

Euro Area Policies: 2011 Article IV Consultation—Staff Report; 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 2011 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 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 31, 2011, with the officials at EU institutions on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 1, 2011. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 18, 2011 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for France, 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
Euro Area Spillover Report and Selected Issues Paper
Lessons from the European Financial Stability Framework Exercise

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 2011 Article IV Consultation
with Member Countries**

Prepared by the European Department

Approved by Antonio Borges and Aasim Husain

July 1, 2011

KEY ISSUES

The recovery and macroeconomic policies. The recovery is resilient in spite of the sovereign tensions, with the strength of the core dominating the periphery and inflation up from its trough. Domestic demand is supporting the upswing but high commodity prices and banking sector deleveraging constitute a drag. Imbalances have been reduced mainly through a fall in domestic demand in deficit countries, leaving behind pockets of weak growth. Capital markets are being segmented, with the periphery relying on ECB and official financing, and sovereign spreads being passed on to corporate funding. It was agreed that containing the sovereign tensions to the periphery would protect the recovery, allowing continued repair of public finances and adjustment of policy rates as needed to keep inflation expectations anchored.

The sovereign tensions and associated risks. A benign baseline scenario is not assured until euro area policymakers come to grips with the sovereign tensions. There was shared concern that the sovereign tensions could spill over into the core economies via the financial system with large adverse regional and global implications. Thus strong program implementation would need to be complemented with private sector driven cross-border solutions, immediate capital raising throughout the euro area, and a further strengthening of crisis management mechanisms to help restore confidence in debt sustainability.

The state of the financial system. It was agreed that banks urgently need more and better quality capital, in part to be able to withstand the sovereign stresses. The follow up to the stress tests is expected to deliver a healthier financial system, but uncertainty persists, as sovereign risk is not fully addressed and the approach to banking problems remains national, thus perpetuating the intertwining of banks and sovereigns. And some banks continue to struggle with illiquid private assets. Hence, unconventional liquidity support will need to remain in place for some time and consideration should be given to establishing a term funding facility and promote private sector driven cross-border consolidation. Regulatory changes are posing challenges, putting a premium on avoiding regulatory arbitrage, while implementing sufficiently flexible macroprudential policies and developing nonbank financing.

The resilience and stability of economic and monetary union (EMU). More economic and financial integration is needed to secure a stable and efficient EMU and unleash its growth potential. The ongoing strengthening of governance in the euro area is definitely welcome, but preserves national control over fiscal, macroprudential and structural policies. Staff considers some delegation of policy power to the center necessary to ensure the integrity of EMU. The crisis has made the case for common policy execution, with better ex ante fiscal risk sharing, and a pan-euro area approach to the financial system, including a collective backstop to complete the new financial stability framework. Similarly, more efforts are needed to enable a truly free flow of goods, services, labor and equity capital across borders.

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1. **The resilient recovery of the euro area economy stands in marked contrast with the authorities' struggle to come to grips with the sovereign crisis affecting some member states and casting a shadow over the EMU project.** The recovery in the core economies has become broad based and less dependent on public support, while inflation has risen, but several member states remain in dire shape. More than a year after Greece called upon international financial support, the Greek sovereign debt crisis is again dominating headlines and the choices made in its resolution will shape the future of the euro area. There is much agreement about what went wrong, but no consistent roadmap ahead, leaving both orderly and disorderly outcomes on the table, with possible significant regional and global spillovers. Moreover, despite genuine efforts to strengthen governance and cooperation at the center, the reaction by national authorities and economic agents has been one of retrenchment, threatening to turn back the clock on economic and financial integration, the very foundation of EMU. These developments could easily jeopardize the recovery and cloud the medium-term growth outlook.

2. **Against this background, the discussions focused on the following key issues:** (a) the strength of the recovery and its consequences for macroeconomic policies and the periphery; (b) the risks associated with the sovereign crisis affecting some member states and its resolution; (c) the capacity of the financial system to deal with illiquid private assets, sovereign tensions, and changes in the regulatory environment; and (d) the requirements for a resilient and stable EMU. Clearly, all these issues are interconnected: resolving the sovereign tensions in a way that fosters economic and financial integration will underpin confidence in EMU and help the financial system; fixing the financial system will in turn make handling the sovereign crisis easier; and strengthening EMU's governance will provide confidence to investors that future difficulties can be safely handled.

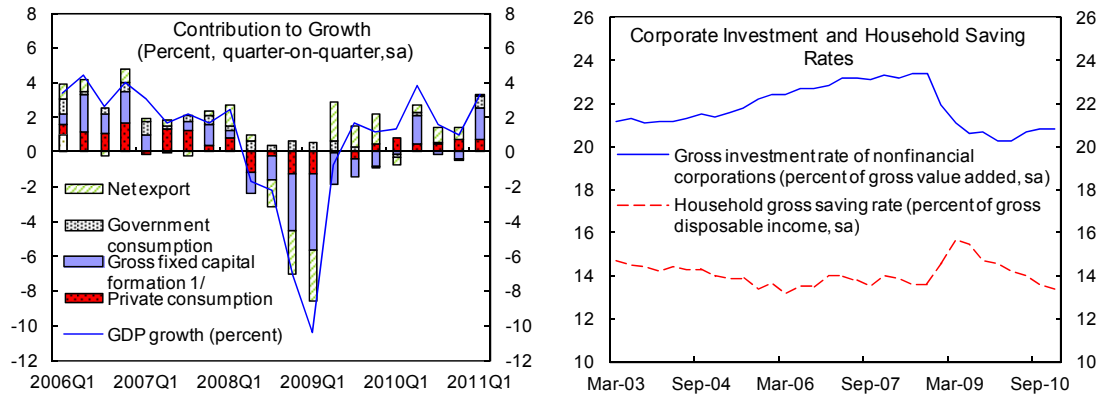
I. STEADYING THE RECOVERY

A. Expansion in the Offing but Not Everywhere

3. **The economic recovery in the euro area has surprised on the upside over the past year.** Robust global demand and a turn in the inventory cycle supported a rebound from the worst recession in decades. Despite the sovereign debt problems in some countries and weakness in the banking system, the recovery is broadly following the historical pattern of previous upturns and showed robustness in early 2011, with very strong first quarter growth (Figure 1). Firms are rebuilding profit margins but corporate investment activity is still far below pre-crisis levels, despite low funding costs in most countries. Household consumption fared better as the crisis-induced spike in precautionary savings has unwound.

4. **Sharp growth divergences persist across the area and are set to shape the outlook** (Box 1). A majority of members is experiencing solid economic activity supported by increasingly healthy labor markets and relatively sound balance sheets of households and firms. Their economies are pulling away from those suffering from a sovereign debt crisis (Greece, Ireland, Portugal), the legacy of real estate bubbles (e.g., Spain), and chronic underperformance (e.g., Italy) that are working through various combinations of a correction

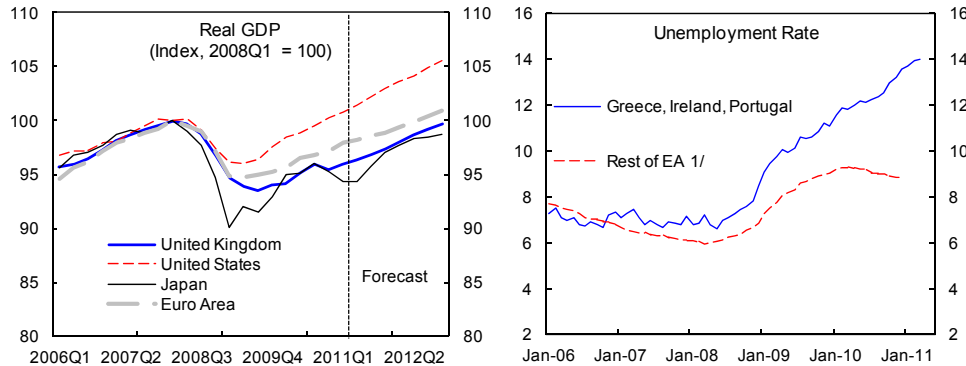
of pre-crisis imbalances, high debt, unemployment and tensions in financial markets, alongside balance sheet adjustment, sectoral restructuring and deep fiscal austerity measures. At the same time, member states' current account imbalances have been reduced since the crisis mainly reflecting the contraction in domestic demand in deficit countries (Figure 2). However, in many deficit countries private capital inflows have largely been replaced with ECB and official financing, which is unsustainable.



Sources: Eurostat; and IMF staff calculations.
1/ Data for 2011Q1 includes inventories.

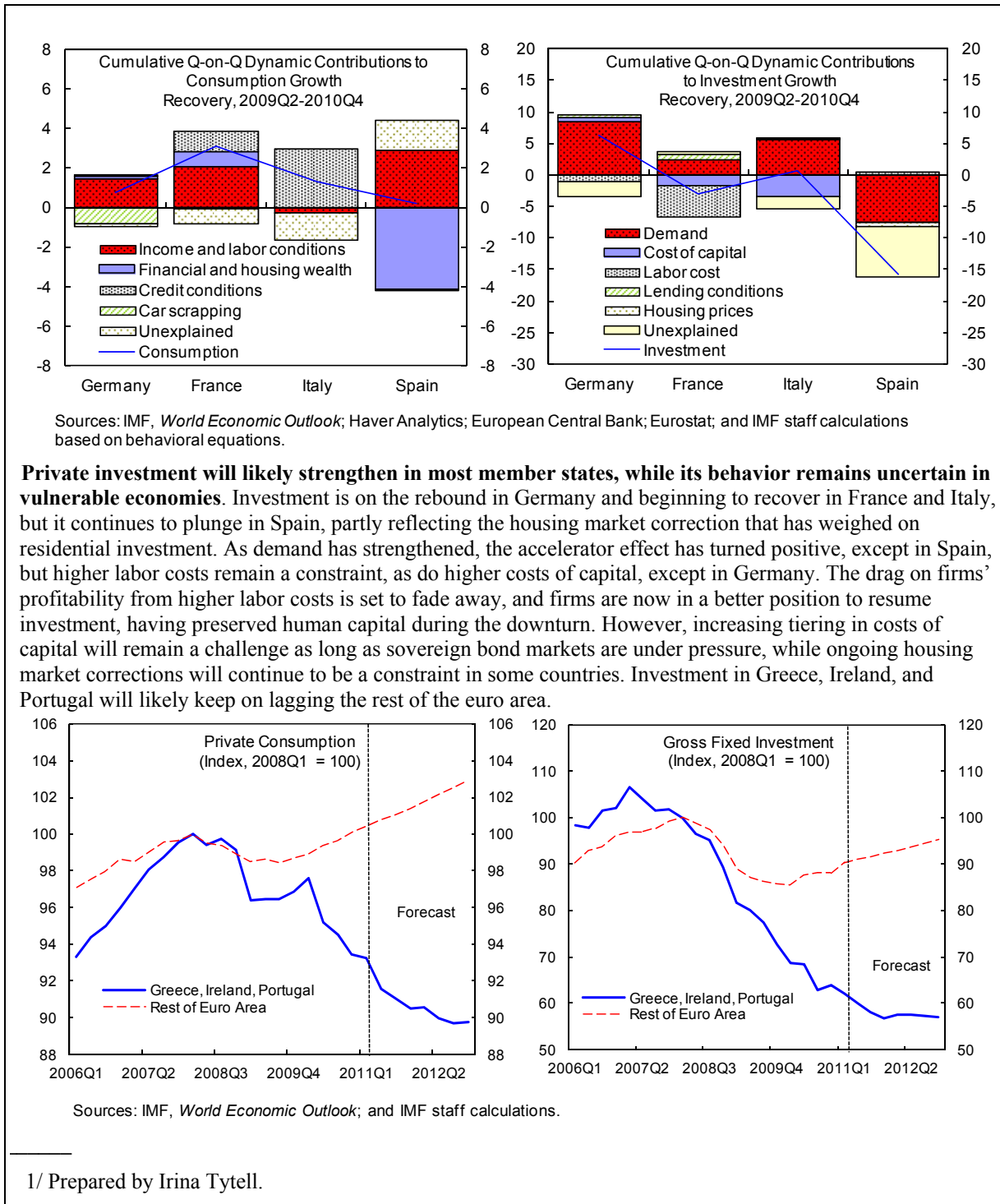
Box 1. A Two-Speed Recovery in the Euro Area¹

The euro area recovery is a tale of two speeds, with a majority of member states cruising and the others stalling or falling. Indeed, the very strong first quarter outcome was driven by the northern euro area, led by Germany, but also France, the Netherlands, Belgium, and Austria, while growth in Italy, Spain, and Greece was weaker and Portugal posted negative growth. Expected growth divergence remains large: 2011 growth is currently projected to range from nearly -4 percent in Greece and about -2 percent in Portugal to over 3 percent in Germany, Estonia, Finland, Luxembourg, and Slovakia.



Sources: IMF, *World Economic Outlook*; Haver Analytics; Eurostat; and IMF staff calculations.
1/ EA17 excluding Greece, Ireland, and Portugal.

The recovery in private consumption will remain uneven reflecting the largely divergent income and labor market dynamics and wealth developments. With improving income and labor market conditions, consumption is recovering in Germany, France, and Italy, although it remains subdued in Spain where a drag from negative wealth effects dominates. Rising disposable income is poised to support consumption in Germany and elsewhere, while ongoing labor market adjustment and fiscal withdrawal in Spain and peripheral economies may weaken consumption. In a number of countries, especially Germany, where the deterioration in labor markets was relatively contained during the global crisis—thanks to labor hoarding practices and partial unemployment schemes—labor markets are stabilizing. In contrast, unemployment has risen markedly in the wake of bursting housing bubbles, notably in Spain and Ireland, leaving many low-skilled, young, and temporary workers without a job and threatening to increase inequalities. Private consumption in Greece, Ireland, and Portugal is set to continue lagging the rest of the euro area.



5. **There was broad agreement that the recovery in the bulk of the euro area was relatively sound and becoming less dependent on public support.** The ECB and Commission stressed that growth in the core had consistently surprised on the upside, with increasing contributions from private domestic demand. They noted that as expected following a financial crisis, growth and potential growth would be subdued for some time, a view the staff shares. Indeed, growth is expected to soften in the second half of 2011.

Real GDP Forecast for 2011–12

(Percent)

	ECB (June 2011)	European Commission (May 2011)	IMF (June 2011)	Consensus (May 2011)
2011	1.9	1.6	2.0	1.7
2012	1.7	1.8	1.7	1.7

Sources: ECB; EC; IMF WEO database; Consensus Forecasts.

6. **Going forward, all agreed that high energy and food prices will cut into disposable income and together with fiscal consolidation and high unemployment weigh on growth.** Persistent and elevated unemployment is causing much pain in several member states and is likely to hold back consumption (Box 1). Fiscal consolidation is set to dampen growth in the short term, but sound finances are needed to underpin confidence and support a more solid medium-term outlook. Despite higher energy efficiency in Europe than in other large economies, the sharp increase in energy costs over the past year is likely to constitute a drag on growth in the near term.

7. **One overarching concern is whether investment will fully assume its key role in the recovery.** Typically, strong investment activity follows the rebound in trade and drives the business cycle upswing in its early phase. While some member states did see a rebound of investment demand (Box 1), overall euro area investment contracted in the second half of 2010 and began to recover strongly only in the first quarter of 2011. Rising profits and higher equity prices have lifted firms' net worth and should increasingly accelerate investments as uncertainty about the outlook and risks diminish. However, higher interest rates and sovereign spreads in some member states that are increasingly being transmitted to corporate funding costs may hold back stronger investment activity.¹ And bank deleveraging in response to a running down of illiquid private assets, funding strains, and the new regulatory environment is likely to dampen investment activity (Section III).

8. **In sum, provided the crisis in the periphery is contained, the outlook is for modest growth ahead.** While there are considerable cross-country differences, the aggregate output gap is set to close steadily over the next two years. Serious trouble in the periphery spilling over into the core would upset this scenario, with a very unpredictable outcome and significantly larger spillover effects (Section II).² Policies will need to be geared toward minimizing this risk, but will otherwise need to take into account the underlying cyclical developments.

B. Restoring Fiscal Health

9. **Public finances are in poor shape following the crisis, making fiscal consolidation a top priority** (Figure 3). The euro area aggregate budget deficit has deteriorated sharply

¹ Staff research found that a significant share of a sovereign's increased funding costs are passed on to its banks and nonfinancial corporates, see Selected Issues Paper, Chapter 1.

² See Spillover Report for the Euro Area.

since 2007 and public debt has reached record highs in many countries. Discretionary fiscal measures accounted for about half of the deterioration in the euro area deficit. The fiscal burden and expected debt dynamics associated with a weak growth outlook led to severe sovereign funding pressure in Greece, Ireland and Portugal and their governments turned to the EU/IMF for financial aid. It was agreed that maintaining easier fiscal policies in the core for the benefit of the periphery would be of little help, as direct demand effects are small,³ interest rate effects may offset the gains, and contingent fiscal liabilities loomed.

10. There was agreement that fiscal consolidation should continue broadly as planned.

The 2010 fiscal deficit for the euro area remained at the previous year's level of about 6 percent of GDP. The targeted adjustment that countries have agreed to under the Excessive Deficit Procedures (EDP) of the Stability and Growth Pact (SGP) is substantial, mostly expenditure-based and frontloaded where funding pressures are most severe (Figure 3). The adjustment is included in the staff and authorities' baseline scenarios. In discussing its impact, the authorities argued that the counterfactual without fiscal consolidation was unlikely to be positive for growth, as risk premia would rapidly increase, eroding confidence compared to the consolidation scenario.

11. Consolidation is proceeding, but it will be important that announced plans are implemented and policy gaps filled.

Faster growing economies should let automatic stabilizers work and reach their EDP targets earlier than planned. Crisis countries might have to extend their plans in line with program requirements, but consolidation will have to continue. While the periphery was lagging, the authorities saw little alternative to credible fiscal consolidation across the region. They agreed that targets were appropriate, but noted that specific measures need to be identified as of 2012.

12. Declining debt is required over the long run. Staff projects the debt-to-GDP ratio to peak at slightly below 90 percent in 2012 and gradually decline thereafter. Reducing debt-to-GDP ratios to sustainable levels will require action on all fronts to restore competitiveness and reinvigorate growth; pursue strong and sustained fiscal consolidation; and reform pension and health care systems. New rules to guide the path of debt towards the 60 percent target and to control spending have been proposed and subject to strengthened governance procedures (see Section IV.B).

C. Inflation and Monetary Policy

13. Headline inflation has accelerated sharply in early 2011 mostly on the back of higher energy and food prices. Since February, inflation has exceeded 2 percent with the largest contributions coming from energy and food prices. Here the strong recovery of demand in many emerging markets played a role, with the stronger euro compensating some of the resulting price pressures. But supply factors including tensions in the Middle East and adverse weather conditions also mattered.

³ See Staff Report for Germany 2011 Article IV Consultation.

14. **But underlying inflation has also picked up.** Core inflation, trimmed means and other measures of underlying inflation hovered around 1 percent for most of 2010 but have increased more recently (Figure 4). This reflects elements of the cost-push shock induced by higher energy and food prices and dissipating disinflationary pressure from a closing output gap. Higher indirect taxes and administered prices added to the picture. The authorities saw a continuing gradual rise in underlying inflation, a view supported by key indicators:

- **Industrial producer prices.** While input price pressures further down the production chain remain moderate so far, intermediate goods prices have risen strongly fueled by higher energy and commodity costs.
- **Wages.** Various labor cost indicators are holding steady, reflecting a still weak area-wide labor market. However, as in particular the ECB emphasised, strong employment prospects in some countries and wage indexation in others could soon result in higher wage outcomes which, if not matched by productivity gains, could lead to price pressure. The expectation of higher headline inflation would accelerate this process.
- **Profits.** Profitability of nonfinancial firms has been recovering quickly. But profit margins still remain somewhat below historical averages and may limit companies' ability to absorb higher input costs.
- **Capacity utilization.** Capacity utilization has recovered considerably since the start of the recession and is approaching its historical average while in the faster growing parts of the region, historical levels have already been exceeded. This could create the expectation of future cost and price increases.
- **Money and credit.** The ECB considers the underlying pace of monetary expansion gradually increasing and cautions that monetary liquidity remains ample and may accommodate price pressures.

15. **Against this background, headline inflation is expected to peak at elevated levels in 2011 and recede to slightly below 2 percent in 2012.** The forecast assumes that energy and food prices will be stabilizing and inflation expectations will stay well anchored to keep underlying inflation in check. Most forward-looking measures of inflation currently remain at around 2 percent, but break-even inflation rates have risen amidst some volatility (Figure 5) and the baseline incorporates an upward adjustment of interest rates in order to keep expected and actual inflation below the 2 percent threshold by 2012. Model calculations confirm this pattern although in a small dynamic stochastic general equilibrium (DSGE) model, inflation is more sluggish, probably due to the highly stylized nature of the model (Box 2). The ECB staff reported that simulations using a larger-scale model of the euro area suggest that inflation would be higher if monetary policy adjustment was delayed.

Inflation Forecast for 2011–12 (Percent)

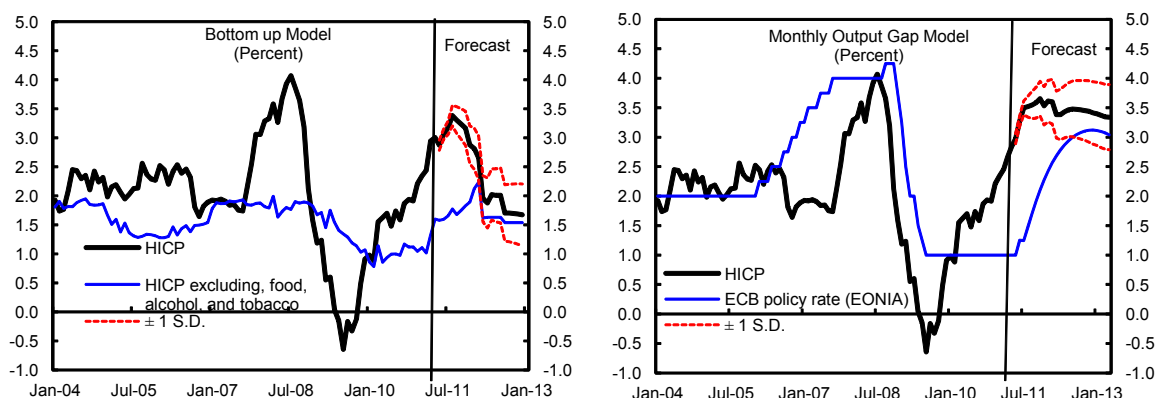
	ECB (June 2011)	EC (May 2011)	IMF (June 2011)	Consensus (May 2011)
2011	2.6	2.6	2.6	2.5
2012	1.7	1.8	1.8	1.9

Sources: ECB; EC; IMF WEO database; Consensus Forecasts.

Box 2. Euro Area Inflation Projections

This box presents two models to forecast euro area inflation. Against the backdrop of elevated rates of inflation, a key question is whether the current surge will subside or give way to second-round effects. For this purpose, two models are used: a time series model forecasting the major subcomponents of the CPI index; and a small structural DSGE model.

The time series ‘bottom-up’ model reveals a decline in inflation by late 2011, mainly owing to a decline in energy price inflation under the baseline. Separate estimations of food, energy, and core inflation suggest that inflationary pressures would likely subside as energy prices stabilize. Core inflation would remain contained and the pass-through from energy prices to headline inflation would be limited. However, uncertainty over the path of inflation appears quite large towards the end of 2012, with estimates ranging between 1.1 and 2.2 percent, although the upper bound remains close to the ECB target.



Sources: Haver Analytics; and IMF staff estimates.

The DSGE model forecasts higher—albeit also slowly downward trending—inflation, reaching levels still significantly above 2 percent by end-2012. This forecast is based on an inflation expectations-augmented Phillips curve, an aggregate demand equation specified in terms of the output gap and the real interest rate, and a policy reaction function specified as a standard Taylor rule with interest rates inertia. The interaction between the variables in the model as well as a series of stochastic shocks imply a rise in inflation to a maximum by early 2012 before gradually declining by end-2012, as the model sees policy rates increase to about 3 percent.

1/ Prepared by Nico Valckx.

2/ Based on Emil Stavrev, 2006, “Measures of Underlying Inflation in the Euro Area: Assessment and Role for Informing Monetary Policy,” IMF Working Paper No. 06/197.

16. **The outlook calls for a gradual withdrawal of monetary stimulus.** The ECB highlighted that the exit from record-low interest rates would help prevent the currently high rates of headline inflation from becoming entrenched and forestall excessive risk taking in search for yield. At the same time, the recovery is expected to move at a moderate speed and some of the price pressure related to energy and food prices should dissipate on its own. Moreover, regulatory changes in the banking sector are likely to increase bank lending

spreads in the future. This suggests a gradual approach to monetary tightening. That said, the impact of an ECB interest rate hike on banks is far from uniform (see text figure) and will vary, among many things, with the interest rate elasticity of the balance sheet and possibly the location of banks.⁴ It could even be positive in some program countries as it allows banks to reprice variable rate assets tied to the policy rate. Moreover, the ECB underscored that its primary mandate is price stability for the euro area overall and staff analysis suggests that the difference between the common interest rate and what standard macroeconomic policy rules would suggest for individual member countries is likely to remain small (Figure 6).

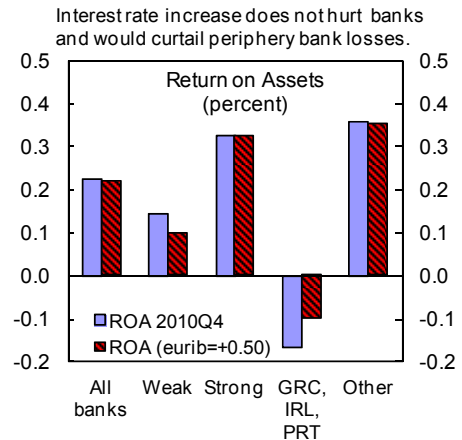
17. The ECB clarified that it was not committed to a path of rising policy rates. While

acknowledging the arguments for a gradual approach put forward by staff, the ECB stressed it would adjust interest rates as necessary to anchor inflation and inflation expectations at below, but close to 2 percent—which could mean a faster or slower path of adjustment as necessary.

18. All agreed that the extraordinary crisis measures would need to remain in place as a safeguard against financial and sovereign market tensions but should not become a permanent substitute for resolving these tensions. As the functioning of money and interbank markets improved and reliance on the ECB's deposit facility fell, the ECB discontinued one-year refinancing operations, shrinking its overall balance from around 620 billion euro in May 2009 to currently around 450 billion euro. Staff argued, however, that refinancing at a fixed rate with full allotment continues to be critical for banks with limited access to wholesale or interbank funding, and there is a need to keep it in place for now. The ECB confirmed that the exit from unconventional support measures would be dictated by the evolution of financial market tensions, but should not foster delays in tackling underlying problems.

II. RISKS AND SPILLOVERS: FOCUS ON SOVEREIGN TENSIONS

19. Solvency concerns in some member states persist and could spill over to the core of the euro area and threaten the recovery. Markets continue to price in significant default

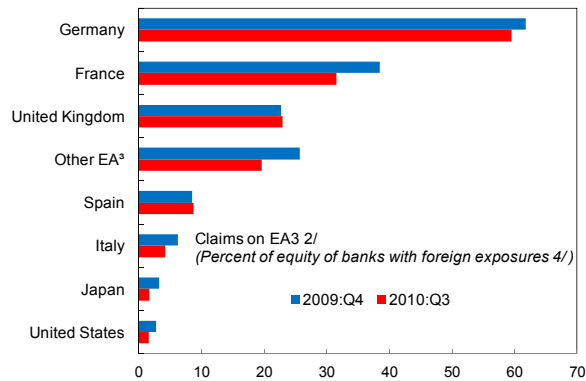


Sources: Bloomberg L.P.; and IMF staff calculations. Note: Chart shows the effect on bank return on assets (ROA) from a 50 basis points increase in the euribor, based on various panel estimations, evaluated at the average ROA in 2010Q4. All banks, weak and strong show the impact at various levels of capital strength (weak: low, strong: high and all: average capital). Results for country groups are evaluated with the help of dummy interaction terms. See for details the SIP on "ECB policies and euro area banks" by N. Valckx.

⁴ See Selected Issues Paper, Chapter 2.

risk for some member states (Figure 7). Banks in Greece, Ireland and Portugal have significantly increased their government debt exposure during 2010. Shunned by financial markets and faced with deposit withdrawals, they survive only because the ECB meets in full their demands for liquidity against collateral of rapidly declining quality (Figure 8).

Selected Advanced Countries: Claims on Domestic Banks and Public Sector 1/



Sources: Bank of England; BIS Consolidated Banking Statistics; Bankscope; IMF, *International Financial Statistics*; and staff calculations.

1/ The exposures were adjusted using data from the Bank of Ireland to account for the fact that a significant portion of the claims are claims on foreign banks domiciled in Ireland.

2/ EA3: Greece, Ireland, and Portugal.

3/ Other EA includes Austria, Belgium, Ireland, Portugal, and the Netherlands.

4/ The exposures are calculated in percent of the equity of banks that have foreign exposures. Banks that do not have exposures to Greece, Ireland, and Portugal, are not included in the computation.

20. **Cross-country financial exposure and the risk of contagion remain high.** In the absence of mitigating policies, a sovereign default or disorderly bank failures could send shockwaves through Europe's financial sector and liquidity could well dry up again, with potentially strong and negative global spillovers,⁵ underscoring the need for actions to mitigate contagion, which could spread through the following channels:

- Direct exposure to sovereigns and banks at risk of default. According to the latest BIS data, banks have reduced further their cross-country exposure. Nevertheless, several French and German banks remain significantly exposed to credit risk in the periphery. Having in place adequate bank recapitalization plans in these markets would help mitigate contagion risk.
- Sudden large credit losses may trigger a bank run in the absence of adequate liquidity and bank recapitalization facilities. Strengthened commitments to deposit insurance schemes, and domestic guarantees on bank assets and new debt issuances would further reduce market fears. A sovereign or bank default may affect the incentive structure of other sovereigns and banks.
- A credit event may reveal unexpected counterparty risks if sellers of default protection cannot live up to commitments. On the other hand, default protection could also shield some investors from losses, with an uncertain net effect.

⁵ See Spillover Report for the Euro Area.

- A bank funding shock and sharp fall in equity prices could accelerate deleveraging while macro policies have very limited space to respond. Credit backstops would help mitigate the risk of a damaging credit crunch.

Both the Commission and the ECB considered that a sovereign default or a credit event would likely trigger contagion to the core euro area economies with severe economic consequences. Staff however also saw serious risks of contagion, even under a strategy which tries to avoid default or credit events.

21. The staff and authorities agreed that seeking an orderly solution to the sovereign difficulties in the periphery, and in particular in Greece, was of the utmost importance.

The focus should be on strong program implementation, with sufficient proceeds from privatization, adequate financing from other official sources on terms supporting debt sustainability, and private sector based solutions to banking problems (such as cross-border takeovers). This strategy, however, might be difficult to reach given the scale of the targeted adjustment, its possible social repercussions, as well as unfavorable financial market circumstances. The ECB was concerned that a credit event would require it to exclude the affected sovereign debt from its eligible collateral with devastating implications for the country's financial system and scope for spillovers.

22. The crisis has changed a basic paradigm of the euro area, namely that all sovereign debt of euro area member countries is equal. This premise lost credibility in the eyes of market participants some time ago, with markets taking their cue from the discussion about the role of private sector involvement in the design of the European Stability Mechanism (ESM), the permanent successor of the European Financial Stability Facility (EFSF). The Commission and the ECB shared the view that, while market discipline should be pursued, doing so in the midst of a sovereign debt crisis is poorly timed. In their view, such a shift could overburden a thinly capitalized banking system not yet completely ready to shift away from zero risk weight on sovereign holdings, and default could become self fulfilling. Alternatively, public funding could gradually overtake private funding, de facto making common bond issuance increasingly a feature of the euro area and calling into question whether national fiscal sovereignty can be preserved within EMU.

23. Limiting any further damage is now crucial. Aside from strong program implementation, staff emphasized the need to quickly scale up the capacity and flexibility of the EFSF and to go further than planned by allowing the EFSF to intervene in secondary markets and assist with problems in the financial system (see next section). More generally, it will be important to bring the discussion about private sector involvement to completion—both in specific programs and in the context of the ESM. And having in place adequate bank recapitalization plans is essential to mitigate contagion from sovereign tensions. The authorities observed that political constraints delayed clear progress on many of these fronts but emphasized that crisis management efforts had been substantial, noting that in the end courageous decisions had been taken to preserve the stability of the euro area. They anticipated that this time too a solution would be found.

24. **In comparison to the sovereign tensions, other downside risks appear manageable.** Geopolitical problems in the Middle East and disruptions to energy supply could derail global growth. Fiscal consolidation could have stronger adverse effects on domestic demand than currently expected. Persistent weaknesses in the banking sector could put an additional drag on credit supply and delay the much needed normalization in lending conditions. The euro, which is now broadly in line with fundamentals, has been relatively volatile recently. It could move away from this value on either side, not only as a function of developments in the sovereign crisis in the periphery, but also as a result of policy changes abroad or the unwinding of global imbalances, a risk emphasized by the authorities.

III. STRENGTHENING THE FINANCIAL SECTOR

25. **The euro area's banking system continues to display weaknesses.** Leverage remains high, as does dependence on wholesale funding, while considerable refinancing needs will compete with sovereign and corporate issues over the next few years. In the periphery, banks are vulnerable from large exposures to their governments and real estate and from high marginal wholesale funding costs. Indeed the emergence of funding gaps has contributed to heightened competition for deposits in several member states. In other member states, weak governance in some banks led to structurally low profitability and the global financial crisis pushed capital to very thin levels making them vulnerable to any further shocks. Core euro area banks are significantly exposed to the periphery. A number of banks, not exclusively in the peripheral member states, still have to work through a large share of doubtful assets. Recognizing losses promptly, provisioning adequately, and restructuring weak banks will be key. Meanwhile, banks are under pressure to meet and exceed Basel III capital requirements ahead of schedule.

26. **It will be important to get deleveraging right and balance the needs for strengthened bank balance sheets and adequate supply of credit to finance the recovery.** Large companies issued debt at record levels over the past two years but banks continue to provide the overwhelming share of external funding for many firms. Bank lending conditions are stabilizing and credit to firms appears to have bottomed out in the euro area, but many SMEs continue to lack access to bank credit. As Basel III is implemented, banks are likely to pass on some of the costs associated with the regulatory changes which may put further upward pressure on lending rates and limit credit supply especially if the deleveraging is achieved through shrinking assets (Box 3). Nonetheless, capital raising is not likely to have large output effects and long-term benefits outweigh the costs.

27. **There was agreement on the unequivocal need for substantially more and higher quality bank capital and the restructuring of weak institutions.** Many banks remain very dependent on short-term wholesale funding and the reliance on ECB refinancing remains high, especially for banks of the periphery. Yet the experience of Japan shows that insufficient restructuring and regulatory forbearance following a financial crisis can lead to serious macroeconomic consequences in an economy where bank-based financing still dominates. Bank equity issuance has been stepped up, including since the beginning of the year and in the run-up to the current stress tests, but less adjustment has taken place in the

Box 3. Bank Deleveraging in the Euro Area¹

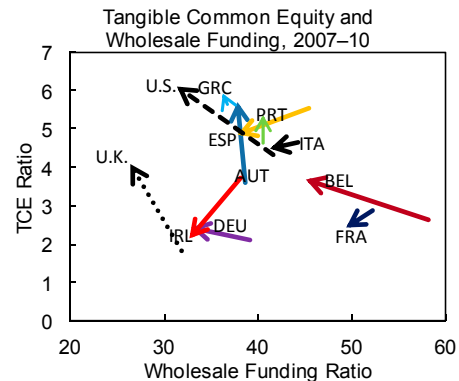
Euro area banks' leverage remains high by international standards.¹ Before the 2008 crisis, euro area banks relied on wholesale funding to keep capital-asset ratios low and turn a relatively weak operating performance into high returns on equity. Since the beginning of the crisis, banks have gradually reduced wholesale funding and, to a degree, leverage ratios, but leverage levels generally remain high, both in absolute terms and compared to the U.S. and U.K. In order to withstand potential future income shocks, euro area banks will need to increase their capital buffers.

Staff estimates suggest that bank profitability is going to remain low overall, questioning the capacity of banks to rely on retained earnings to build capital buffers. Staff projects that profitability will improve slightly under the baseline WEO scenario but will stay far below pre-crisis levels, mainly because of persistently high nonperforming loans. Slightly less than half of the banks, accounting for 30 percent of banking sector assets included in the exercise, would remain unprofitable until 2015. Moreover, exposures of core euro area banks to the program countries are high as a percent of bank capital. According to BIS official data, exposure of German, French, Belgium but also Irish banks is particularly high. Hence, many European banks will have little alternative but to resort to private equity markets to rebuild their capital buffers.

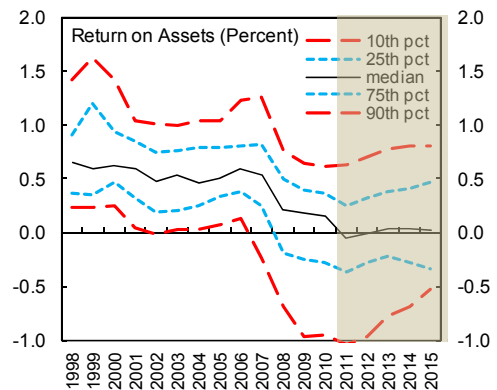
Building capital buffers faster and to higher levels than required under the Basel III agreement will come at moderate output costs. According to Fund estimates based on the BCBS MAG study, the peak output loss from increasing capital requirements by 1 percentage point of risk weighted assets range from about 0.29 percent to 0.32 percent depending on the country and the speed of implementation. Importantly, a faster implementation of Basel III—for example within 2 years instead of the 6 years currently envisaged—would make virtually no difference in term of the average output loss, suggesting that fast equity issuance would not penalize economic growth.² This reinforces the call for strengthening the banking sector through capital issuance rather than lending, which would likely add to the output effects.

1/ Prepared by Thierry Tressel and Nico Valckx

2/ See also the IMF Regional Economic Outlook for Europe (REO) on deleveraging in the euro area, May 2011 (pp.10–12).

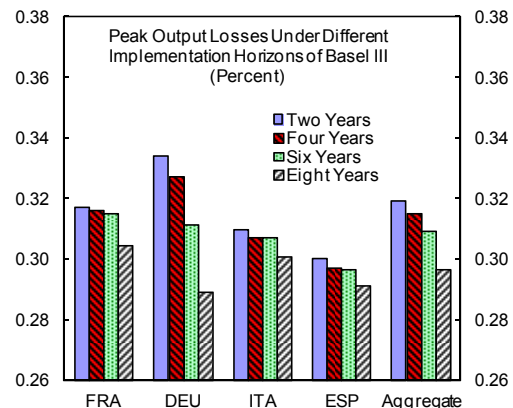


Sources: Bloomberg; and IMF staff estimates.



Source: Bloomberg, staff computations

Note: ROA is estimated by subcomponents with dynamic panel regression techniques, using a set of standard country-based macro and financial variables as explanatory variables. Exceptional income is excluded from ROA. Projections assume a 20% income tax and 10% rebate in case of losses.



Sources: Vitek, F. (2009), Monetary policy analysis and forecasting in the world economy: A panel unobserved components approach, *International Monetary Fund Working Paper*, 238.

euro area than in the United States and the United Kingdom, in terms of recapitalization and the reduction of reliance on wholesale funding. Against this background, the ECB concurred that banks should recapitalize well ahead of the Basel III timetable, in line with market pressures, with a strong frontloading especially by second tier weak banks. The authorities agreed that overall capital needs were likely to be manageable, while acknowledging that program countries had, however, run out of fiscal capacity. The lack of progress in raising capital was seen as the result of shareholder protection, public sector stakes, and the focus on national solutions. The authorities were confident that the ongoing stress test exercise would be more credible and of higher quality and intended to press banks close to the chosen threshold to raise capital as well. Staff emphasized the need for consistent follow up of the stress tests and expressed concern about the incomplete treatment of sovereign risks. Staff also urged the authorities to raise capital as soon as possible, as was happening in some countries.

28. **It will be important to look for private cross-border solutions to strengthen the euro area's financial system.** The Commission and the ECB agreed that clear priority should be given to private sector solutions, including private capital raising and cross-border mergers and acquisitions. Staff emphasized that the relevant Directives for Cross-Border Acquisitions and Takeovers should be applied, or reviewed if necessary, to overcome the formal and informal national obstacles to the free flow of equity capital. Public support may nonetheless still be necessary and should be made available in a manner coordinated across the EU.

29. **Staff argued that re-developing the market for securitization, appropriately regulated and based on high quality standards, should complement credit supply as bank deleveraging proceeds.** European regulators should actively support the development of market-based alternatives for corporate finance to reduce the dependency of the euro area economy on the banking system. The ECB noted that the structure of the financial system has served Europe well in the past but agreed that the development of securities markets should not be impeded. There was agreement that many banks that depend heavily on ECB financing would have problems regaining market access in the near term. Staff argued for establishing a conditional term funding facility for private illiquid (but performing) assets, operated by the ECB with the explicit backing of euro area sovereigns (e.g., via the EFSF) to protect the ECB's independence and flexibility, and reinforce the need to tackle the banking problems at their root. This would also relieve pressure on the ECB in the context of private sector involvement in crisis countries. However, the ECB felt that this was beyond its remit.

IV. SECURING ECONOMIC AND MONETARY UNION

30. **Incomplete economic, financial and fiscal integration is casting a shadow on the future of EMU and weighing on the euro area's growth potential.** National policymakers in the euro area need to move away from the illusion that a national approach to fiscal, financial, and structural issues preserves sovereignty in a monetary union. Instead, they should focus on the fact that interconnectedness requires more common thinking from an area wide perspective. While progress has been made in strengthening governance, political obstacles remain to be overcome. The staff sees the ultimate need to deal with the financial system at the euro area rather than the national level and to put in place some form of ex ante

fiscal risk sharing, conditional on prudent fiscal policies and in the context of a binding economic governance framework that would remove remaining obstacles to the free flow of goods, labor, and capital across all sectors and national borders of the euro area. This may be a tall order, but without a decisive breakthrough in these areas, the euro area is unlikely to live up to its potential.

A. Financial Sector Reforms and Macroprudential Policies

31. **Establishing the credibility and effectiveness of the key new elements of the EU financial sector architecture now in place is a priority.**⁶ The European Systemic Risk Board (ESRB) and the European Supervisory Authorities (ESAs) have become operational, and should become the core of a more coordinated and integrated European financial stability framework. However, their credibility needs to be established, and some gaps remain in the framework that limit its effectiveness. Particularly important will be the collaboration among EU institutions, including regarding data and information sharing, and the relationship with national authorities. The ESRB should move ahead forcefully in developing the EU macroprudential policy toolkit in collaboration with other EU institutions and national authorities.⁷

32. **There was agreement that rapid progress towards establishing the single rule book is needed, and Capital Requirements Directive 4 (CRD4) should implement Basel III swiftly and without exceptions.** The Commission and the ECB called for harmonization of new rules at the EU level with scope for providing some flexibility for macroprudential purposes. Staff supported the position that capital requirements should be set at an ambitiously high common level (above Basel III) to reflect prevailing balance sheet uncertainties, a high degree of interconnectedness and the lack of an effective resolution framework for banks operating cross-border. In addition, capital regulations must allow sufficient flexibility to introduce macroprudential tools, including adjusting capital and liquidity requirements or varying risk weights, to mitigate systemic risk that could jeopardize financial stability. This flexibility needs to extend to capital surcharges for systemically important financial institutions. The ESRB should play a prominent role in the coordination and calibration of macroprudential instruments, including on key aspects of home-host coordination and reciprocity, and finding a balance between rules and discretion.⁸ Staff suggested that the zero risk weight for sovereign bonds in bank capital requirements will need to be adjusted to reflect the market perception of sovereign risk and the design of the ESM, which should be taken into account when strengthening bank capital.

33. **The staff called for faster progress toward a unified European financial supervisory, resolution and stability framework.** The European Banking Authority must become effective rapidly to guarantee high standards of supervision for banks operating across euro area and EU borders, including through the building of a prudential database and

⁶ For detailed analysis, please consult the accompanying background paper, entitled “Lessons from the European Financial Stability Framework Exercise” (EFFE).

⁷ For a discussion of the interplay between national and supranational macroprudential policy frameworks, see Selected Issues Paper, Chapter 3.

⁸ See Selected Issues Paper, Chapter 3.

data sharing with and among national authorities. The staff felt that it would be important to complete the EU financial stability framework with the establishment of a European Resolution Authority backed by common deposit guarantee and resolution funds—that could be financed by a levy on the industry—to improve ex-post burden sharing and provide an EU-centered backstop for both liquidity and solvency support. At the minimum, such an end-goal would need to be agreed upon now. This would provide the right incentives to underpin the cooperation in the new supervisory architecture, allow the use of cross-border private sector based solutions to address banking problems and end the intertwining of sovereign and bank balance sheets. This approach would be fully consistent with the objective of limiting the use of taxpayer funds while minimizing market disruptions.

34. **With responsibility for supervision remaining national, the authorities felt that some of the staff’s proposal would be infeasible, at least in the short run.** While there was general agreement on the need for a more common approach to the financial system in the EU, and especially in the euro area—a point emphasized by the ECB, the authorities felt that it was premature to consider the establishment of a European Resolution Authority. Instead, the current proposal is for setting up resolution colleges (bringing together national resolution authorities) and harmonizing national resolution tools and deposit guarantee schemes. The authorities also felt that the new institutions needed to be given time to establish their effectiveness and envisaged a review of the entire framework in 2014. The staff responded that the national approach had proven deficiencies, and that fixing weaknesses identified by the EFFE should not be delayed.

B. Advancing Policy Coordination in the Euro Area

35. **The staff feels that governance reforms currently envisaged will have to go further to establish an effective EMU.** Effective crisis management and a resilient monetary union call for some delegation of countries’ sovereignty to the center, that would have an authoritative say in the formation of national policies, and issue a reasonable amount of well-managed debt, supported by larger and credible revenues.⁹ This would put both public finances and the financial system on a sounder footing and require adjustments in the structure, institutions and political underpinnings of the euro area that go beyond the Treaty. However, the authorities see the current political economy as divided on the need for such an approach.

36. **The ESM presents a first step towards a fiscal insurance scheme for the euro area.** The ESM will provide support for countries facing sovereign funding pressures. Its final design and coverage should encourage prudent national policies while preserving financial integration of EMU and the attractiveness of its sovereign debt instruments which is key for a large reserve currency. Financial support under ESM should not be conditional on debt restructuring and be conducive to continuing private sector engagement. The ESM could evolve into a European debt management agency if the political will were mustered for limited fiscal integration that included common bonds backed by enhanced euro area fiscal capacity.

⁹ See Selected Issues Paper, Chapter 4 which discusses these issues in more detail.

37. **The new Euro Plus Pact should become an important instrument to accelerate economic integration of the euro area** (Box 4). Under the Pact, national leaders coordinate and commit to a limited set of national policies, key to promoting competitiveness and employment and safeguarding financial stability and fiscal sustainability. Measures announced so far, however, do not live up to expectations. To become an important instrument to govern economic policies, commitments should be more ambitious, concrete and time-bound. Other EU enforcement instruments of common policies such as guidelines and recommendations (e.g. the employment guidelines), or directives (e.g. the Services Directive)—should be strengthened. The new Excessive Imbalances Procedure (EIP) could help detect and correct policies giving rise to unsustainable imbalances.

38. **Successful fiscal consolidation requires more stringent budgetary surveillance at the EU level** (Table 1). Recent reforms are important steps in this direction. The European semester, which establishes an ex ante peer review of member states' plans prior to the finalization of national budgets, has become the key policy coordination tool to strengthen fiscal discipline, complemented by the Euro Plus Pact. New SGP rules will include an amended EDP with numerical benchmarks also for debt reduction in countries exceeding 60 percent of GDP and a cap on growth in public spending net of discretionary revenue measures to encourage saving revenue windfalls. Sanctions will start already in the preventive arm of the SGP and be more progressive. However, a number of concerns remain regarding the effectiveness of the SGP. In particular, the standard decision-making process with qualified majority voting in the Council still applies to the initiation of the EDP and the possibility to suspend sanctions and extend deadlines for countries under the EDP.

39. **The directive on national fiscal frameworks will encourage prudent national fiscal behavior.** By setting institutional incentives for responsible budgetary policy (Figure 9), the directive is a necessary complement to the SGP reform. The proposal is meant to make fiscal rules more binding, enhance medium-term orientation to fiscal policy, improve fiscal transparency, and contemplates the possibility of national councils responsible for independent surveillance of budgetary policies. The directive could be made more effective by requiring systematic disclosure of information on state-owned corporations and public private partnerships, spelling out good practices for fiscal rules, escape clauses and budget control, and extending the list of fiscal risks beyond contingent liabilities. Other critical elements of budgetary frameworks such as budgetary unity and the need for a top-down sequence in budget preparation would be most welcome.

40. **Securing a more dynamic and resilient monetary union through deeper integration has broad support, but there are differences in ambition.** The ECB particularly welcomed the mission's attention to the benefits of completing the integration of European capital, labor, goods and services markets, while the Commission pointed at the many longstanding initiatives in this direction and the need to review some of the relevant directives to replenish its toolbox. Both hold high hopes for the new Excessive Imbalances Procedure to foster the opening up of markets and other structural reforms at the national level, but the ECB remains disappointed by the lack of ambition in the area of fiscal governance.

Box 4. Governance Reform: Are We There Yet?¹

The history of the European project is marked by a tension between the pursuit of deeper integration and its members' will to perpetuate economic nationalism. The creation of the customs union during the 1960s—granting to the Union *exclusive* competence on external commercial policy—was followed by the launch of the single market in the 1980s, giving the Union *shared* competence with member states. Still countries' legislative role in internal market matters is subordinated to that of the EU. By contrast, in the fiscal, structural and macroprudential areas, the Union just exerts a *coordinating* role, supplemental to members' policies. There is an inescapable dilemma between absolute control by the national state, deep cross border economic integration and full democratic integration (Rodrick, 2011). This is why decentralization in economic policy is challenging the integrity of the European construction.

The crisis has prompted reforms to strengthen EU's coordinating role of fiscal, structural and financial policies, while keeping national sovereignty in these areas mostly intact. The governance package foresees a reform of the SGP and a new EIP. The revamped SGP will help contain pro-cyclical policies in good times (by capping the expenditure-to-GDP ratio), make the debt criterion operational (by placing under EDP countries reducing indebtedness at a yearly pace lower than 1/20th of the distance from the 60 percent limit), and strengthen enforcement (including by a wider spectrum of sanctions). While welcome steps, the effectiveness of fiscal surveillance could be substantially improved by: (i) introducing legal provisions requiring the correction of past upward drifts in public expenditure; (ii) calibrating more ambitious and country differentiated Medium-Term Objectives (MTOs) to realistically face sustainability challenges posed by the crisis and aging populations; (iii) initiating EDPs by reverse qualified majority (RQM), whereby the Commission's recommendation prevails unless the Council decides otherwise by qualified majority; (iv) restricting sanction waivers; and (v) tightening legal deadlines for corrective action.

As fiscal excesses may be neither the only nor the most important source of macroeconomic imbalances, the new EIP is being introduced as a complement to the revised SGP. Imbalances can be of two kinds, internal (if prompted by irresponsible fiscal behavior, credit excesses and asset bubbles) and external (if rooted in competitiveness deficiencies), both affecting the current account balance (CAB) and international investment positions (IIP). The EIP comprises a *preventive* arm, identifying imbalances and their underlying causes, and a *corrective* arm, requiring the adoption of adequate fiscal, structural and macroprudential remedies. Current proposals helpfully identify general objectives, but to be effective, EIP regulations will have to: (i) specify alert thresholds for key indicators (CAB and IIP at the very least, given their comprehensive character); (ii) set out binding deadlines throughout the EIP; and (iii) use RQM in the activation of the EIP and all relevant steps.

The proposed governance package steps up the amount of surveillance, peer pressure, and sanctions—yet it leaves Rodrick's trilemma unresolved: more coordination helps, but a fully integrated Economic and Monetary Union will need to shape national economic policies in a more intrusive way that ensures that common interests prevail also (or in particular) in times of crisis. A genuine fiscal and economic union can deliver this, but additional and bold institutional changes will be needed. For example:

- *Shared competence over fiscal matters for sovereigns breaching the region's rules.* This could require, among other things, the establishment of a euro area institution vested with powers to override national policies conflicting with the common interest. An alternative route to ensure responsible fiscal behavior would be to constitutionally mandate constraints on national borrowing (for example, as part of the planned national fiscal framework Directive)
- *Risk-sharing against country-specific shocks.* Some ex ante fiscal risk sharing would be beneficial but the *quid pro quo* for a sizable flow of transfers within the region must be more binding fiscal governance including the delegation of some sovereignty towards the center. Along similar lines, a more complete euro area financial stability framework backed by a proper EU banking supervisory authority, would be desirable.

- *Euro area fiscal stabilization would require an increase in the resources managed by the center, while Eurobonds would ensure an efficient inter-temporal allocation of fiscal capacity. Given the size and liquidity of its market, the Eurobond should have a substantially lower cost than the weighted average of the national bond yields. And appropriate design should avoid moral hazard issues (Delpla and Weizsacker, 2010).*
- *Enhanced flexibility in capital, labor and product markets will be needed to insure countries against protracted adjustment. While fiscal transfers should assist countries when shocks affect their fundamentals, they will never be sizable enough to fully substitute for market-driven adjustment.*

A more resilient EMU is likely to require curbing the powers of national governments and amending the Treaty and Constitutional laws in a major way. But such a curb is more apparent than real compared to the cost of crises caused by lack of integration.

1/ Prepared by Esther Perez-Ruiz.

C. Growing Out of Crisis

41. **Overcoming the euro area sovereign crisis requires Europe to finally unleash its growth potential and complete economic and financial integration.** Europe’s ambitious growth agenda for the past decade failed and the income gap with the US and other advanced countries increased further even before the crisis hit. Lack of determined political action, an overloaded agenda, poor coordination and conflicting priorities all contributed. A more dynamic and stronger economy is now crucial to safeguard Europe’s cohesion, reduce imbalances and allow the countries under sovereign stress to grow out of crisis. Reforms should focus on:

42. ¹⁰

- Measures to deepen financial integration and reduce public ownership and involvement in the banking sector. Domestic banks often enjoy protected “national champion” status, and prevent sufficient competition and efficiency, also hampered by the lack of standardization of financial products.
- Lowering remaining barriers to competition still present in network industries, retail trade and regulated professions; and removing unnecessary procedures and costs weighing on entrepreneurship. Reform and harmonization of bankruptcy proceedings would facilitate exit of inefficient firms. For SMEs this can be achieved by transposing to national legislations the principles stipulated in the *Small Business Act*.
- An ambitious liberalization of the 160-odd professions covered by the *Services Directive* is imperative to raise efficiency and competitiveness (since many services serve as inputs for final export goods), especially in the periphery. Alignment with

¹⁰ For a discussion of the main growth drivers and constraints, please consult the Selected Issues Paper, Chapter 5.

best liberalization practices can benefit from the peer review under the Mutual Evaluation Process and greater involvement of the European Court of Justice.

- Improving enforcement of competition rules and strengthening the independence of national competition authorities.
- Addressing labor market segmentation, informal economy and inadequate wage flexibility (especially in countries suffering from competitiveness problems) in a move towards a Single Labor Market. Upgrading education systems will be important to enhance productivity, especially in the periphery. More flexible arrangements for part-time work should help raise employment rates, especially for women where they remain low. Pension reforms could support higher employment rates for older people.
- A deficit-neutral shift in taxes from labor to consumption (e.g., VAT), preferably coordinated across the euro area. Competitive corporate tax rates and simplification and harmonization of tax codes and regulations should limit the burden on firms across the EU. Further trade liberalization, the unwinding of sectoral subsidies and the end to disguised forms of protectionism are needed as well.

V. STAFF APPRAISAL

43. **Despite strengthened economic activity in the euro area, the handling of the sovereign crisis in the periphery will define the outlook and the future of the economic and monetary union.** A dominating core is pulling ahead of a periphery facing daunting challenges, with very high debt levels, severe competitiveness problems, and fragile banking systems. While strong national policy action will remain essential and courageous common steps have been taken to address the crisis, policymakers now need to make a fundamental choice between allowing national domestic considerations to upset the project of integration and monetary union, or forging ahead to strengthen EMU. The latter is the only viable course of action, without which tensions from the periphery could flare up and infect the core of the euro area with large regional and global spillovers.

44. **If contagion from the periphery can be contained, macroeconomic policies should be able to reflect that the recovery is becoming less dependent on public sector support.** Pursuing fiscal consolidation as planned would then enhance confidence, with positive spillovers to the rest of the world, provided policy gaps between announced targets and actual policies are closed and automatic stabilizers are allowed to work. Program countries may need to extend their adjustment path to minimize the recessionary impact of their adjustment, subject to available financing. With price pressures up but still moderate, monetary accommodation can be withdrawn at a very gradual pace, while leaving some unconventional measures in place to attend to pockets of stress in the financial system.

45. **To resolve the crisis in the periphery, not only strong national program implementation, but also a cohesive and cooperative approach by all euro area stakeholders will be essential.** Rapid implementation of the commitment to scale up the

EFSF and a further extension of its potential uses is important to confirm that member countries “will do whatever it takes to safeguard the stability of the euro area.” In this

context, it will be essential to use great care in communicating to markets the modality of private sector involvement, and avoid any impression that under the ESM, financial support will be conditional on debt restructuring. Consistent treatment of sovereign risk will also require revisiting the capital risk weighting of sovereign debt in financial sector balance sheets.

46. Strengthening the financial system to allow banks to deal with remaining uncertainties is an immediate priority. Capital raising from private sources should move ahead immediately and the follow up to the ongoing stress tests should lift capital to levels that can handle the current high degree of uncertainty and mitigate the contagion from the sovereign crisis affecting some member states. Any residual public support that must be put in place should be coordinated across the EU. There is also merit in considering a term funding facility for illiquid, but still performing, private assets, with the explicit backing of the euro area sovereigns, e.g., through the EFSF/ESM. And capital market development should be embraced rather than resisted to reduce the dependence of the euro area economy on the banking system.

47. To succeed, all these actions need to be undertaken in the context of a consistent push to strengthen EMU:

- The interconnectedness of the financial system argues for a rapid completion of the financial stability framework of the euro area, building on recent progress. The missing piece, crisis management and resolution with a common backstop (largely funded by the industry to protect the taxpayer), needs to be put in place without delay. Meanwhile, ambitious and common rules for regulation and supervision should be adopted without exception, to underpin the single financial market, while leaving sufficient room for macroprudential policies, coordinated by the ESRB. A full fledged EU FSAP taking into account interconnectedness would be useful.
- Stronger economic governance of the euro area is indispensable, combined with a greater degree of ex ante fiscal risk sharing. The welcome efforts underway to strengthen the SGP’s preventive and corrective arms, upgrade national fiscal frameworks, promote policy coordination under the European Semester, foster structural reform under the Euro Plus Pact, and detect and correct imbalances under the EIP need to be taken further. All these governance tools will need to be made more binding and relevant for national decision making, with quasi-automatic activation and tighter deadlines.
- More economic and financial integration is essential for a dynamic and stable EMU and to boost potential growth. This calls for the completion of the single market. Labor, goods, and services, and especially equity capital need to flow freely across sectors and borders. A fully integrated economy has no need for “national

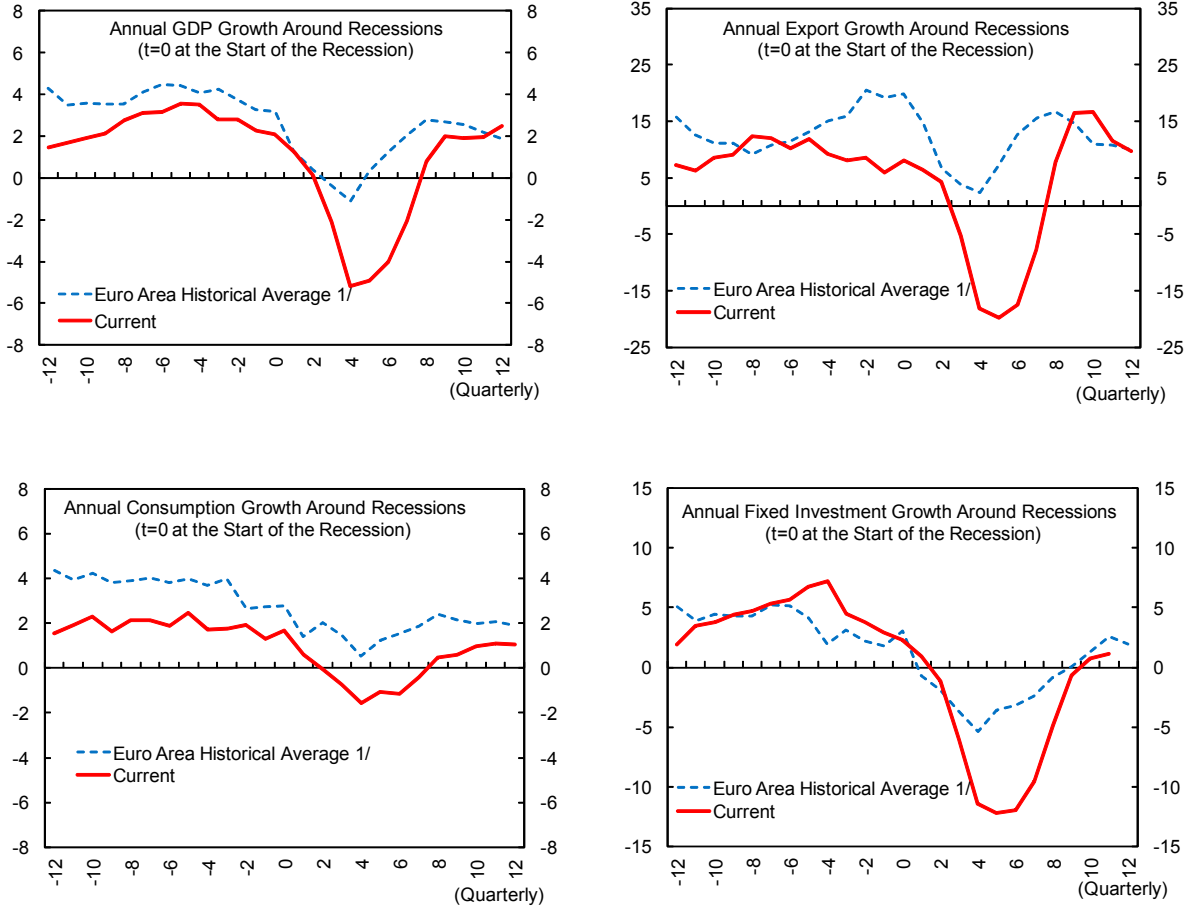
champions,” and calls for a consistent and broad application of relevant European regulations and Directives. In this context, executing the structural reform agenda with more emphasis on ensuring contestability and competition will greatly bolster growth prospects.

48. **Given the euro area’s role in the global economy, success in addressing the sovereign crisis in some of its member countries and raising growth has a significant impact elsewhere.** A cohesive and cooperative approach containing the sovereign crises will limit global spillovers. At the same time, the rest of the world will profit from policies that lift the euro area’s growth potential, and would have positive, though modest, external spillovers. Similarly, the EU’s support for a successful Doha round of trade liberalization remains essential.

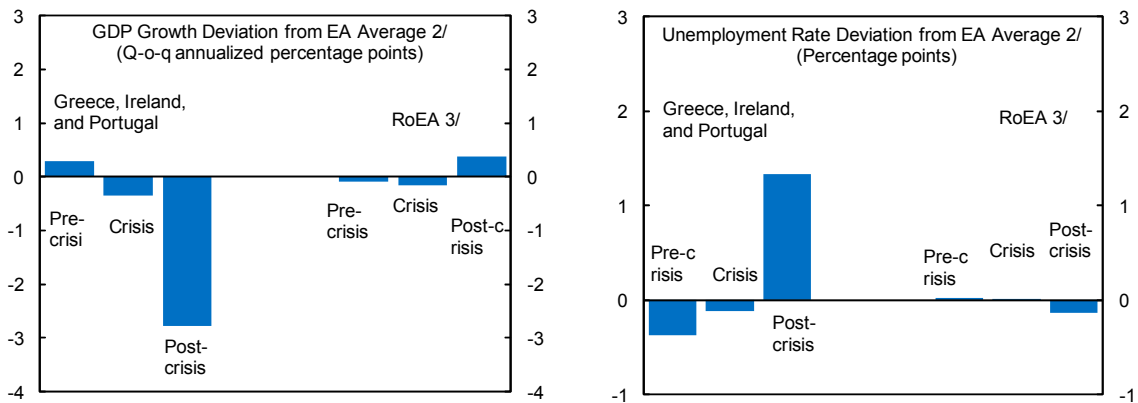
49. The staff proposes that the **next consultation** on euro area policies in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

Figure 1. Euro Area: Current Crisis Compared to Past Episodes
(Annual percentage change, unless otherwise indicated)

Following an unusually deep downturn, the recovery is now tracking the pattern of past upturns, with growth rates of GDP, exports, consumption, and fixed investment broadly in line with past experiences.

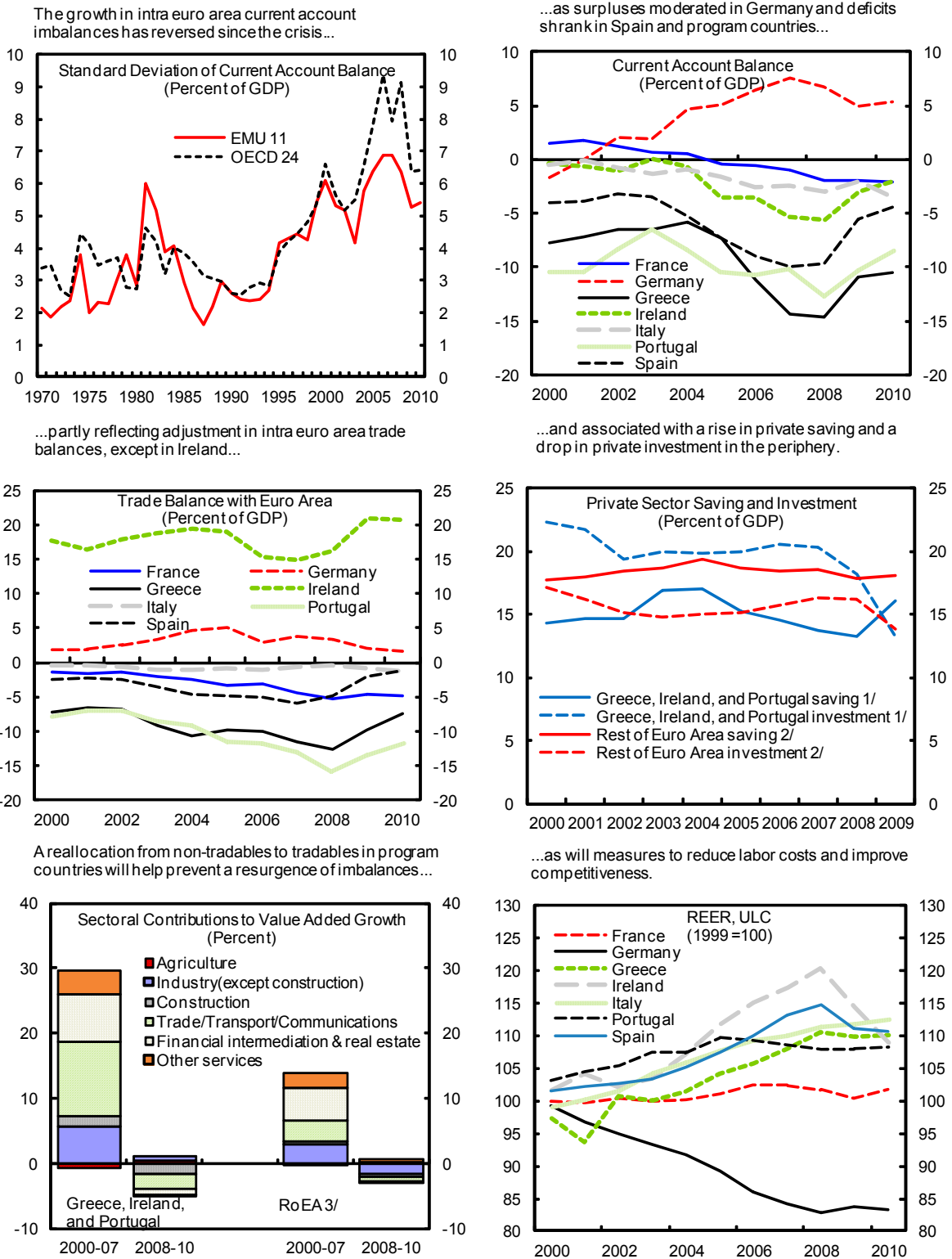


However, substantial divergences persist across economies, with Greece, Ireland, and Portugal lagging the rest of the euro area in terms of GDP growth and labor market stabilization.



Sources: OECD; Eurostat; IMF, *World Economic Outlook*; and staff calculations.
 1/ Historical data are from 1960Q2.
 2/ Pre-crisis: 2006Q1-2008Q1; crisis: 2008Q2-2009Q1; and post-crisis: 2009Q2-2010Q4.
 3/ Rest of euro area.

Figure 2. Intra Euro Area Imbalances



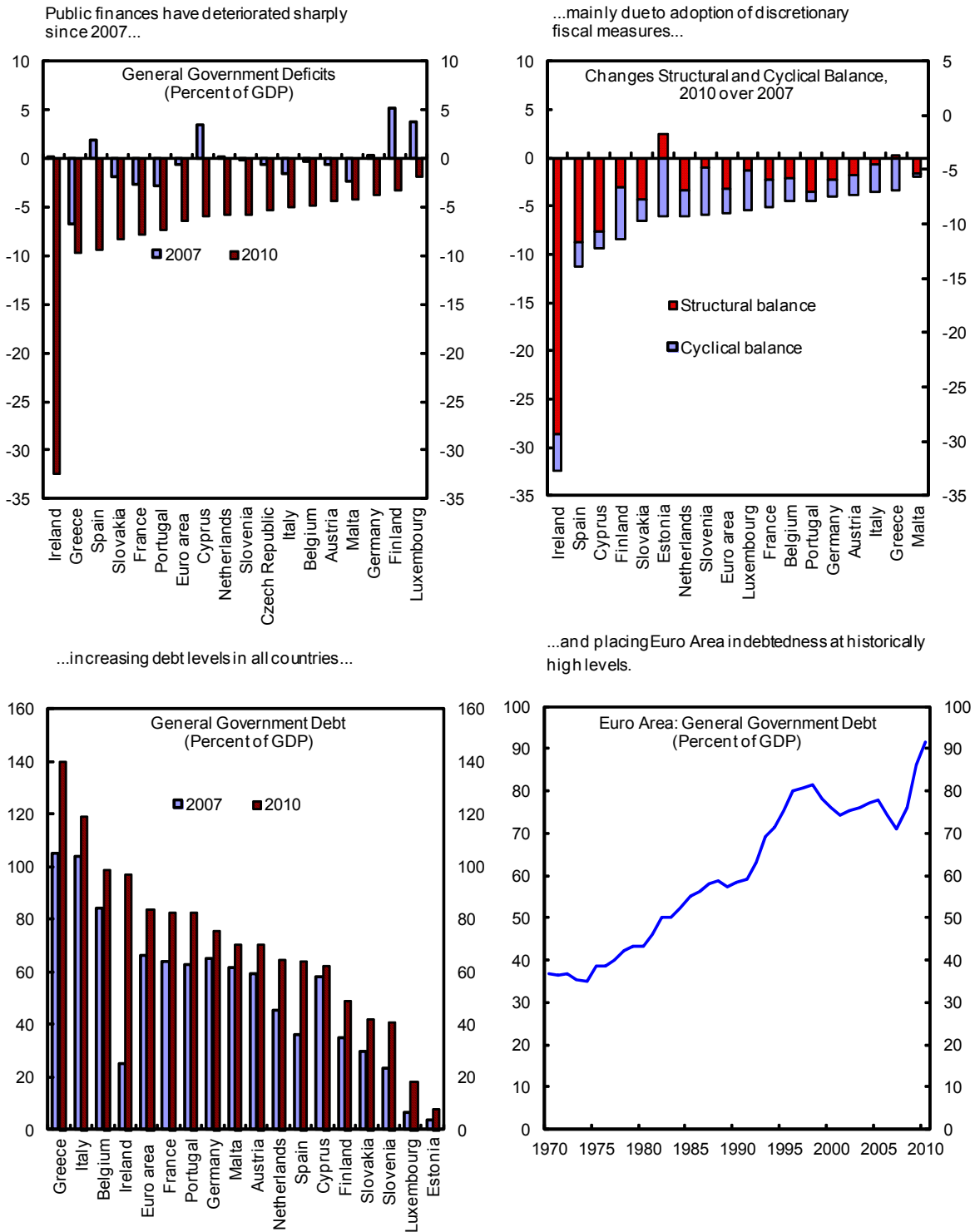
Sources: European Commission; Eurostat; IMF, *World Economic Outlook*; and staff calculations.

1/ Excludes Ireland for 2000-01.

2/ Excludes Malta and Luxembourg.

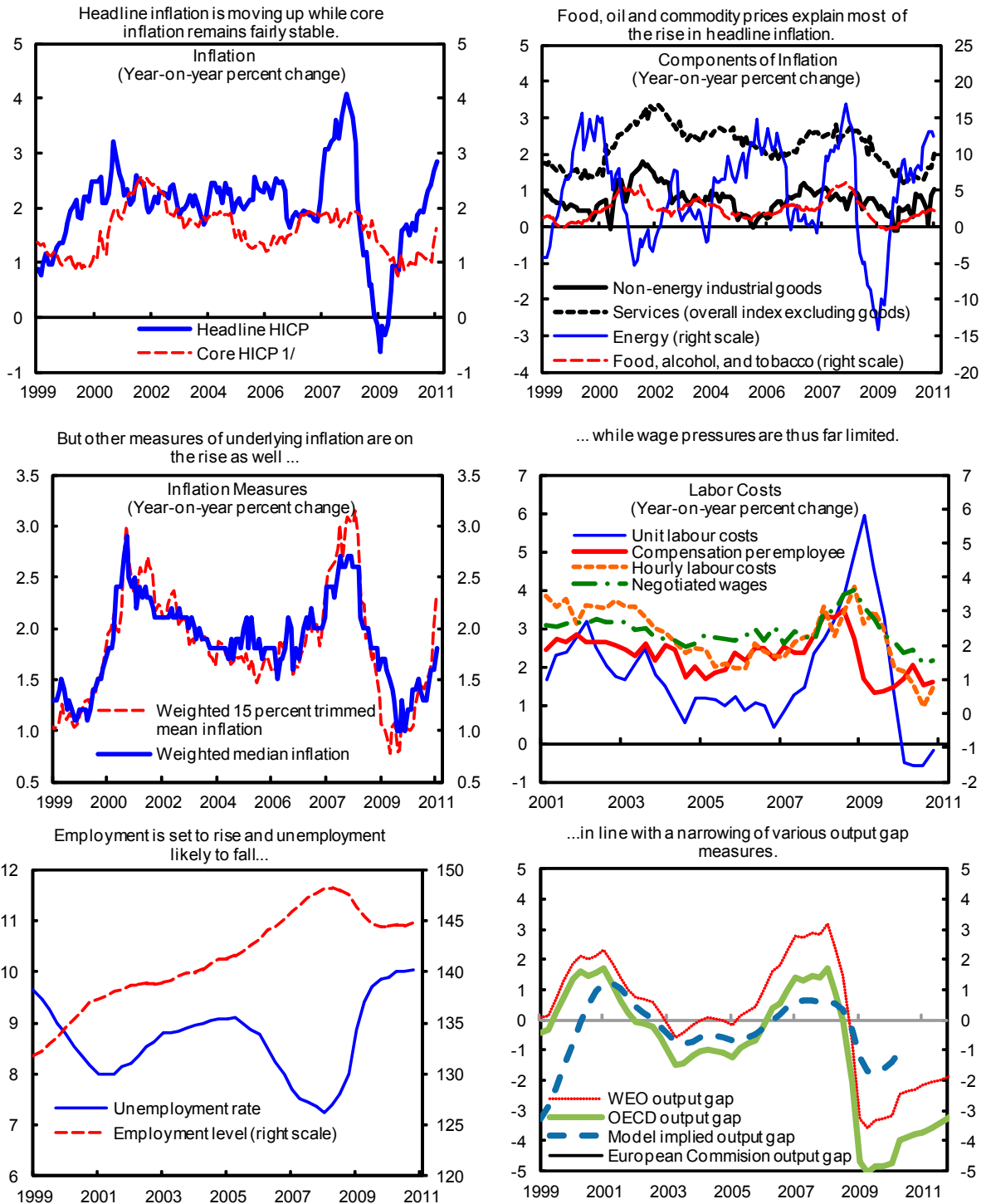
3/ Rest of euro area excludes Estonia.

Figure 3. Euro Area: Deficit and Debt Developments, 2007–10



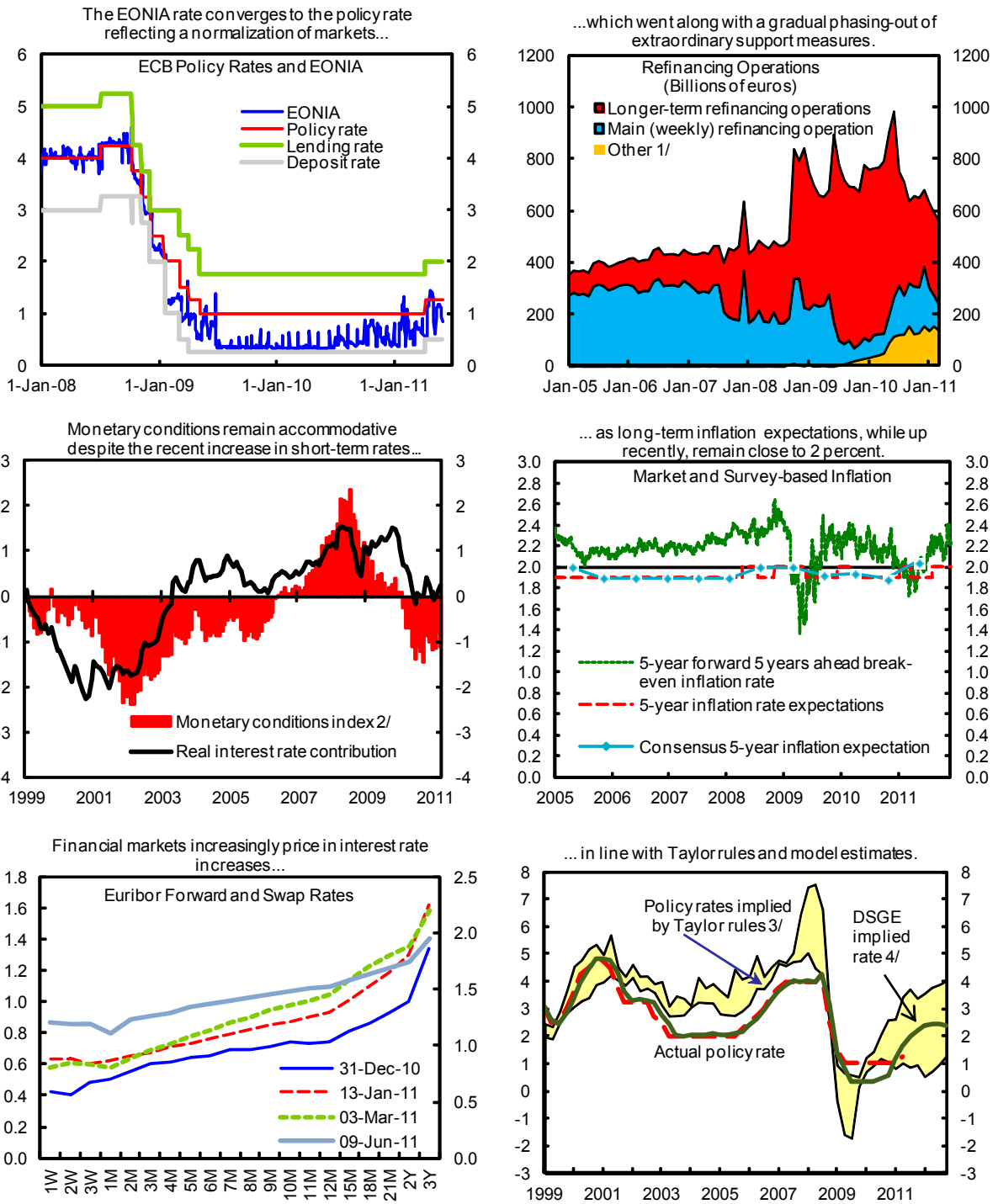
Sources: IMF, *World Economic Outlook*; and OECD.

Figure 4. Euro Area: Inflation, Labor Costs, Unemployment and Output Gap



Sources: Eurostat; ECB; European Commission; Haver Analytics; OECD; IMF, *World Economic Outlook*, and staff calculations. 1/ Core inflation is measured as HICP ex food, alcohol and tobacco. In January 2011, the treatment of seasonal products (fruits, vegetables, clothing and footwear) was changed, which adds to the volatility of the annual changes.

Figure 5. Euro Area: Monetary Policy



Sources: EuroStat; ECB; Economic Commission; Bloomberg L.P.; and IMF staff calculations.

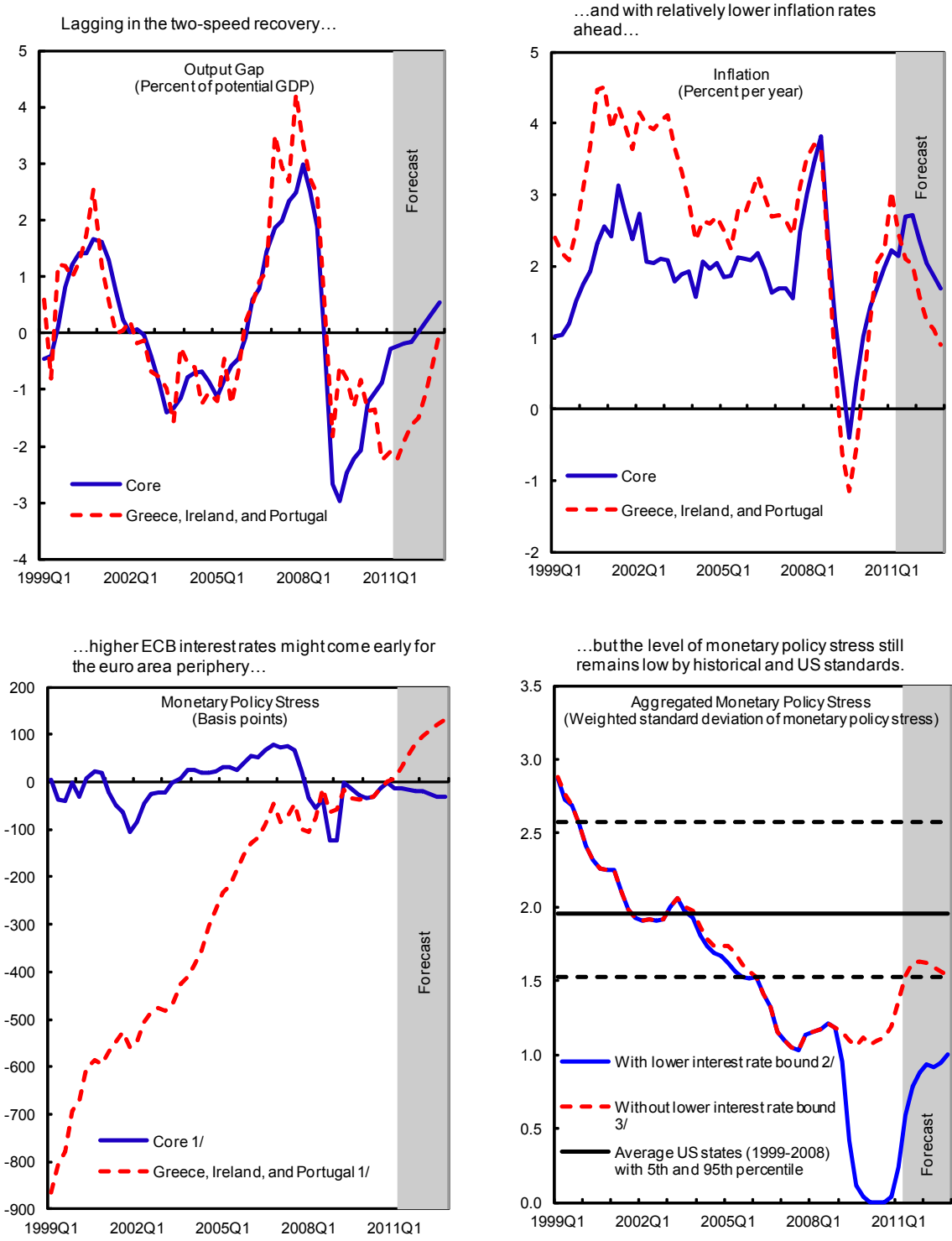
1/ Includes covered bonds, SMP purchases, margin calls, fine-tuning operations.

2/ The monetary conditions index is a weighted average of real interest rate and real exchange rate deviations from their 1993–2006 means.

3/ Range (in yellow) based on various Taylor rules calculated using standard coefficients, headline or core inflation, and actual or expected inflation deviations from target.

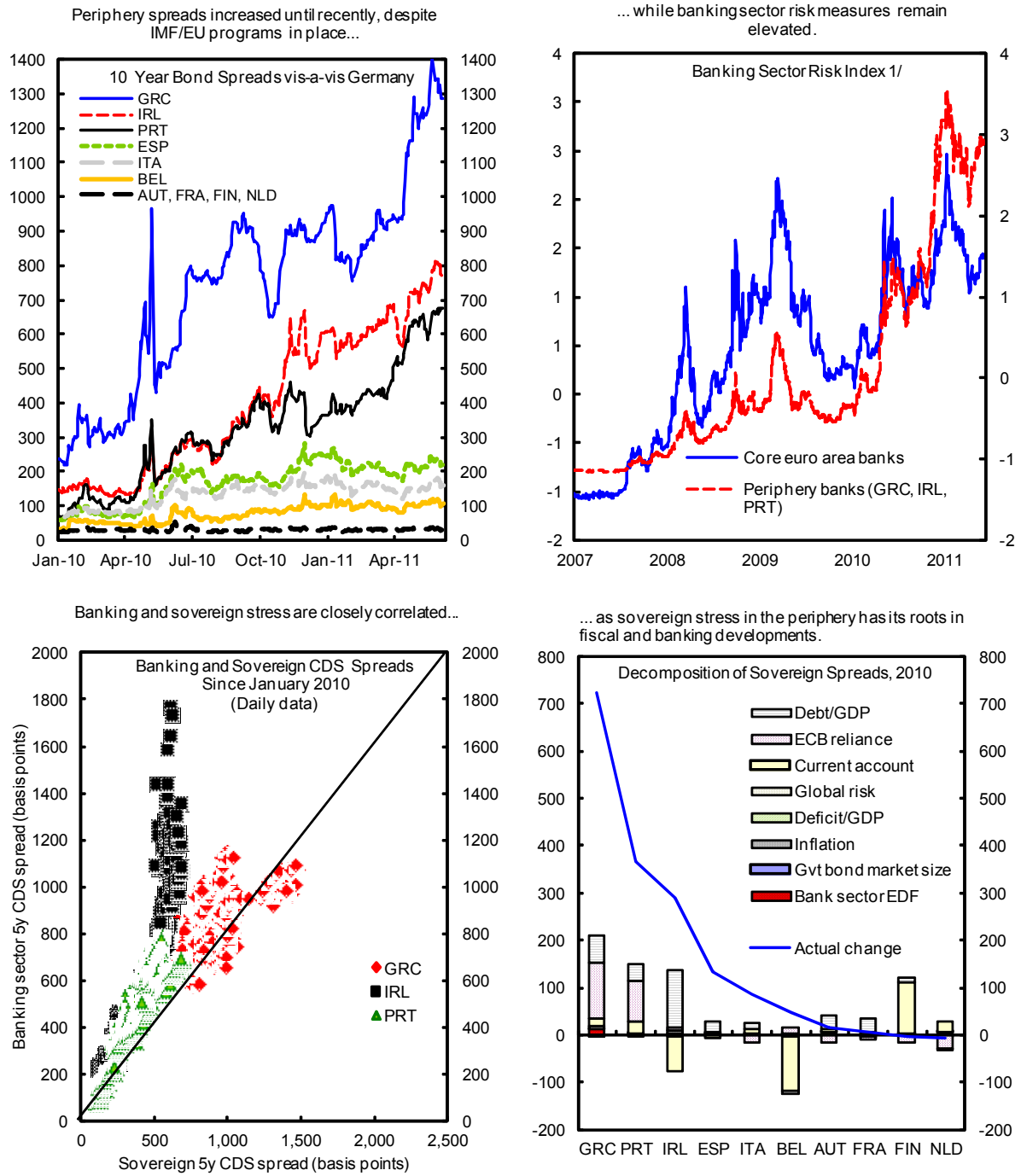
4/ Implied Policy rate based on DSGE model (green line).

Figure 6. Euro Area: Monetary Policy Stress



Sources: IMF, *World Economic Outlook*; and staff calculations.
 Notes: Core: Belgium, France, Germany, Italy, and Netherlands.
 1/ Difference between the actual ECB policy rate and Taylor-rule implied optimal country interest rates. All interest rates are predicted by a Taylor rule using WEO forecasts.
 2/ Taylor rule implied country interest rates are bound at 1 percent (the observed ECB minimum policy rate).
 3/ Taylor rule implied country interest rates are unconstrained.

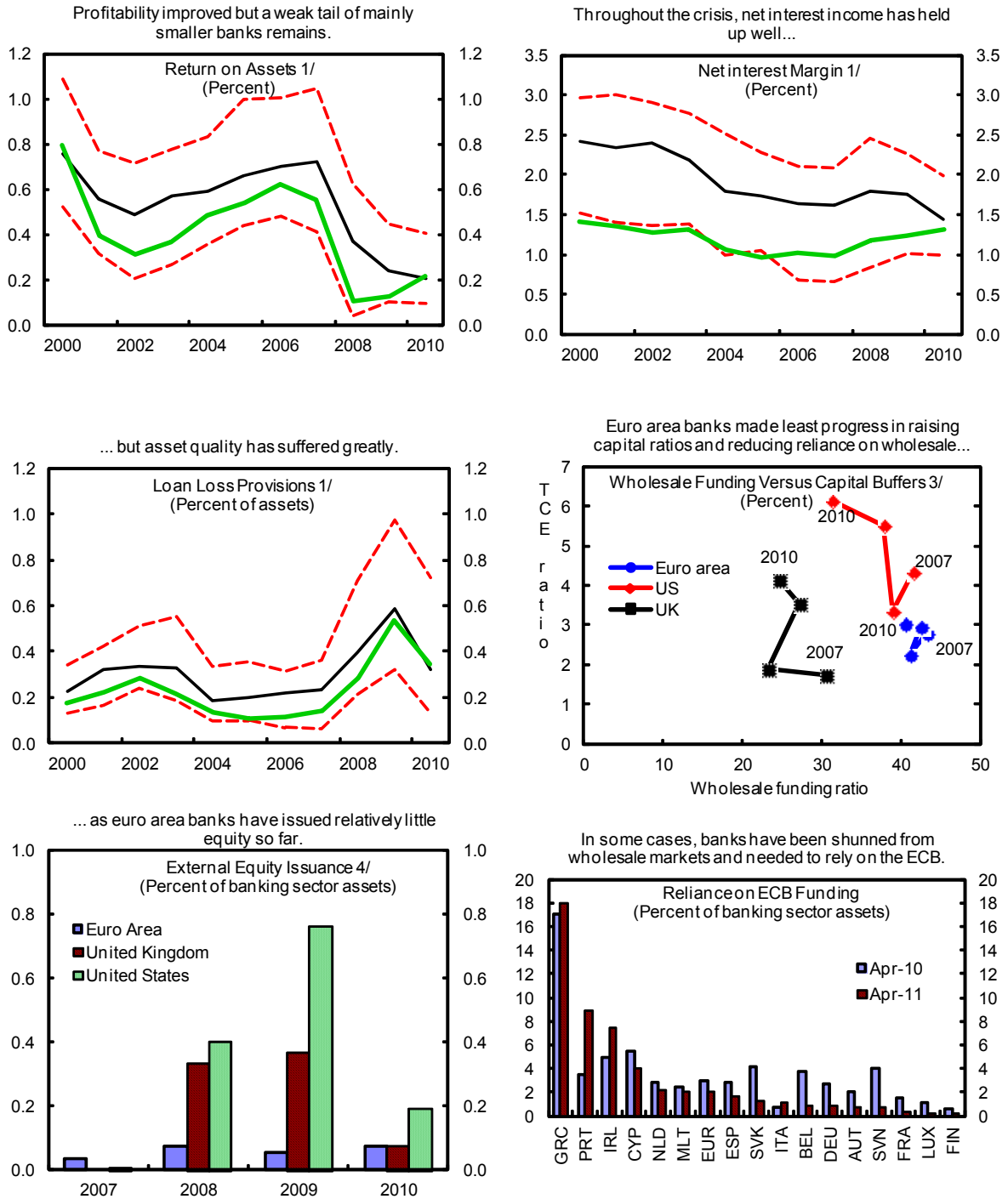
Figure 7. Euro Area: Sovereign and Banking Sector Risk Spillovers



Sources: Bloomberg L.P.; Haver Analytics; and IMF staff calculations.

1/ Normalized score from a principal component analysis on 5-year senior bank credit default swap spreads, estimated using daily data (January 2005-June 2011). The core risk index comprises CDS spreads of 35 banks and the periphery risk index 11 banks (GRC, IRL, PRT). The first principal component captures 85.5% of the common variation across core country banks and 82.5% across periphery country banks.

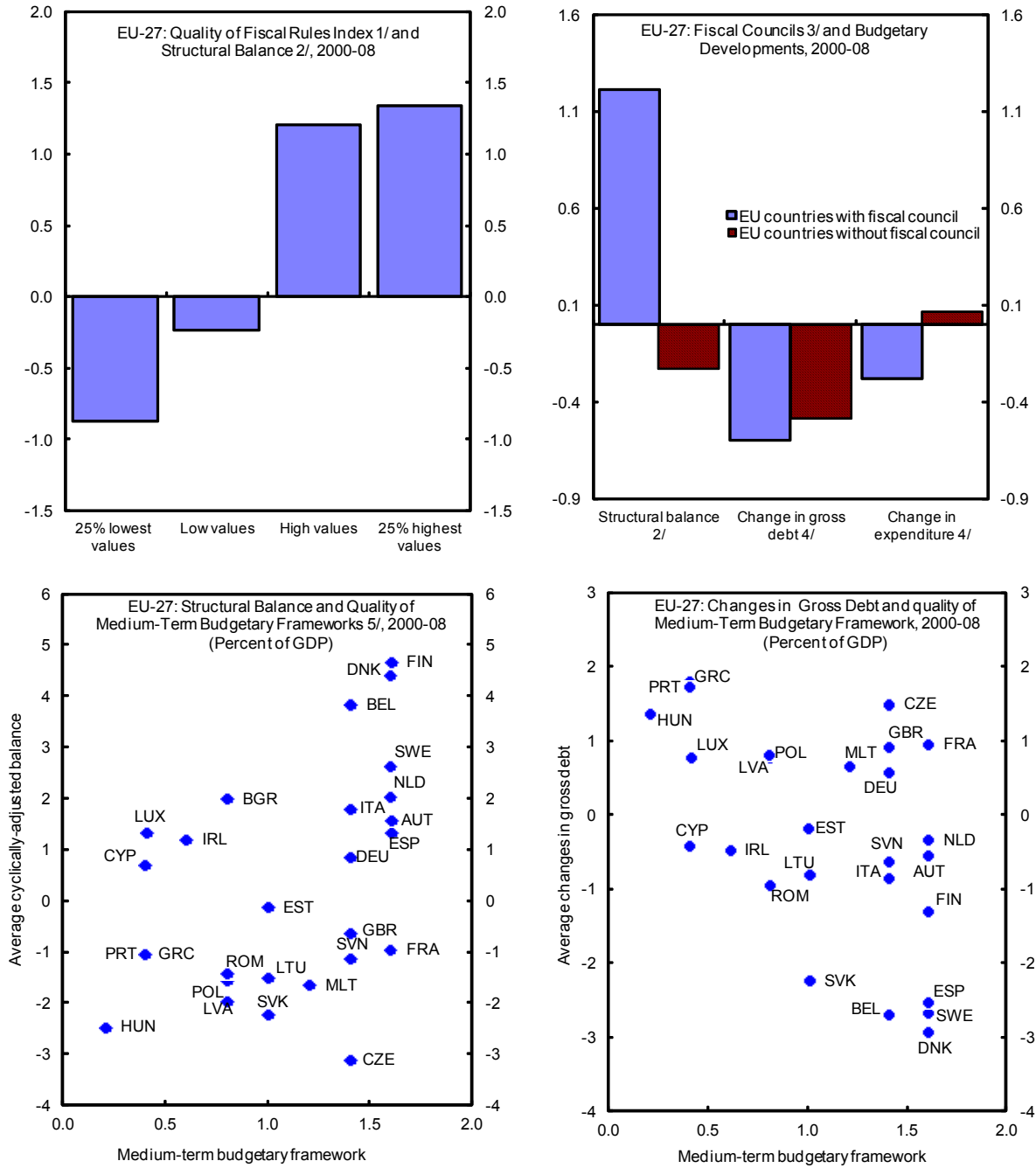
Figure 8. Euro Area: Banking Sector Health, 2000–10



Sources: Bloomberg L.P.; Bankscope; Haver Analytics; ECB; and IMF staff calculations.
 Banking sample consists of euro area and UK banks in the 2010 CEBS stress test and 18 US banks from the 2009 US stress test program (SCAP).
 1/ Panel figures 1-3 show the distribution for the variable along the 25th-75th percentile (red lines), the median (black line) and the weighted average (green line).
 2/ Net interest margin is calculated as net interest income over earning assets (loans, real estate and other investments)
 3/ Wholesale funding ratio is short and long-term borrowing and repos to assets. TCE ratio is tangible common equity to tangible assets.
 4/ Based on additional equity issues data as reported by underwriters and compiled by Bloomberg L.P.

Figure 9. EU 27: National Budgetary Frameworks and Fiscal Outcomes

Fiscal rules, medium-term budgetary planning and independent fiscal councils improved fiscal performance where they exist.



Sources: European Commission; Fiscal Governance Indicators; and IMF staff calculations.
 1/ The index assesses the effectiveness of all numerical targets set for budgetary aggregates in each country based on the rules' legal status, monitoring and enforcement mechanisms. The index is bound between 0 and 4, with higher scores indicating higher effectiveness.
 2/ Structural balance in percent of GDP. Average over the 2000-08 period.
 3/ Independent fiscal institutions are non-partisan public bodies that prepare macroeconomic forecasts for the budget, monitor fiscal performance and advise the government on fiscal policy.
 4/ Average yearly percentage change in the ratio to GDP over the 2000-08 period.
 5/ The index reflects the quality of multi-annual budget plans based on the connectedness between the annual and multi-annual targets, the involvement of the national parliament, the coordination between different government levels, and monitoring and enforcement mechanisms. The index is bound between 0 and 2, with higher scores indicating higher quality of MTBF.

Table 1. Euro Area: Main Economic Indicators, 2005–12
(Percent change)

	2005	2006	2007	2008	2009	2010	2011	2012	
								staff projection	
Demand and Supply									
Real GDP	1.7	3.1	2.9	0.4	-4.1	1.8	2.0	1.7	
Private consumption	1.8	2.1	1.7	0.4	-1.1	0.8	1.0	1.2	
Public consumption	1.6	2.2	2.2	2.3	2.5	0.7	-0.1	0.0	
Gross fixed investment	3.2	5.4	4.7	-0.8	-11.4	-0.8	3.7	2.8	
Final domestic demand	2.1	2.8	2.4	0.5	-2.7	0.5	1.3	1.3	
Stockbuilding 1/	-0.2	0.1	0.2	-0.2	-0.9	0.5	0.0	-0.1	
Domestic Demand	1.9	3.0	2.6	0.4	-3.4	0.9	1.2	1.2	
Foreign balance 1/	-0.2	0.1	0.2	0.1	-0.7	0.8	0.8	0.6	
Exports 2/	5.1	8.6	6.3	0.9	-13.1	11.2	6.9	4.8	
Imports 2/	5.8	8.5	5.8	0.8	-11.9	9.3	5.3	3.8	
Resource Utilization									
Potential GDP	1.6	1.6	1.8	1.5	0.5	0.9	1.1	1.3	
Output gap	-0.3	1.2	2.3	1.2	-3.5	-2.7	-1.9	-1.4	
Employment	1.0	1.7	1.8	0.7	-1.9	-0.5	0.3	0.5	
Unemployment rate 3/	9.1	8.4	7.6	7.7	9.5	10.1	10.0	9.6	
Prices									
GDP deflator	2.0	1.9	2.4	2.1	1.0	0.8	1.4	1.6	
Consumer prices	2.2	2.2	2.1	3.3	0.3	1.6	2.6	1.8	
Public Finance 4/									
General government balance	-2.5	-1.3	-0.6	-2.0	-6.3	-5.9	-4.2	-3.3	
General government structural balance	-2.7	-2.3	-2.1	-2.6	-4.3	-4.0	-3.0	-2.4	
General government gross debt	70.1	68.5	66.3	69.9	79.4	85.5	87.8	88.3	
Interest Rates 3/ 5/									
EURIBOR 3-month offered rate	2.2	3.1	4.3	4.6	1.2	0.8	1.4	...	
10-year government benchmark bond yield	3.4	3.9	4.3	4.4	4.0	3.8	4.4	...	
Exchange Rates 5/									
U.S. dollar per euro	1.24	1.26	1.37	1.47	1.39	1.33	1.4	...	
Nominal effective rate (2000=100)	126.6	127.0	132.3	138.8	140.6	130.9	133.8	...	
Real effective rate (2000=100) 6/	121.5	120.8	124.4	128.4	128.9	118.6	119.8	...	
External Sector 4/ 7/									
Current account balance	0.1	-0.1	0.1	-1.5	-0.3	-0.4	0.1	0.3	

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 monthly available data for 2011.

6/ CPI based.

7/ Based on ECB data, which excludes intra-euro area flows.

Table 2. Euro Area: Balance of Payments

	2003	2004	2005	2006	2007	2008	2009	2010
	(Billions of euros)							
Current account	20.9	60.8	10.9	-12.7	7.3	-142.4	-25.6	-36.7
Goods	98.7	94.1	42.2	8.1	42.3	-22.5	37.5	20.7
Services	22.5	32.9	39.6	42.5	47.9	40.9	33.8	41.0
Income	-44.8	-6.8	2.4	16.6	5.3	-63.3	-6.3	1.6
Current transfers	-56.1	-59.5	-73.4	-79.6	-87.9	-97.9	-90.7	-100.3
Capital account	12.2	16.6	12.0	9.6	4.8	9.3	6.6	7.7
Financial account	-14.0	-78.6	-35.2	-6.2	3.1	141.5	9.9	34.3
Direct investment	-9.7	-79.4	-203.9	-159.6	-90.4	-236.1	-109.1	-78.4
Portfolio investment	54.4	44.1	106.4	186.0	126.8	283.3	270.5	143.3
Equity	32.8	-2.3	105.1	89.5	102.3	13.5	65.0	66.9
Debt instruments	21.4	46.6	3.5	98.1	25.4	270.0	206.8	76.0
Financial derivatives	-13.7	-8.3	-17.3	-0.7	-67.0	-82.7	37.3	8.0
Other investment	-72.8	-47.9	62.1	-30.9	38.7	180.3	-193.2	-28.1
Reserve assets	28.0	12.6	18.2	-1.1	-4.9	-3.4	4.6	-10.1
Errors and omissions	-19.1	1.1	12.4	9.4	-15.1	-8.3	9.3	-5.4
	(Percent of GDP)							
Current account	0.3	0.8	0.1	-0.1	0.1	-1.5	-0.3	-0.4
Goods	1.3	1.2	0.5	0.1	0.5	-0.2	0.4	0.2
Services	0.3	0.4	0.5	0.5	0.5	0.4	0.4	0.4
Income	-0.6	-0.1	0.0	0.2	0.1	-0.7	-0.1	0.0
Current transfers	-0.7	-0.8	-0.9	-0.9	-1.0	-1.1	-1.0	-1.1
Capital account	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Financial account	-0.2	-1.0	-0.4	-0.1	0.0	1.5	0.1	0.4
Direct investment	-0.1	-1.0	-2.5	-1.9	-1.0	-2.5	-1.2	-0.9
Portfolio investment	0.7	0.6	1.3	2.2	1.4	3.1	3.0	1.6
Equity	0.4	0.0	1.3	1.0	1.1	0.1	0.7	0.7
Debt instruments	0.3	0.6	0.0	1.1	0.3	2.9	2.3	0.8
Financial derivatives	-0.2	-0.1	-0.2	0.0	-0.7	-0.9	0.4	0.1
Other investment	-1.0	-0.6	0.8	-0.4	0.4	1.9	-2.2	-0.3
Reserve assets	0.4	0.2	0.2	0.0	-0.1	0.0	0.1	-0.1
Errors and omissions	-0.3	0.0	0.2	0.1	-0.2	-0.1	0.1	-0.1
Memorandum items:								
GDP (billions of euros)	7,559.7	7,869.5	8,161.7	8,575.1	9,035.4	9,264.3	8,970.4	9,203.3
Reserves of the eurosystem 1/ (billions of euros)	306.7	281	320.1	325.8	347.2	374.2	462.4	591.2

Source: ECB.

1/ End of period stocks.

APPENDIX I. STATISTICAL ISSUES¹

Statistics for the euro area (and the EU-27) are produced by Eurostat and the ECB in collaboration with National Statistical Institutes (NSIs) and National Central Banks (NCBs). These statistics are generally of sufficient quality, scope, and timeliness to allow effective macroeconomic surveillance, thanks to major progress made since the start of EMU. However, the financial crisis and the situation in some member states have generated a number of challenges for official statistics. This appendix summarizes recent ongoing developments and desirable improvements clustered under thematic areas.

Information Gaps Initiative (IGI): As members of the Inter-Agency Group (IAG)², Eurostat and the ECB are collaborating with the IMF to take forward the 20 recommendations endorsed by the G-20 in 2009 to address key information gaps in economic and financial statistics.

- Noteworthy are Eurostat's efforts to support the conceptual work on measuring cross-border exposures on corporate groups on a consolidated national basis, including by the development of a Euro Groups Register (EGR). Equally promising are ongoing PEEI-related initiatives (developed in collaboration with the UN and the IMF) to form an integrated view of business, growth and acceleration cycles; refine turning point techniques; and to construct a composite indicator for early warning purposes at the euro area level.
- The ECB was generally content with the progress made under the IGI and the leadership provided by the IMF in this regard. While it saw the collection and distribution of macroeconomic data on a good track, challenges remain with regard to macroprudential data. These include data sharing and confidentiality issues as well as completing the legal groundwork for non-bank institutions. Complementing existing initiatives, the ECB is working on a securities holding database for the euro area that is planned to be completed within 2-3 years

Public finance statistics—actions to tackle statistical issues in program countries: Fiscal and other public sector reporting are being improved in Greece, Ireland and Portugal, in line with requirements established in EC/ECB/IMF-supported adjustment programs. Measures taken in 2011 by the Greek government to prevent the recurrence of data under- and misreporting include a Memoranda of Understanding of ELSTAT with 9 ministries and entities aiming to improve the compilation of ESA95 general government fiscal statistics; collection of data on arrears covering both current and investment expenditure across all central government units

¹ Participants in the discussions comprised Helge Berger, Esther Perez and Nico Valckx (all EUR), Mauricio Soto (FAD), and Miguel Alves, Claudia Dziobek, Manik Shrestha, Mick Silver, and Mark van Wersch, (all STA). Mark van Wersch acted as STA coordinator.

² The IAG was established to coordinate improvements of economic and financial statistics after the crisis. Members of the IAG are the IMF (chair), the BIS, Eurostat, the ECB, the OECD, the UNSC and the World Bank.

(including, line ministries, social security funds, public hospitals, extra budgetary funds, and the largest local governments) and the monthly publication of a consolidated report for the general government . To help ensure timely reports, the incentives of agencies and ministries have been adapted by introducing automatic sanction for delays in reporting. The newly compiled statistics by the Central Bank of Ireland include positions vis-à-vis nonresidents with breakdown by type of financial instruments, maturity, and currency; and separate datasets for banks servicing the domestic market and those focusing on the nonresident market. This data show that foreign exposure to the Irish banking system has fallen sharply. In Portugal, the SOEs, PPPs, and social security decisions with fiscal implications will be integrated within the budget process; and fiscal arrears will be monitored more closely.

Public finance data—Directive on National Fiscal Framework (NFFs)s: The draft directive on NFFs aims to align fiscal behavior with SGP commitments. To facilitate fiscal and liquidity control, countries will be required to publish cash based fiscal data at a monthly frequency, (before the end of the following month) for all government levels except local entities; and explain the methodology used for the reconciliation of cash and ESA-based data. However, Eurostat has plans neither collect nor to disseminate cash-level data. Fiscal transparency will be enhanced by expanding the perimeter of government to include all extra-budgetary funds and bodies, and also by the disclosure on data on contingent liabilities. More broadly, Member states have been asked to report to the ECOFIN on the estimated fiscal impact of the revised ESA by autumn 2011. Going forward, it will be essential that member states take all necessary measures to facilitate Eurostat’s verification of public financial data.

Public finance statistics—Stock-Flow Adjustment (SFA): Factors contributing to changes in government debt other than government deficits are regularly monitored by Eurostat. SFAs have been consistently positive in recent years for the euro area aggregate, peaking at 3.2 percent of GDP in 2008 (and situating at 0.9 and 1.9 percent respectively in 2009 and 2010). Concerns that governments may resort to SFA transactions to ensure deficit compliance with EDP requirements justify the proposal for incorporating SFAs analysis in the revamped SGP.

Public finances—Statistical consequences of the EFSF: In cooperation with the Central Bank of Luxembourg and STATEC, Eurostat is defining the content and structure of the template that will be used to estimate the impact of the EFSF on GFS and BoP payments statistics in euro area countries. Figures will be reported on a monthly basis, with the first release being scheduled for July 2011.

Pensions systems: To improve the comparability of pension schemes the 2008-SNA requires the comprehensive recording of all pension entitlements accrued by households regardless of the type of social security arrangement. Pension tables are already elaborated on a voluntary basis by eight euro area members. In the absence of SNA specific guidelines, Eurostat is holding regular seminars with the ECB, NCBs and NSIs to give methodological guidance to NSIs, and providing TA where needed. A fully-fledged release of data is only targeted by 2014 with the new ESA 2010 transmission program.

Short-term business statistics (STS): Work in collaboration with NSIs proceeds to improve STS indicators and PEEIs along various dimensions, including the implementation of the ESS guidelines for seasonal adjustment and ensuring consistency between the euro area GDP and the Industrial Production Index (IPI), as well as consistency of the latter with individual countries' IPIs. Timeliness of STS statistics improved in the last years, in particular for PEEIs-related STS. Nevertheless some indicators still lag US dissemination speed.

Price statistics: Key priorities in this area include

- *HICP improvements:* The new rules³ on the treatment of seasonal products took effect with the index of January 2011 requiring some NSIs to change their calculation methods in order to comply with the new standards. Implementation acts will follow in member states until November 2011, with Eurostat closely following on the impact of the implementation. Early indications suggest a moderate positive impact on euro area headline inflation (+ 0.1 percentage points on average for the EU during the first [two] quarters), with a relatively higher impact in Southern countries, mostly driven by the food and clothing sub-components. New minimum standards for the quality of HICP weighting⁴ will require additional efforts from NSIs during 2011 to ensure implementation by January 2012. Eurostat is also pursuing changes in the production of monthly euro area inflation flash estimates, with a possible breakdown to four main components (processed food, unprocessed food, non-energy industrial goods, and services).
- *House Price Indexes (HPI) and Owner-Occupied Housing (OOH):* Eurostat is leading work to improve real estate price information in the context of IGI Recommendation #19, with OOH remaining a high priority methodological development for the HICP. Pilot projects geared by the NSIs and coordinated by Eurostat have led to the release of the first experimental data. Eurostat is preparing a legal act to insure the continuation of the project beyond its pilot phase. Eurostat is considering the possibility of including the quarterly House Price Indices in the list of PEEIs.
- *Handbook of Residential Property Price Index (RPPI):* Lack of homogeneity of methodologies in the compilation of RPPIs makes this a highly problematic area and the release of the *Handbook* should, at least in principle, help promote good and more consistent practice. Preliminary work and plans are for a companion *Handbook for Commercial Property Price Indices*.

Structural Business Statistics (SBS): SBS are being improved along the lines of the **Program for the Modernization of European Enterprise and Trade Statistics (MEETS)**⁵ launched

³ Regulation EC No 330/2009.

⁴ Regulation EC No 1114/2010.

⁵ Decision EC No 1297/2008.

in 2008. Actions this year focus on constructing data warehouses and developing further tools for micro data linking; back casting data (e.g. in business demography statistics); and improving the collection of data on access to financing by SMEs. The creation of a register for MNEs operating in the European market (the Euro Groups Register, or EGR) has been partly outsourced to private providers. The EGR is seen as a promising tool for compilation of a number of statistics affected by globalization (e.g. FDI, trade, and knowledge), currently suffering from fragmentation and inconsistency problems.

Balance of Payments and International Trade Statistics (ITS): Users are generally satisfied with ITS data (Quality Report, 2010). Ongoing work aims to improve statistics on SEMs involved in international trade, for instance by using VAT data to measure trade not covered by Intrastat reporting. Data for 2008 and 2009 will be disseminated in the coming months. On asymmetries, a longstanding concern of Eurostat, the outcome of reconciliation exercises carried out during 2011, has been largely positive. The FDI network has proved a useful platform to share confidential data on large FDI transactions, helping identify asymmetries and improve quality data in this area.



INTERNATIONAL MONETARY FUND

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Public Information Notice (PIN) No. 11/91
FOR IMMEDIATE RELEASE
July 19, 2011

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

IMF Executive Board Concludes Article IV Consultation on Euro Area Policies

On July 18, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation on Euro Area Policies.¹

Background

The euro area recovery is broadly sound, even though growth remains uneven and moderate overall. A majority of members is experiencing solid economic activity supported by increasingly healthy labor markets and relatively sound balance sheets of households and firms. Their economies are pulling away from those suffering from sovereign debt crises and working through various combinations of a correction of pre-crisis imbalances, high debt, unemployment and tensions in financial markets, alongside balance sheet adjustment, and deep fiscal austerity measures. Member states' current account imbalances have been reduced since the crisis mainly reflecting the contraction in domestic demand in deficit countries. However, in many deficit countries private capital inflows have largely been replaced with European Central Bank (ECB) and official financing, which is unsustainable.

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 Acting 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 euro area aggregate budget deficit deteriorated sharply since 2007 and public debt has reached record highs in many countries. Discretionary fiscal measures accounted for about half of the deterioration in the euro area deficit. The 2010 fiscal deficit for the euro area remained at the previous year's level of about 6 percent of GDP. Consolidation is now proceeding at a differentiated pace.

Monetary policy remains very accommodative. The ECB has raised its policy rate slightly in the face of higher inflation and an accelerating economy. Several of the nonstandard policy measures have been extended as a safeguard against lingering financial and sovereign market tensions.

These sovereign tensions constitute a key risk to the outlook with possible large regional and global implications. Indeed, a year after Greece first sought financial support from the official international community, its adjustment problems are once again dominating headlines and many solutions—orderly and disorderly—are still possible. Despite adjustment efforts and support from euro area member states and the ECB, market participants remain unconvinced that a sustainable solution is at hand.

The euro area's banking system continues to display weaknesses. Leverage and dependence on wholesale funding remain high. Banks in the periphery are vulnerable from large exposures to their governments and real estate and from high marginal wholesale funding costs. Across the region, banks are significantly exposed to sovereign risks, with a weak tail of banks with low profitability and very thin capital levels remaining particularly vulnerable to further shocks.

Measures are being taken to strengthen the euro area's governance framework. With the European Systemic Risk Board (ESRB) and European Supervisory Authorities (ESAs), key elements of the new EU financial sector architecture are now in place, while proposals for crisis management and resolution rest on harmonization of national frameworks and tools. Fiscal and structural governance is set to improve with the new Euro Plus Pact and Excessive Imbalances Procedure, the European semester, and the reforms being agreed on the Stability and Growth Pact (SGP) and Excessive Deficit Procedure (SDP).

Executive Board Assessment

Executive Directors noted the risks that the euro area sovereign debt crisis poses to both the European and the global recoveries, and called for strong policy implementation in the program countries, a more consistent effort across the euro area to restore market confidence, and a significant strengthening of economic governance, building on current efforts.

Directors agreed that growth has rebounded but noted the increasing disparities among member states and the large tail risk from sovereign stresses combined with pockets of financial fragility. They noted that, if these stresses remain contained and the recovery stays on track,

planned fiscal consolidation should continue and there would be room for gradually phasing out monetary policy accommodation. However, given the continued tensions in some sovereign markets, Directors saw a need to maintain unconventional monetary support as long as necessary and raise bank capital buffers beyond the requirements of Basel III.

Directors urged a comprehensive and concerted approach for effectively addressing the sovereign debt crisis. Strong implementation of existing commitments should be supported with adequate financing on terms supporting debt sustainability and private sector based solutions to banking problems. At the euro-area level, Directors stressed a number of essential actions. First, they urged a rapid implementation of the commitment to scale up the capacity of the European Financial Stability Facility (EFSF) and supported a more flexible use of the EFSF as a backstop for sovereign and banking problems. Second, Directors called for clarity in the approach to private sector involvement with regard to ongoing programs and in the context of the European Stability Mechanism. And third, they called for immediate measures to strengthen the financial system through adequate capitalization and a strong follow up to the stress-test.

Directors saw the establishment of the ESAs and the ESRB as an opportunity to bolster the economic governance framework by building a strong and harmonized regulatory and supervisory environment for the single financial market. They called for improving institutions for crisis management and resolution, with an agreed burden sharing solution and common backstop. They also saw a need for a flexible macro-prudential toolkit, coordinated by the ESRB to support reciprocity and address home-host coordination.

Directors emphasized the need to push forward with fiscal consolidation and structural reforms. In this context, they welcomed the efforts to strengthen the SGP and improve national fiscal frameworks, coordinate policies, foster structural reform, and reduce imbalances, underscoring that more binding procedures would be helpful. They saw deeper financial and economic integration, including by closing the competitiveness gaps, as a precondition for unleashing the euro area's growth potential.

Directors concurred with the findings of the spillovers analysis that spillovers could be large if stress in euro-area crisis countries spreads to other members. They emphasized the need to stem contagion through a cohesive and cooperative approach, noting that delays in resolving the crisis could be costly for the euro area and the global economy. Directors also noted that the rest of the world would profit from policies that lift the euro area's growth potential.

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 2011 Article IV Consultation on Euro Area is also available.

Euro Area: Main Economic Indicators
(Percent change)

	2005	2006	2007	2008	2009	2010	2011	2012
							Staff projection	
Demand and Supply								
Real GDP	1.7	3.1	2.9	0.4	-4.1	1.8	2.0	1.7
Private consumption	1.8	2.1	1.7	0.4	-1.1	0.8	1.0	1.2
Public consumption	1.6	2.2	2.2	2.3	2.5	0.7	-0.1	0.0
Gross fixed investment	3.2	5.4	4.7	-0.8	-11.4	-0.8	3.7	2.8
Final domestic demand	2.1	2.8	2.4	0.5	-2.7	0.5	1.3	1.3
Stockbuilding 1/	-0.2	0.1	0.2	-0.2	-0.9	0.5	0.0	-0.1
Domestic Demand	1.9	3.0	2.6	0.4	-3.4	0.9	1.2	1.2
Foreign balance 1/	-0.2	0.1	0.2	0.1	-0.7	0.8	0.8	0.6
Exports 2/	5.1	8.6	6.3	0.9	-13.1	11.2	6.9	4.8
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Resource Utilization								
Potential GDP	1.6	1.6	1.8	1.5	0.5	0.9	1.1	1.3
Output gap	-0.3	1.2	2.3	1.2	-3.5	-2.7	-1.9	-1.4
Employment	1.0	1.7	1.8	0.7	-1.9	-0.5	0.3	0.5
Unemployment rate 3/	9.1	8.4	7.6	7.7	9.5	10.1	10.0	9.6
Prices								
GDP deflator	2.0	1.9	2.4	2.1	1.0	0.8	1.4	1.6
Consumer prices	2.2	2.2	2.1	3.3	0.3	1.6	2.6	1.8
Public Finance 4/								
General government balance	-2.5	-1.3	-0.6	-2.0	-6.3	-5.9	-4.2	-3.3
General government structural balance	-2.7	-2.3	-2.1	-2.6	-4.3	-4.0	-3.0	-2.4
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Interest Rates 3/ 5/								
EURIBOR 3-month offered rate	2.2	3.1	4.3	4.6	1.2	0.8	1.4	...
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Real effective rate (2000=100) 6/	121.5	120.8	124.4	128.4	128.9	118.6	119.8	...
External Sector 4/ 7/								
Current account balance	0.1	-0.1	0.1	-1.5	-0.3	-0.4	0.1	0.3

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 2011.

6/ CPI based.

7/ Based on ECB data, which excludes intra-euro area flows.

**Statement by Mr. Fayolle, Executive Director for France
on behalf of the Euro Area Authorities
July 18, 2011**

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

The authorities of the euro-area Member States are grateful for open and fruitful consultations with staff and for their constructive policy advice. The authorities welcome the staff's Spillover Report and broadly concur with its findings. The authorities also stress their commitment to free trade and the conclusion of the Doha round.

The authorities emphasise that the efforts to implement a comprehensive response to the ongoing debt crisis have been forcefully stepped up over the recent months. These new efforts include reinforced commitments to fiscal consolidation and structural reform, the macroeconomic adjustment programmes in several countries, strengthening financial mechanisms for countries in distress, rigorous stress tests of the banking and insurance sectors and improvements in economic and fiscal governance. In spite of these bold efforts market volatility remains high. In this context, the authorities reiterate their resolve to take all the necessary actions to preserve the integrity and stability of the euro area.

Short-term economic outlook

The economic recovery in the euro area continues to make headway, even though at a moderate pace. While the external environment continues to support exports, the recovery is broadening out, with domestic demand contributing increasingly to growth. However, there are considerable differences in the pace of recovery across the euro area Member States. Labour markets, which on average showed remarkable resilience during the crisis, stabilised in the course of 2010 and are set to improve gradually, but dispersion in unemployment rates remain high. The authorities share staff's view on the outlook. Economic growth in the euro area is expected to continue along a trajectory of around 2%. While investments contributed significantly to growth in the beginning of 2011, private consumption is expected to pick up modestly this year and its gradual recovery will be underpinned by slowly improving labour-market conditions, moderate income growth, and lower saving rates. Despite the positive prospects for economic growth in the euro area as a whole, uncertainty remains high and downside risks to the outlook are present.

Monetary policy and the outlook for price stability

The ECB early July decided to increase its key interest rates by 25 basis points, after having raised them by 25 basis points in April, in the light of upside risks to price stability. Inflation in the euro area is currently at 2.7% (June Eurostat flash estimate and May realisation), mainly reflecting higher energy and commodity prices. Looking ahead, inflation rates are likely to stay above 2% over the coming months. Risks to the medium-term outlook for price developments remain on the upside, in particular related to risks of higher than assumed

increases in energy prices. The underlying pace of monetary expansion is continuing to gradually recover, while monetary liquidity remains ample with the potential to accommodate price pressures in the euro area. Recent price developments should not give rise to broad-based inflationary pressures over the medium term, thus there is a need to keep inflation expectations firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Upside risks to price stability will continue to be very closely monitored.

As regards the non-standard measures, the ECB in June decided to continue its refinancing operations as fixed rate tender procedures with full allotment in the third quarter of 2011. It furthermore suspended the application of the minimum credit rating threshold in the collateral eligibility requirements for bonds issued or guaranteed by the Portuguese government, as it had done before with Greek and Irish sovereign bonds. The provision of liquidity and the allotment modes for refinancing operations will be adjusted when appropriate, taking into account the fact that all the non-standard measures taken during the period of acute financial market tensions are, by construction, temporary in nature.

Fiscal policy

The authorities share staff assessment of the fiscal situation, in particular on the consolidation needs and the plans put forward by Member States to this end. Fiscal consolidation is a priority for the euro area as a whole, albeit with different degrees of urgency across the countries. Fiscal plans in the Stability Programmes broadly reflect this priority: they show considerable reduction in the general government deficit, with the euro area improving its fiscal positions every year, to reach an average deficit of 1.3% of GDP in 2014. Overall, the time profile of the consolidation plans is front-loaded and based mainly on expenditure reductions. Such a consolidation strategy will lead to halting and eventually reversing the increase in government debt as from 2012. The authorities agree that this hinges upon the rigorous and full implementation of the budgetary plans. Moreover, fiscal windfalls from higher than expected growth should be used for faster deficit reduction. Therefore, in the country-specific recommendation finalising the first European Semester, adopted by the Council last week, the Council called on Member States to take and implement all the measures planned and needed to ensure the achievement of their national fiscal targets and to comply with the recommendations under the excessive deficit procedure. This is essential to ensure trust by the public and markets in the sustainability of euro area public finances.

Financial stability mechanisms

Euro area Member States have significantly strengthened the stability mechanisms for countries in distress. It has been decided that the effective lending capacity of the temporary European Financial Stability Facility will be brought to € 440 bn, and a permanent European Stability Mechanism (ESM) has been agreed. The treaty which establishes the ESM was signed by euro area Member States on 11 July, and the ESM will be effective as from July 2013.

The main features of the ESM, including the conditions for granting assistance, were agreed and announced already in March 2011. If indispensable to safeguard the financial stability of

the euro area as a whole, the ESM may provide financial assistance to an ESM Member, subject to strict economic policy conditionality under a macro-economic adjustment programme, commensurate with the severity of the economic and financial imbalances experienced by that ESM Member. The ESM will have an effective lending capacity of € 500 bn. The Board of Governors may decide, as an exception, to arrange for the purchase of bonds of an ESM Member on the primary market, with the objective of maximising the cost efficiency of the financial assistance.

The ESM will enjoy preferred creditor status *vis a vis* all official and private creditors, other than the IMF, to which it will be junior. However, this seniority over creditors other than the IMF will not apply to loans made by the ESM in support of programs that had already received financial support from European countries as of the date of the signature of the ESM treaty. An adequate and proportionate form of private-sector involvement will be sought on a case by case basis where financial assistance is received by an ESM Member, in line with IMF practice. The nature and the extent of this involvement will depend on the outcome of a debt sustainability analysis and will take due account of the risk of contagion to other Member States and third countries. If it is concluded that a macro-economic adjustment programme can realistically restore public debt to a sustainable path, the beneficiary country will take initiatives aimed at encouraging the main private investors to maintain their exposure. If it is concluded that a macro-economic adjustment programme cannot realistically restore the public debt to a sustainable path, the beneficiary ESM Member shall be required to engage in active negotiations in good faith with its non official creditors to secure their direct involvement in restoring debt sustainability. In the latter case, the granting of financial assistance will be contingent on the ESM Member having a credible plan for restoring debt sustainability and demonstrating sufficient commitment to ensure adequate and proportionate private-sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decisions on disbursements.

Collective Action Clauses (CACs) will be included in the terms and conditions of all new euro-area government securities with maturity above one year from July 2013, in such a way as to preserve market liquidity and in a standardised manner which ensures that their legal impact is identical. The detailed legal arrangements for including CACs in euro area government securities will be finalised by the end of 2011.

Financial sector

The authorities are in the midst of an ambitious and intensive programme of regulatory reform for the financial services sector, which includes better supervision and regulation for financial services, greater consumer and investor protection, and the development of appropriate mechanisms for crisis management. At the same time, fostering and deepening the single market for financial services remains a central policy objective.

The establishment on January 1, 2011 of the new supervisory framework marked a major step in the implementation of the reform agenda. The authorities welcome the European Financial Stability Framework Exercise and its findings. The authorities think that the track

record of the new institutions is still too short to draw firm conclusions on their effective functioning, but first experience has been positive.

Against the backdrop of continuing funding pressure on banks, the authorities continue to press ahead with financial sector repair. The new round of EU-wide stress tests of the banking sector will be made available shortly. The test is more rigorous, based on more consistent application of the methodology and enhanced disclosure. Moreover, to strengthen market confidence, the authorities are currently putting in place in a coordinated manner credible backstops, compliant with EU state aid rules, to deal with any bank whose core tier 1 capital ratio fell below the threshold (5%) under the adverse scenario and requires public support. Meanwhile, the second European stress test exercise in the insurance sector has shown that European insurers remain robust.

The comprehensive regulatory reform agenda for the financial sector stretches over all financial market segments to reinforce the bed-rock foundations of the whole financial system. The main elements include: the implementation of the Basel III framework through the fourth revision of the Capital Requirements Directive and a Regulation implementing the single rule book, the revision of the Markets in Financial Instruments Directive, the Market Abuse Directive and the Transparency Directive, the proposed European Market Infrastructure Regulation and the Regulation on Short Selling and certain aspects of Credit Default Swaps, the legislative proposal on Central Securities Depositories (CSDs) and on harmonisation of certain aspects of securities settlement, the Regulation on credit rating agencies, Solvency II regulation for the insurance sector and the upcoming Commission proposals on an EU framework for crisis management in the financial sector.

At the same time, the authorities would like to stress the need for global coordination on financial regulation and supervision in order to maintain the level playing field and to avoid regulatory arbitrage.

Economic governance

In the aftermath to the global financial and economic crisis the authorities have embarked on a deep and comprehensive reform of economic governance in the EU and in particular the euro area. Once adopted, the new governance structure, together with the new supervisory institutions and the financial stability mechanisms referred to above, will equip the euro area with a more robust institutional framework, which will reduce the likelihood of economic and financial crisis in the future.

The authorities expect that agreement with the European Parliament on the legislative governance package will be reached shortly. The draft legislation aims at significantly strengthening fiscal surveillance by the operationalisation of the debt criterion in the excessive deficit procedure via a numerical benchmark and by introducing an expenditure growth benchmark, alongside the change in the structural balance, to assess progress towards the medium-term budgetary objective in the preventive arm of the Stability and Growth Pact (SGP). A new directive on national budgetary frameworks will reinforce reform efforts in this field and will improve the quality of the budgetary processes. In addition to fiscal surveillance, the establishment of a new excessive imbalances procedure (EIP) to correct

excessive macroeconomic imbalances, accompanied by an enforcement regime, will strengthen the coordination of economic policies, as advised by staff, and will work towards preventing macroeconomic excesses in the future. The decision making process under the new EIP incorporates a large degree of automaticity through the use of reverse qualified majority voting by the Council. Moreover, the EIP process takes into account the specific nature of macroeconomic imbalances, which are less under the control of the authorities and which may require more room for a case-by-case assessment.

Economic surveillance in the euro area and the EU as a whole has already benefited from the introduction of the so called European Semester, which aims at providing integrated and ex ante economic policy guidance to the Member States, in time to be taken into account in the formulation of national budgets for the following year. The first set of integrated country-specific recommendations was adopted by the Council in July, on a recommendation from the Commission. Marking a clear break with the past, the recommendations integrate fiscal and structural policy guidance and feature a much higher level of granularity and specificity than before in terms of recommended policy action. Moreover, the reform process has received an additional political impetus in the form of the Euro Plus Pact. With the Pact, the participating Member States committed at the highest political level to further strengthen the economic pillar of EMU and achieve a new quality of economic policy coordination, implementing a number of concrete policy actions which are key for improving competitiveness and avoiding harmful imbalances, thereby leading to a higher degree of convergence and preserving our social models.

Structural reforms

The authorities emphasise that the Single Market has been and continues to be the cornerstone of economic integration in the euro area and in the whole EU, and with the single currency the euro area forms the most economically integrated part of the world economy. Nevertheless, the authorities agree that there is still more potential to be exploited.

The Commission has presented a Single Market Act with a view to taking the Single Market to a new stage by tapping the full potential of the services sector, encouraging the uptake of a digital economy, facilitating cross-border transactions, improving access to finance, especially for SMEs and fast-growing innovative companies, increasing workers' mobility by modernising the system for recognising professional qualifications, modernising standard setting and intellectual property regimes, and creating cost-effective access to energy. In services, a special emphasis is put on the need to remove non-tariff barriers to trade and to the harmonisation of product regulations and technical standards. The major recent liberalisation effort in the services sectors is the implementation of the Services Directive. Although it is too soon for its full effects to have materialised, it is expected to have a major impact on trade and FDI flows and has already created a momentum for services liberalisation. In network industries, progress has been made in opening markets and ensuing increased competition and further liberalisation is ongoing. The liberalisation in telecoms has led to a fall in the market share of the incumbent and to a reduction in prices. In the electricity and gas sectors, the implementation of the Third energy package will further enhance competition and integration.