconomic imbalances and macro-relevant structural reforms will occur simultaneously. This alignment in time will mean that the basis for the policy guidance will be a fully integrated analysis across policy areas for each Member State.

Within fiscal surveillance the European Council agreed to strengthen the preventive and corrective arms of the SGP, with sanctions attached to the consolidation path towards the medium term objective; to give much more prominent role to debt and overall sustainability; to ensure that all Member States have national budgetary rules and medium term budgetary frameworks in line with the Stability and Growth Pact; and to ensure the quality of statistical data by making statistical offices fully independent for data provision.

In order to safeguard macroeconomic stability and to prevent harmful macroeconomic imbalances, the Council agreed to develop a scoreboard to better assess competitiveness developments and imbalances in Member States and to allow for an early detection of unsustainable trends. The Council also called for developing an effective surveillance framework, reflecting the particular situation of euro area Member States. Moreover, as of 2011 all strands of surveillance will be coordinated together in the first half of the year in order to give clear ex ante guidance for all economic policies, and especially fiscal policy, on the national level in the second half of the year.