INTERNATIONAL MONETARY FUND

IMF Country Report No. 24/248

EURO AREA POLICIES

2024 ANNUAL CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MEMBER COUNTRIES

July 2024

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 2024 annual consultation with member countries forming the Euro Area, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 22, 2024, consideration of the staff report that concluded the annual consultation.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 22, 2024, following discussions that ended on May 31, 2024, with the officials of 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, 2024.
- A **Statement by the Executive Director** for France, on behalf of the euro area member states and the European community.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org

International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR 24/292

IMF Executive Board Concludes 2024 Consultation with Euro Area

FOR IMMEDIATE RELEASE

Washington, DC – July 22, 2024: The Executive Board of the International Monetary Fund (IMF) concluded the 2024 discussions on common euro area policies with member countries[1]

The euro area is recovering gradually, with a modest acceleration of growth projected for 2024, gathering further speed in 2025. Increasing real wages together with some drawdown of household savings are contributing to consumption, while the projected easing of financing conditions is supporting a recovery in investment. Inflation is also coming down as past monetary tightening and the decline in commodity prices are having an effect on prices in the euro area. However, disinflation will continue to be gradual, and the inflation is projected to return to target in the second half of 2025.

Risks to growth are on the downside while they are two-sided for inflation. Past monetary policy tightening could put a stronger drag on output than expected. Adverse external developments—such as intensifying geopolitical tensions and/or weaker global demand—could also hold back growth. Were labor markets to weaken, the projected consumption growth may not materialize. Such developments could also drag inflation below the baseline. However, there are counterbalancing upside inflation risks from stronger-than-expected wage pressures or continued high company profits margins. Renewed commodity price spikes or shipping disruptions could also put upward pressure on inflation.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the euro area's resilience, in the face of multiple shocks, with inflation declining toward its target. Directors concurred with the positive growth outlook, while recognizing the downside risks to growth and the two-sided inflation risks. In that context, Directors encouraged the authorities to focus their near-term efforts on finalizing the task of returning inflation to target and ensuring credible fiscal consolidation, particularly in high-debt countries. Noting the need to address challenges related to population aging, the green transition, and security needs, Directors also emphasized the importance of labor market reforms and boosting investment and innovation to generate productivity growth.

---

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

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

Directors commended the European Central Bank for its skillful monetary policy management. They welcomed the recent start to monetary policy easing and stressed that the pace of further easing should continue to be data dependent. Directors underscored the importance of maintaining anchored inflation expectations, while avoiding an overly restrictive policy stance. Clear communication and credible commitment to bring inflation back to target remain essential.

Directors agreed on the need to rebuild fiscal buffers to guard against future shocks and higher spending needs, while minimizing any adverse effects on growth. They highlighted that sustained fiscal adjustment in high-debt and high-deficit countries would help to restore fiscal sustainability and reduce risks to the euro area. Medium-term fiscal adjustment should primarily rely on expenditure measures that protect priority spending. Directors also noted that countries with lower risk of debt becoming unsustainable could use fiscal space to enhance growth and resilience.

Directors welcomed the new EU economic governance framework, recognizing its potential to enhance fiscal policy coordination and fiscal sustainability also via growth-enhancing reforms and investments. Noting its complexity, Directors highlighted that capacity and political support is essential to ensure its effective implementation. Timely preparation of the medium-term fiscal structural plans mandated under the framework is important.

Directors noted the strong capital and liquidity positions of European banks and saw merit in using temporarily high profits to build safeguards, including by increasing countercyclical buffer requirements. Continued monitoring of pockets of vulnerabilities from the commercial real estate sector and nonbank financial sector is important. Directors also encouraged policymakers to develop nonbank macroprudential tools, while continuing efforts to bridge data gaps.

Directors welcomed the authorities' efforts to boost productivity and labor supply. They recommended policies to address skills mismatches and improve labor mobility across the Union, including through better integration of migrants into the labor market. Deeper financial market integration, including by completing the capital markets and the banking unions, is essential to increase productivity and mobilize investment necessary for the green and digital transformations. Directors also underscored the need for higher and better targeted EU public investment and lower barriers within the European Union, to help strengthen the single market. Establishing a common Climate and Energy Security Facility would also be important.

Directors welcomed the European Union's efforts to strengthen the rules-based international system and generally agreed with the need to continue to engage with partners as it implements trade-related environment and climate policies. They also agreed with the need to avoid distortive trade and industrial policies.

It is expected that the next consultation on euro area policies in the context of the Article IV obligations of member countries will be held on the standard 12-month cycle.

Table 1. Euro Area: Main Economic Indicators, 2020–2029
(y/y percent change, unless otherwise specified)

					Projections 1/					
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Demand and Supply										
Real GDP	-6.1	5.9	3.4	0.5	0.9	1.5	1.5	1.3	1.3	1.2
Private consumption	-7.7	4.4	4.2	0.5	1.3	1.7	1.7	1.5	1.4	1.3
Public consumption	1.1	4.2	1.6	0.9	0.9	0.6	0.7	0.8	0.8	0.8
Gross fixed investment	-5.9	3.5	2.5	1.2	-0.2	2.0	1.6	1.1	1.5	1.5
Final domestic demand	-5.4	4.1	3.2	0.8	0.9	1.5	1.4	1.3	1.3	1.2
Stockbuilding 2/	-0.3	0.6	0.4	-0.6	-0.1	-0.1	0.0	0.0	0.0	0.0
Domestic demand	-5.7	4.7	3.6	0.2	0.8	1.4	1.4	1.3	1.3	1.2
Foreign balance 2/	-0.6	1.4	0.0	0.3	0.2	0.1	0.1	0.1	0.0	0.0
Exports 3/	-9.1	11.5	7.2	-0.8	1.7	2.8	3.0	3.0	2.9	2.9
Imports 3/	-8.5	9.2	7.9	-1.4	1.3	2.9	3.0	3.0	3.1	3.0
Resource Utilization										
Potential GDP	-1.4	2.8	1.3	0.9	1.1	1.4	1.3	1.3	1.2	1.2
Output gap 4/	-4.6	-1.7	0.3	-0.1	-0.4	-0.3	-0.1	-0.1	0.0	0.0
Employment growth	-1.4	1.4	2.3	1.4	0.5	0.4	0.1	0.0	0.0	0.0
Unemployment rate 5/	8.0	7.8	6.8	6.6	6.5	6.4	6.4	6.4	6.4	6.4
Prices										
GDP deflator	1.8	2.2	4.7	6.0	2.8	2.5	2.0	1.9	2.0	1.9
Consumer prices	0.3	2.6	8.4	5.4	2.4	2.1	1.9	1.9	1.9	1.9
Public Finance (percent of GDP)										
Overall fiscal balance	-7.0	-5.2	-3.7	-3.5	-3.0	-2.8	-2.6	-2.5	-2.4	-2.4
Primary balance	-5.7	-3.9	-2.1	-2.1	-1.3	-1.0	-0.7	-0.5	-0.3	-0.2
Structural balance 4/	-4.0	-4.0	-3.5	-3.4	-2.7	-2.6	-2.5	-2.4	-2.4	-2.4
Structural primary balance 4/	-2.7	-2.7	-2.0	-1.9	-1.1	-0.8	-0.6	-0.4	-0.3	-0.2
Gross public debt	97.2	94.8	90.8	88.6	88.6	88.3	88.1	88.1	87.9	87.7
External Sector (percent of GDP) 6/										
Current account balance	1.7	2.7	-0.6	1.7	2.1	2.0	2.0	2.1	2.1	2.2
Interest Rates (percent, end of period) 7/										
Euro short-term rate (€STR)	-0.6	-0.6	1.9	3.9	3.9	...	...	...	...	...
10-year government benchmark bond yield	-0.1	0.3	3.0	2.9	3.1	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.2	1.1	1.1	1.1	1.1	...	...	...	...	...
Nominal effective rate (2005=100)	101.3	96.5	96.2	97.7	98.4	...	...	...	...	...
Real effective rate (2005=100, ULC based)	90.7	86.3	84.3	88.1	85.4	...	...	...	...	...

Sources: IMF staff estimates; and European Central Bank.
1/ Projections for 2024-29 are based on the aggregation of the latest projections by IMF country teams, unless otherwise indicated.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
5/ In percent.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2024.

INTERNATIONAL MONETARY FUND

EURO AREA POLICIES

STAFF REPORT FOR THE 2024 CONSULTATION WITH MEMBER COUNTRIES ON COMMON EURO AREA POLICIES

July 1, 2024

KEY ISSUES

Context. The euro area economy has been resilient in the face of multiple, large shocks, including the pandemic, Russia's gas shut-off, and fallout from the war in Ukraine. Nonetheless, the adverse shocks have had persistent effects which shape economic prospects. Energy-intensive industries, in particular, have struggled to adjust to higher input costs and continue to underperform. Despite subdued overall activity, employment growth remains robust. Inflation has declined significantly from its late-2022 peak in response to the ECB's policy tightening and the decline in commodity prices.

Outlook. A modest pickup in growth is projected for 2024, strengthening further in 2025. This primarily reflects expected stronger consumption on the back of rising real wages and higher investment supported by easing financing conditions. Inflation is projected to return to target in the second half of 2025. The economy is confronting important new challenges, layered on existing ones. Fiscal buffers have diminished while spending pressures are set to increase further. Population aging and subdued productivity growth cloud the medium-term outlook. Policy uncertainty can trigger market repricing of sovereign fiscal risks and contribute to higher volatility of asset prices more generally. The risk of intensifying geopolitical tensions, further geoeconomic fragmentation, supply chain disruptions, trade disputes, and distortive industrial policies further complicate economic prospects and the policy making environment.

Policy priorities. Beyond returning inflation to target and ensuring credible fiscal consolidation in high-debt countries, the euro area must urgently focus on enhancing innovation and productivity. Higher growth is essential for creating policy space to tackle the fiscal challenges of aging, the green transition, energy security, and defense. Achieving higher productivity and inclusive and sustainable growth requires strengthening the single market, including through the capital markets union; enhancing the EU budget for public goods investment to address shared long-term challenges; and avoiding industrial and trade policies that generate competitive distortions or adverse spillovers.

Approved By
Oya Celasun (EUR) and Mark Flanagan (SPR)

Discussions took place virtually with European Investment Bank and European Stability Mechanism during May 13–14, and in Brussels (Belgium), Frankfurt (Germany), and Paris (France) during May 21–31, 2024. Mission members included M. Nabar (head), L. Brandao, H. Lin, F. Caselli, A. Dizioli, G. Ljungman, L. Ratnovski, H. Toprak (all EUR), joined by J. John, N. Arnold, F. Toscani, J. Frie, G. Claveres, and G. Tolosa (all EUO). O. Exton (SPR) provided inputs. O. Celasun (EUR Front Office Reviewer) participated in key meetings with the ECB and the European Commission. The Executive Director, A. Buisse, I. Valdés Fernández (OED), R. Rüffer and D. Rakitzis (ECB observers at the IMF), participated in the meetings. A. Fotiou, K. Cerrato, M. Maneely and K. Qin (all EUR) supported the mission from HQ.

CONTENTS

ANNEXES

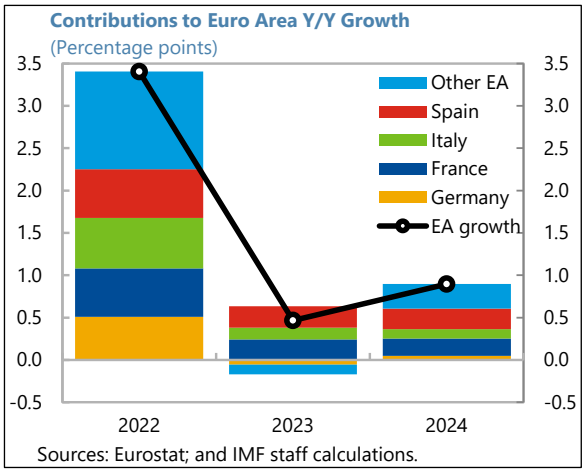
CONTEXT

1. The euro area economy has been resilient in the face of multiple shocks. Strong and timely policy responses have helped cushion the impacts of the pandemic and Russia's war in Ukraine. Nonetheless, the adverse shocks have had persistent effects which shape economic prospects (Figure 1). Real disposable income fell significantly in 2022 because of the large spike in energy prices and real wages have yet to regain their pre-pandemic level. Household saving remains elevated. Energy-intensive industries have struggled to adjust to higher input costs and continue to underperform relative to other manufacturing and services. Interest-rate-sensitive sectors have been further weighed down by the tightening of monetary policy needed to counteract the rise in inflation and inflation expectations. Despite subdued activity, employment growth has stayed robust. Inflation has declined toward target in response to the ECB's policy tightening and declines in commodity prices (Figure 2).

2. The economy is confronting important new challenges, layered on existing ones. Crisis responses have diminished fiscal buffers and weakened public finances. Spending pressures are set to increase further. The euro area faces significant spending needs for advancing the green and digital transitions, aging-related costs, and enhancing energy security, even as debt service has risen compared to before the pandemic because of higher interest rates and subdued growth. In turn, low growth reflects longstanding productivity challenges and rapid aging. New challenges from supply chain disruptions, trade disputes, geopolitical tensions, geoeconomic fragmentation, and industrial policies further complicate prospects, calling for urgent policy responses.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

3. The economy is projected to strengthen modestly in 2024. Momentum in the first half of 2024 suggests stronger activity across the eurozone compared to 2023. Growth is projected to pick up to 0.9 percent in 2024 (from 0.4 percent in 2023), reflecting a gradual increase in consumption underpinned by higher real wages and subsiding effects of the energy shock (Annex I). The largest four economies, accounting for around 75 percent of eurozone GDP, are expected to contribute only half of the aggregate growth in 2024 (text figure)—lower than in 2022-23—with continued divergences between services- (e.g., Spain) and manufacturing-oriented (e.g., Germany) economies. In 2025, growth is projected to pick up further to 1.5 percent as a recovery in investment amid easing financing conditions on the back of the ECB's monetary policy easing which began in June 2024 reinforces stronger consumption. With the drivers of the expansion expected to rotate increasingly toward domestic demand, the contribution of net exports to GDP growth is projected to decline from 0.2 percentage point in 2024 to 0.1 in 2025 (Table 1).



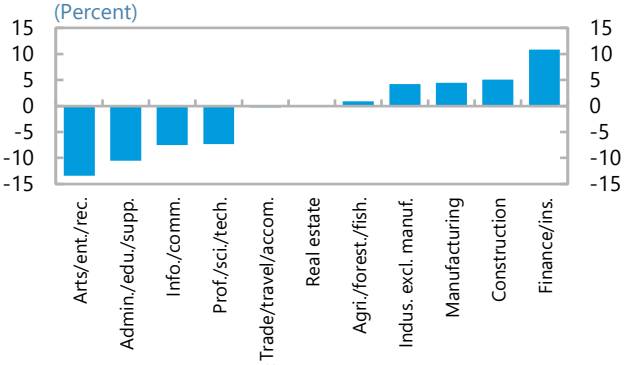
Sources: Eurostat; and IMF staff calculations.

4. Healthy nominal wage growth is expected to support a recovery in real wages. Despite subdued activity, employment and total hours worked continued to increase in the first half of 2024, following robust growth in 2023 (1.6 and 1.3 percent year-on-year).[1] New workers, including migrants, have expanded labor supply, while firms continue to hoard labor in anticipation of accelerating demand and rehiring difficulties. Labor productivity has consequently declined, and unit labor costs have increased. Despite nominal wage increases (with compensation per employee growing 5.2 percent in 2023), workers are yet to fully recoup the purchasing power loss from high inflation (Text Figure 1). The labor market is projected to remain resilient, supporting healthy nominal wage growth.

5. Headline and core inflation are projected to return to the 2 percent target in the second half of 2025. With the easing of supply shocks and tightening of monetary policy in 2022-2023, the disinflation process toward target continues (headline inflation has dropped from above 10 percent in late 2022 to 2.6 percent in May 2024), accompanied by declines in the profit share. The reduction in inflation reflects the fall in energy prices, weak global and local goods demand, which accelerated non-energy goods disinflation, and a gradual easing of services inflation as the effects of past ECB tightening continue to feed through (see Annex II on monetary policy transmission). Excluding energy and unprocessed food, inflation dropped to 2.9 percent in May, although core services inflation remained elevated close to 4 percent. Stickier inflation of the labor-intensive services sector will decline gradually, as some real wage recoup is still expected and the second-round effect of the past terms-of-trade shock fades slowly (Text Figure 2). A continued decline in profit shares (measured as gross operating surplus / nominal gross value added) toward their 2019 level of 40.7 percent is expected to accommodate healthy wage growth in 2024 (as much as 4 percent year-on-year would be consistent with staff's inflation projections; if wage growth stays close to 4.5 percent, then profits would have to drop further to 40.2 percent) and facilitate disinflation as projected in the baseline. Elevated profits are concentrated in a few sectors, including in some services with large weight in the CPI basket (text figure). For 2025, the disinflationary forces are partially offset by the removal of some price-suppressing fiscal measures, for example in Spain, and an expected firming of energy prices.

Percent Change in Profit Shares Since the Pandemic, 2024 Q1

(Percent)



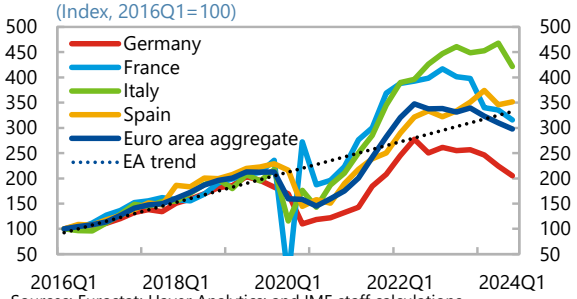
Sources: Eurostat; and IMF staff calculations.
Note: The chart shows the percentage change of the current profit shares from the average profit shares in 2019. Profit shares are defined as profits over the sector nominal value added.

[1] See also chapter 2 of the October 2023 *Regional Economic Outlook* for Europe for the analysis of wage dynamics.

Text Figure 1. Euro Area: Labor Markets Developments

Ratio of Vacancies to Unemployed

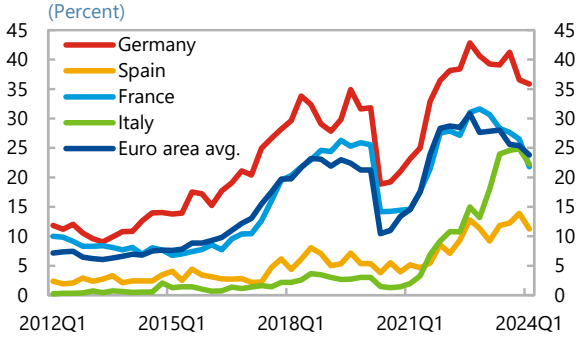
(Index, 2016Q1=100)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
Note: Ratio of vacancies to unemployed is defined as the ratio between the number of vacancies and the number of unemployed aged 15-64. Job vacancies data may comprise all sectors or only industry-construction-services depending on data availability at the country level. Ratio of vacancies to unemployed for the euro area is computed by summing the country-level data on number of vacancies and unemployed, and then computing the ratio.

Labor Shortages

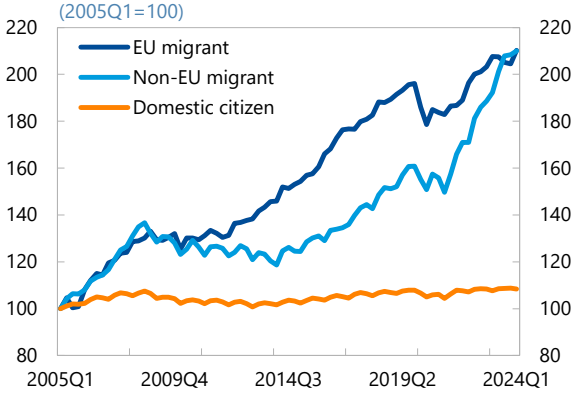
(Percent)



Sources: European Commission; and IMF staff calculations.
Notes: Percent of firms mentioning labor as a factor limiting production. Labor shortages refers to average across the manufacturing, construction and service sectors. Greece and Ireland excluded for data availability.

EU Employment Index by Citizenship

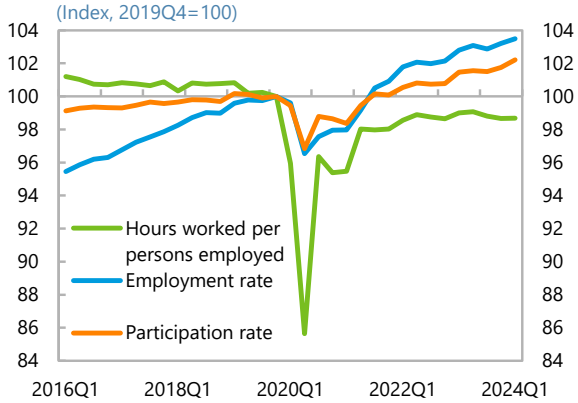
(2005Q1=100)



Sources: Eurostat and IMF staff calculations.

Hours Worked, Employment, and Participation Rates

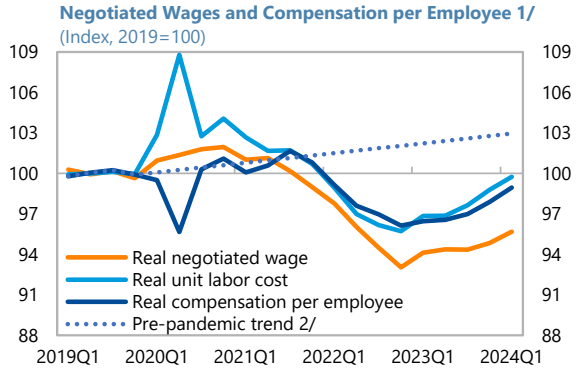
(Index, 2019Q4=100)



Sources: ECB; Eurostat; and IMF staff calculations.

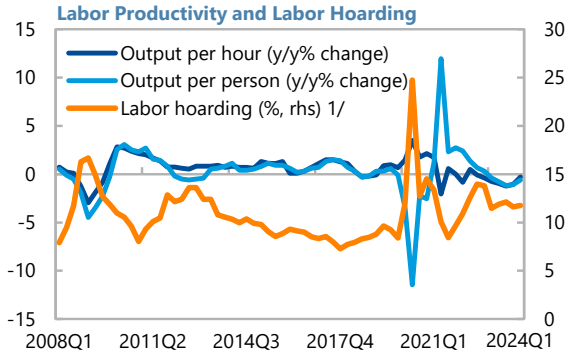
Negotiated Wages and Compensation per Employee 1/

(Index, 2019=100)



Sources: ECB; Eurostat; Haver Analytics; and IMF staff calculations.
1/ Data in real terms are deflation by inflation.
2/ Trendline for real compensation per employees.

Labor Productivity and Labor Hoarding

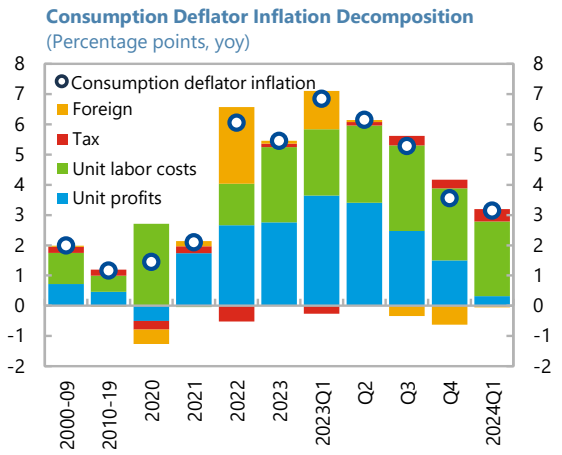


Sources: Eurostat; and IMF staff calculations.
1/ Labor hoarding is defined as the percentage of firms that expect their output to decrease but their employment to increase or remain unchanged.

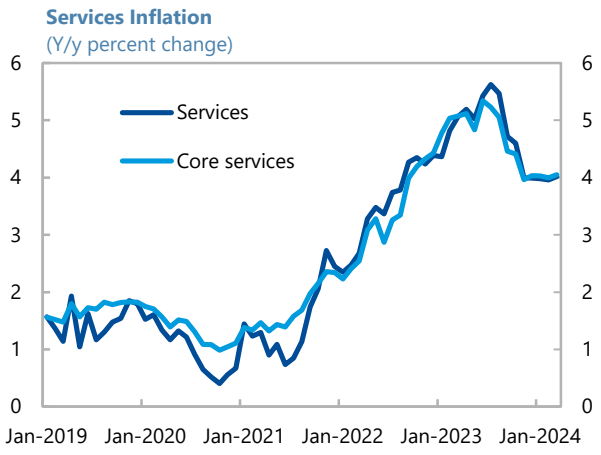
6. Although falling steadily since 2021, fiscal deficits and public debt ratios remain above pre-pandemic levels. Supported by the recovery of nominal GDP—which grew largely due to the unexpected inflation surge—aggregate euro area debt has fallen from close to 100 percent of GDP in 2020 to less than 90 percent of GDP in 2023, with all (but a few) members lowering debt ratios (Text Figure 3, Figure 3). Similarly, the aggregate euro area fiscal deficit halved from its 2020 peak to

around 3.5 percent of GDP in 2023 and is expected to drop below 3 percent of GDP in 2024. Despite the appropriate unwinding of Covid-era support measures and most energy crisis support programs—the rest of which will be phased out in 2025—fiscal deficits across the region are projected to stay substantially above the pre-pandemic levels of around 0.5 percent of GDP, partly reflecting higher interest payments.

Text Figure 2. Euro Area: Inflation Drivers



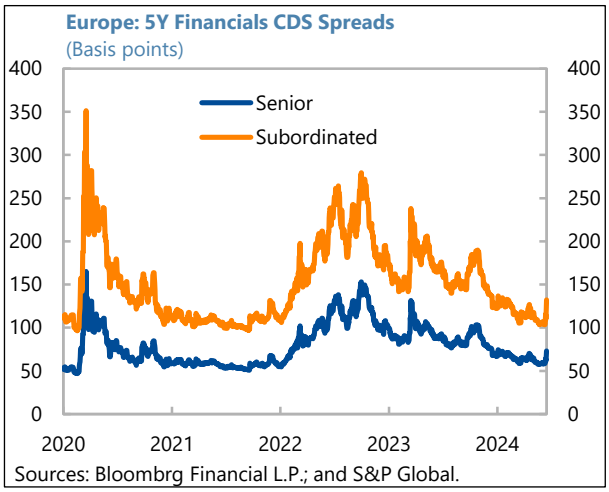
Sources: Eurostat, OECD, IMF staff calculations.



Sources: Eurostat; and IMF staff calculations.

7. The euro area current account balance is projected to increase further in 2024, following its return to surplus in 2023 driven by a significant decline in import prices. In 2023, the euro area current account reached 1.7 percent of GDP, up from -0.6 percent of GDP in 2022 (Text Figure 4, Figure 5). This was due largely to an increase of goods balances (e.g. in Austria, Finland, Germany, and Italy) from lower import prices, and, to a lesser extent, an improved income balance. The CPI- and ULC-based REER appreciated by 3.5 and 4.4 percent, respectively, compared to 2022. Staff assesses that the euro area's external position in 2023 was broadly in line with fundamentals and desirable policies (Table 2). The within-euro area external imbalances have moderated somewhat compared to the pre-war years. Staff projects the current account to strengthen to 2.1 percent of GDP in 2024 and stay around that level over the medium term.

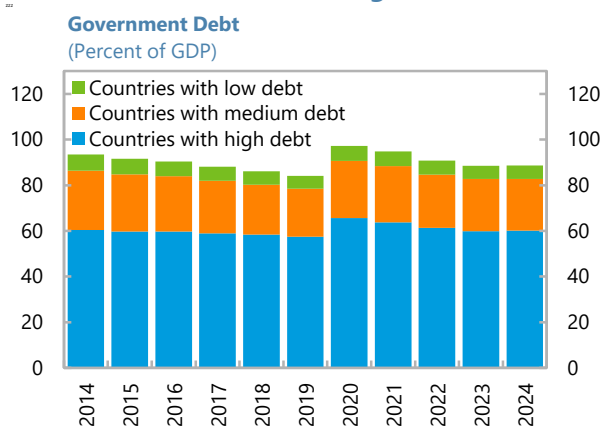
8. Eurozone banks are robust but entering a more difficult operating environment. Systemic financial risks in bank and nonbank financial intermediation (NBFI) sectors appear to have subsided since the last consultation, as illustrated by declining bank CDS spreads (text figure), consistent with the dissipating effects of the early-2023 banking turbulence in the U.S. and Switzerland and the anticipated turn of the monetary policy cycle. The most recent available data as of 2023Q3 indicate that euro area banks in aggregate have



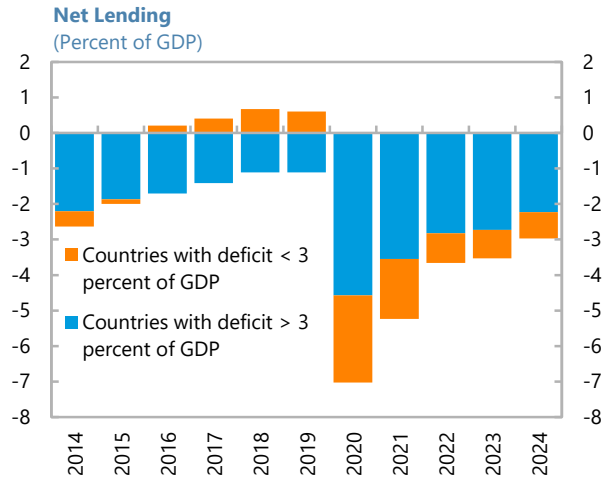
Sources: Bloombrg Financial L.P.; and S&P Global.

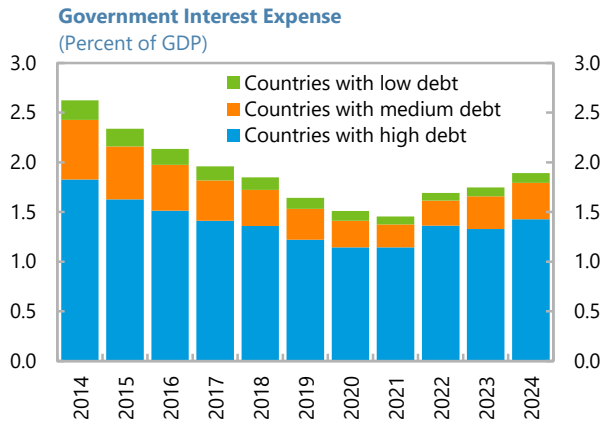
CET1 capital ratio of 15.6 percent, LCR of 159 percent, and NSFR of 126 percent (Text Figure 5). Widening net interest margins (reflecting rapid pass-through of monetary policy tightening to lending rates and more sticky overnight deposit rates) have lifted EU banks' profitability to post-GFC highs. Recent stress tests suggest that euro area banks are in aggregate resilient even under severely adverse macroeconomic scenarios.[2] Still, there is substantial heterogeneity of bank conditions: both across countries and bank sizes, and with bank-level pockets of vulnerability identified in stress tests. Moreover, much of recent bank profits is linked to a slow pass-through of policy interest rates to deposits.[3] As deposit rates catch up, nonperforming loans (NPLs)—connected to the pandemic, Russia's war in Ukraine, and past monetary policy tightening—rise, and lending volumes potentially continue shrinking, bank profits will likely moderate, which may expose pockets of vulnerability.[4]

Text Figure 3. Euro Area: Fiscal Policy Developments

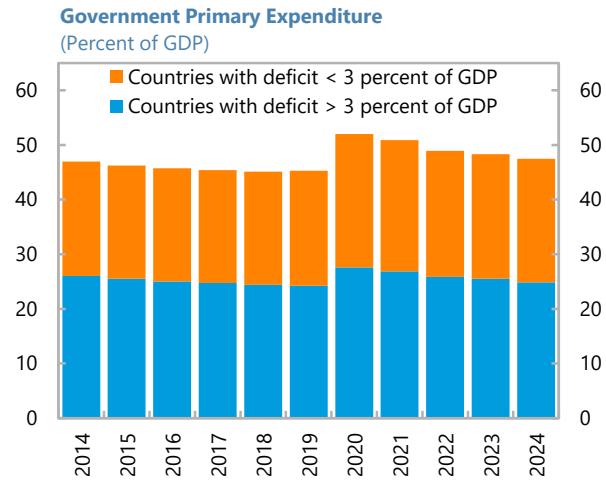


Note: High debt > 90%, medium debt is 60% to 90%, and low debt < 60%.





Note: High debt > 90%, medium debt is 60% to 90%, and low debt < 60%.



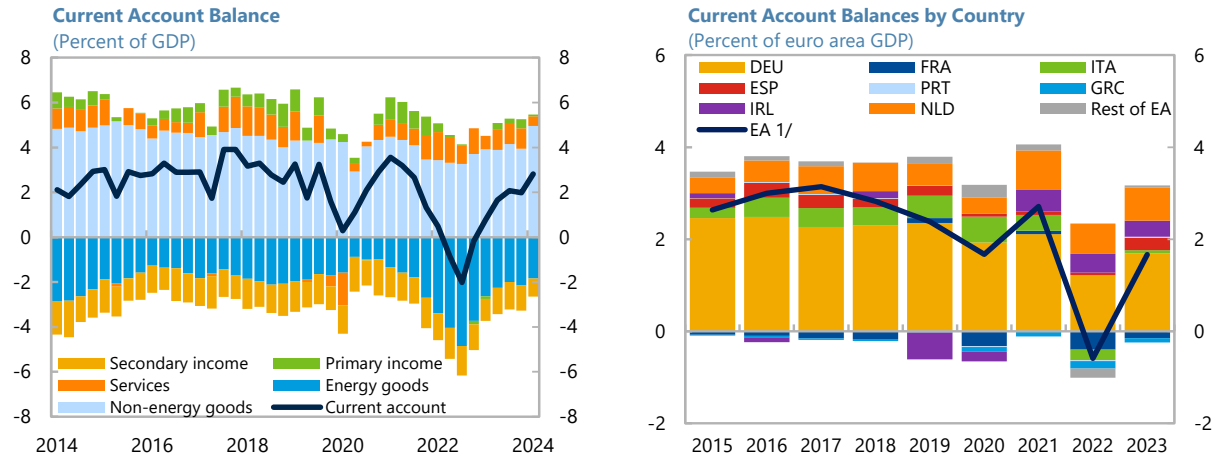
Sources: IMF WEO; and IMF staff calculations.

[2] See the October 2023 Global Financial Stability Report, Financial and Climate Policies for a High-Interest-Rate Era, Chapter 2: A New Look at Global Bank Vulnerabilities, and European Banking Authority's 2023 EU-Wide Stress Test Results.

[3] Pass-through from policy rates to most bank interest rates was between 30 and 50 percent weaker in this tightening cycle relative to the 2005-2008 cycle (Beyer et al., 2024. "Monetary Policy Pass-Through to Interest Rates: Stylized Facts from 30 European Countries." IMF Working Paper No. 2024/009).

[4] See Chen et al., 2024. "Bank Profitability in Europe: Not Here to Stay" IMF Working Paper, forthcoming.

Text Figure 4. Euro Area: Current Account



Sources: European Central Bank; Eurostat; and IMF staff calculations.
1/ The euro area current account balance excludes intra-EA trade, thus the sum of the bars do not equal the euro area balance.

9. Commercial real estate (CRE) poses challenges and potential risks in the less-regulated nonbank sector remain a concern. Pandemic-induced structural changes in the demand for office and retail space and higher borrowing costs for CRE have weighed on prices (e.g., in Germany real prices of offices and retail properties fell 19 and 15 percent in the four quarters through 2023Q4). CRE exposures tend to be concentrated in several jurisdictions and within select financial institutions (i.e. in some small banks, insurers, and pension and investment funds that are exposed to both European and the U.S. CRE through direct property holdings, CRE-related loans, debt securities, and equity shares). Should unemployment increase, banks may become less insulated from residential real estate prices too. However, strong capital and adequate liquidity mitigate the potential effects of real estate price corrections on banks. The nonbank financial intermediation (NBFI) sector remains a source of concern because of its exposure to real estate, potential systemic liquidity mismatches, synthetic leverage, the interconnections with banks, and its opacity due to national and cross-border data gaps.

10. The medium-term outlook is weighed down by subdued potential growth. Population aging, a trend decline in working hours,[5] limited scope for further increases in labor force participation, and skills mismatches[6] are constraining labor supply. Moreover, subdued investment and total factor productivity growth compared to peers weigh on labor productivity, while cost increases stemming from supply chain disruptions and trade tensions could weaken competitiveness. Prolonged low ICT spending reflects subdued innovation and technology

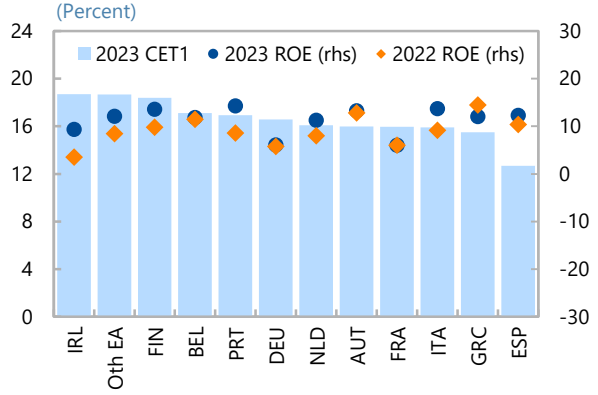
[5] See Astinova et al., 2024. "Dissecting the Decline in Average Hours Worked in Europe." IMF Working Paper No. 2024/002.

[6] After a temporary spike during the pandemic, skills and sectoral mismatches returned to pre-pandemic levels. However, many sectors (healthcare, hospitality, construction, and ICT) and occupations (software professionals, craft workers in construction and engineering) continue to experience labor shortages pointing to structural causes rather than cyclical ones. (European Commission, 2023, "Persistent Labour Market Tightness During a Slowdown: a Reappraisal of Drivers".) See also Arpaia, A. and A. Halasz, 2023. "Short- and long-run determinants of labour shortages", Quarterly Report on the Euro Area Volume 22, No 1 (2023).

adoption.[7] This could be even more of a constraining factor ahead, inhibiting Europe from realizing potential productivity gains related to the spread of Generative Artificial Intelligence. Medium-term growth is expected to converge to 1.2 percent, well below the average 1.9 percent registered in the five years before the pandemic, over 2014-19.

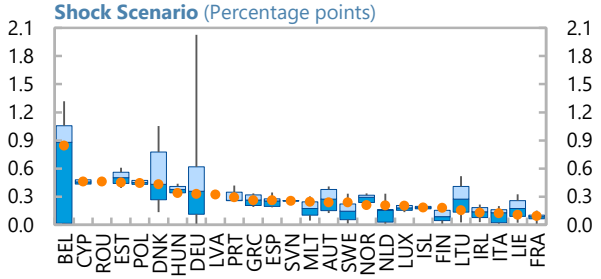
Text Figure 5. Euro Area: Financial Sector Developments

Common Equity Tier 1 Ratio and Return on Equity
(Percent)



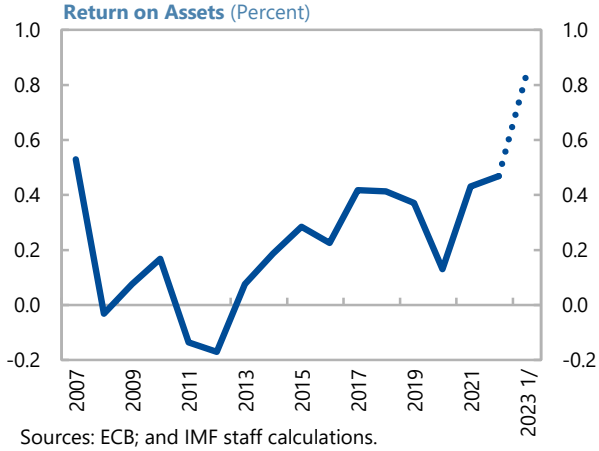
Source: ECB.
Note: Other EA refers to EST, LVA, LTU, LUX and SVN.

CET 1 Depletion Credit Risk Losses in CRE Under Shock Scenario (Percentage points)



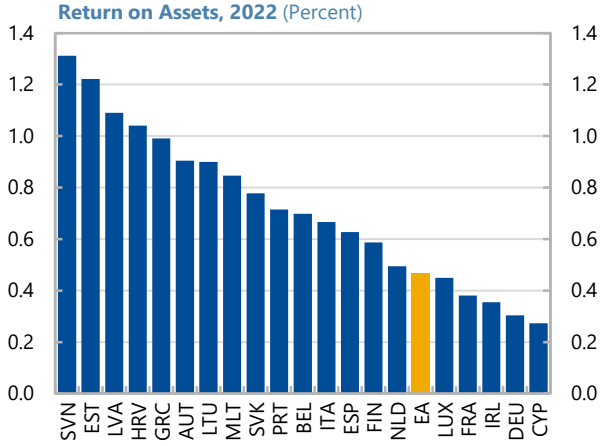
Sources: EBA; and IMF staff calculations.
Notes: Approach is based on a single factor stress test (see November 2023 REO, Box 5). Assumptions include: 20 percent of all CRE loans of EA banks characterized as "risky" stage 2, 3 loans; a 300-bps shock to interest rates; a 10 percent decline in banks' earnings. Orange dots represent asset-weighted averages. The boxplots show the inter-quartile range, with whiskers at the 5th and 95th percentile of the distribution.

Return on Assets (Percent)



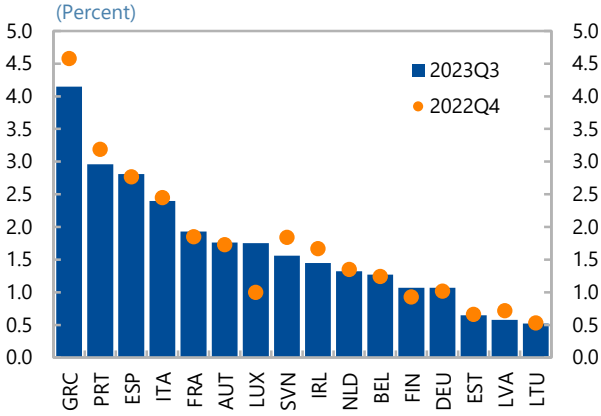
Sources: ECB; and IMF staff calculations.
1/ 2023 data is estimated.

Return on Assets, 2022 (Percent)



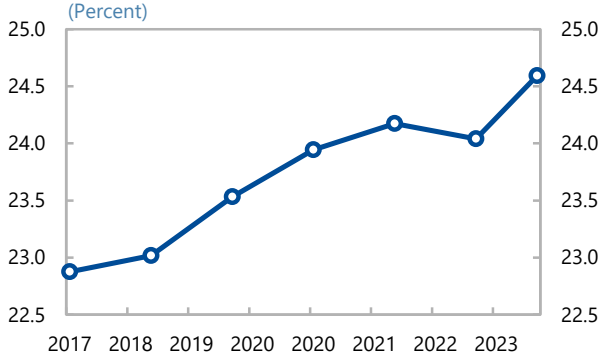
Sources: ECB; and IMF staff calculations.

Non Performing Loans Ratio
(Percent)



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

CRE and Related Exposures Over Total Loans
(Percent)



Sources: ECB and IMF staff calculations.
Note: All bank loans to real estate activities of nonfinancial corporations. Includes lending to construction firms.

[7] See Schnabel, 2024. "From laggard to leader? Closing the euro area's technology gap." European Central Bank.

11. Risks to the growth outlook are tilted to the downside, while risks to inflation are balanced (Table 3).

- *Growth.* Consumers may remain cautious and the pickup in consumption based on recovering real wages may turn out weaker than expected, leading to more subdued growth than in the baseline. Furthermore, the effect would be even stronger if labor demand cools in the face of sluggish activity (reversing the recent pattern of firms' hoarding labor in anticipation of a pickup in growth). The retrenchment could quickly intensify as more firms shed payroll, realizing they can rehire easily from an expanding pool of unemployed (evidence from recent European Commission survey data points to a decline in labor hoarding, though it remains higher than pre-pandemic). Growth could also be weaker than projected if the lagged effects of past monetary policy tightening are stronger than expected (e.g., if mortgage rate resets add pressure to household budgets and delay the consumption recovery; see Chapter 2 of the April 2024 World Economic Outlook). Delayed fiscal consolidation and reform efforts in high-debt countries, including due to policy uncertainty, could weigh on investment and medium-term growth, posing fiscal risks and potential spillovers to other countries. Geopolitical tensions could weaken sentiment further and dampen the projected pickup in consumption and investment. External demand may prove weaker than expected, for example from a slowdown in trading partner growth or intensifying geo-economic fragmentation.

- *Inflation.* The risks to the inflation outlook are now two-sided. Factors that could lift inflation higher than the baseline include: (i) stronger-than-expected wage pressures and unit profits failing to compress adequately to absorb rising labor costs in a low productivity environment; (ii) a reversal of the decline in import prices that has contributed to weak goods inflation and (iii) geopolitical tensions leading to renewed commodity price spikes or shipping disruptions. These could contribute to greater inflation persistence or an increase in inflation expectations, delaying the easing cycle. These elements are counterbalanced by downside risks. Weaker-than-expected domestic or global growth outturns (discussed above) would act to lower inflation relative to baseline. Depending on the severity of the growth slowdown, this could hasten the return of inflation to target.

- *Financial stability*. Although financial conditions have recently eased somewhat (Figure 4), financial stability risks could be ignited if the lagged effects of past monetary policy tightening challenge lenders more than expected. Additional CRE repricing arising from tighter global financial conditions or an unexpected increase in consumer and small business default rates could constrain credit supply and weigh on economic activity. The NBFI sector, in particular real estate investment funds that have low liquidity buffers, may face risks given their direct and indirect exposure to CRE and amplify liquidity risks across the financial system. Policy uncertainty can also trigger market repricing of sovereign fiscal risks and contribute to higher volatility of asset prices more generally—as seen, for instance, in June 2024.

Authorities' Views[8]

12. The authorities broadly shared staff's views on the macroeconomic outlook. They assess that the economy had turned around in the beginning of 2024 and expected growth to remain steady this year and strengthen slightly in 2025. The projected rebound reflects stronger private consumption—supported by robust employment and recovering real incomes—and later also stronger investment, as financing conditions ease and benefitting also from Next Generation EU funds. While expecting a cyclical rebound in labor productivity as demand strengthens, the authorities concurred that its trend remains weak—and together with population ageing—weighs on potential growth.

13. The disinflationary process continues as expected. The authorities noted that the rapid disinflation in 2023 was mostly driven by global factors, such as the unwinding of large supply shocks. Services—more sensitive to wage increases—have so far contributed much less to disinflation. Monetary policy tightening helped contain second-round effects. They expected inflation going forward to be driven less by global forces and more by domestic factors, noting that the effect of past monetary policy tightening still in the pipeline will be a key contributing factor to the disinflation. The authorities viewed the overall direction of wage growth as decelerating and saw room for firms' profit margins to continue compressing in the near term, helping to buffer the impact of labor cost increase.

14. The authorities saw risks to growth tilted to the downside and risks to inflation more balanced. They stressed that key downside risks come from outside the EU, including geopolitical tensions and policy uncertainty —with effects on the energy market, confidence, and trade fragmentation. These downside factors dominate upside risks to growth, which include stronger-than-expected foreign demand and a faster-than-expected decline in the household saving rate. The authorities noted that the disinflation process could accelerate if growth disappoints. However, they pointed out that wages could turn out higher-than-expected in a context of tight labor markets. In addition, the projected compression of firms' profit margin may be smaller if demand holds up better than expected.

15. The authorities agreed that financial stability risks have diminished since late 2023, though potential pressure points remain. As discussed in the ECB Financial Stability Review, these include the risk of corrections to asset valuations; CRE pressures, especially in non-prime office space, which are not considered to threaten the solvency of the banking system but require careful management from exposed banks; liquidity mismatch, liquidity strains, and explicit and hidden leverage in nonbanks. The authorities concurred that bank profitability has likely peaked even though it is expected to remain above pre-pandemic levels in a higher interest rate environment. The authorities also note that heightened geopolitical uncertainty and accelerating climate change may trigger a materialization of risks.

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

16. The authorities broadly concurred with staff's assessment of the euro area's external position, noting the partial reversal of the negative terms-of-trade shock. They expect a further increase in the current account balance over the forecast horizon. While noting that the euro area aggregate current account is likely to stay somewhat below pre-pandemic levels over the forecast horizon, the authorities saw external imbalances persisting for some Member States and highlighted the role of national policies to address them.

POLICY DISCUSSIONS

17. The economy is facing complex challenges. Despite generally encouraging news on inflation, the final descent to target may yet turn out to be difficult. Growth remains subdued. Public sector balance sheets are strained in many countries and spending needs are projected to rise further. Demographic change, geopolitical tensions, and geoeconomic fragmentation constitute powerful headwinds to medium-term growth. The consultation accordingly focused on policies to address these challenges. The forthcoming 2025 FSAP will examine financial sector policies in more detail.

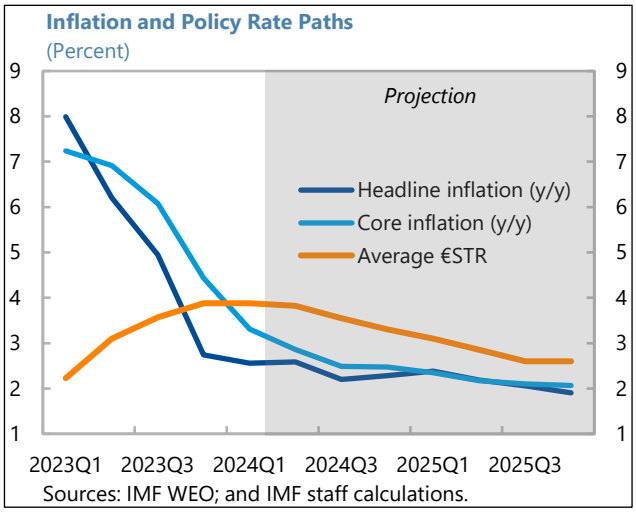
18. Strategy. Policies should aim at returning inflation to target in timely fashion, achieving inclusive and sustainable growth, and boosting productivity. ECB monetary policy should stay focused on securing eurozone inflation at target, calibrating interest rate reductions to evolving data. National-level fiscal policies will also play a vital role in ensuring economic performance continues to improve. Successfully implementing the new EU fiscal rules will provide a framework for medium-term consolidation in which high-debt countries consolidate more, while those with fiscal space can provide relatively stronger countercyclical support as needed. This will improve the distribution of domestic demand within the EU, reduce fiscal risks, and given the EU's systemic role in the global economy, mitigate adverse macroeconomic and financial spillovers. Well-calibrated macroeconomic stabilization policies and structural reforms—including those that strengthen the EU architecture and single market—can reinforce each other to lift growth, enhance resilience, and address challenges from an increasingly shock-prone, fragmented global economy.

A. Ensuring Macroeconomic Stability

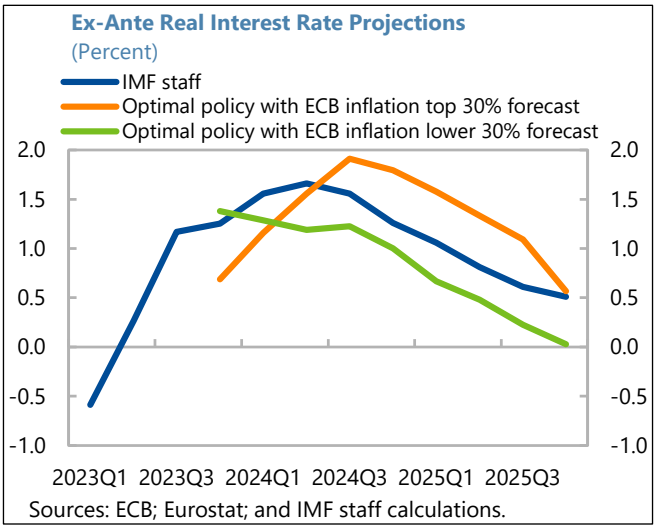
Returning Inflation to Target

19. Given the current inflation outlook (see ¶5), staff recommends that the ECB continue gradually lowering interest rates reaching a neutral stance by the end of 2025Q3. Using the WEO projected path for inflation and the output gap, an interest rate path with 25 basis points' reduction every quarter through 2025Q3 minimizes social welfare losses in a model of monetary policy with adaptive learning (see Annex II on monetary policy transmission). The gradual loosening would ensure convergence of inflation back to target by the second half of 2025 (text figure). This pace would strike a balance between keeping expectations anchored (thereby limiting second-round effects from high past inflation to current price and wage decisions) and avoiding an inflation undershoot. The terminal rate in the easing cycle will depend on the neutral real rate (r*) consistent with the economy operating at full employment and with stable inflation expectations. Staff

estimates that the euro area r* has risen modestly from before the pandemic to around 0.5 percent, consistent with a neutral policy rate of 2.5 percent. The increase in r* is explained by greater investment requirements driven by defense spending, global supply chain disruptions, and higher public spending needs (e.g., energy). The estimate of r* and the associated degree of restriction (difference between the policy rate and neutral) are subject to uncertainty. As the ECB removes restriction, evolving data on financial conditions, activity and inflation can provide more clarity on the terminal rate in the easing cycle.

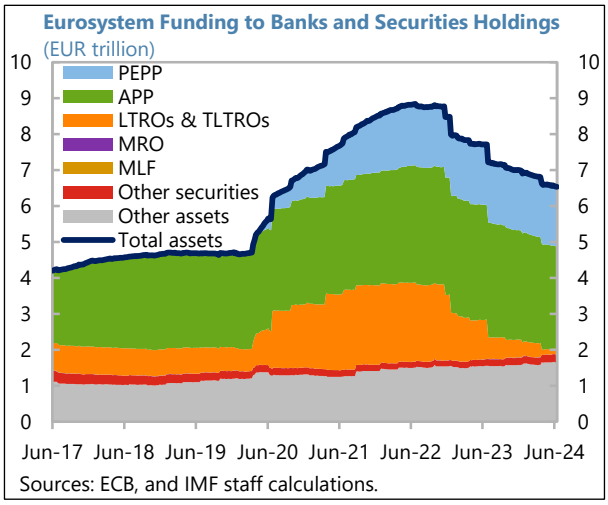


20. Considering the balance of risks to inflation, a data-driven and meeting-by meeting approach to monetary policy remains appropriate. The path of policy normalization may have to be faster or slower than under the current baseline depending on the evolution of underlying inflation, wage and profits growth, and inflation expectations. Staff's recommended interest rate path is robust to forecast uncertainty about inflation developments in the euro area, as published in the March ECB staff projections inflation band, which is used to assess how the recommended policy interest rate path would change under different scenarios (text figure). Clear and transparent ECB communication and a credible commitment to bring inflation back to target—which have contained the increase in inflation expectations in the face of unprecedented supply shocks—remain essential to anchor expectations, with the 1y1y and the 5y5y market inflation expectations hovering around the target.

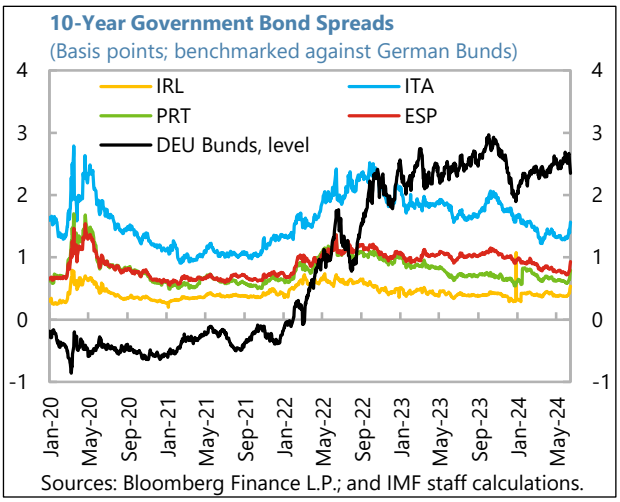


21. The ECB's quantitative tightening (QT) is proceeding appropriately. As of end-May 2024, the Eurosystem held €4.5 trillion in securities for monetary policy purposes (predominantly PEPP and APP). It is reducing this portfolio by approximately €29 billion monthly (text figure). QT has considerably reduced banks' deposits with the Eurosystem in excess of mandatory reserve requirements and liquidity needs for settlement purposes (i.e., excess reserves). Although the ECB has so far been able to separate QT from the discussion of the monetary policy stance, it may still face communication challenges when QT is conducted during a policy rate easing cycle. Despite the ECB's well-telegraphed pace of balance sheet reduction, its combination with policy rate cuts may be misinterpreted by markets, potentially distorting the intended monetary policy stance or affecting

market functioning. The ECB, therefore, should continue to emphasize that the Deposit Facility Rate (DFR) remains the primary instrument for implementing monetary policy, with QT operating in the background in a stable manner to reduce the ECB's market footprint. Overall, the effects of QT on bond yields are assessed to be small, considering a well-designed communication strategy, and the pace of normalization is appropriate and consistent with the intended monetary easing.[9]



22. The ECB is transitioning to a new operational framework aimed at achieving a high degree of control over short-term money market rates with a smaller balance sheet. As QT proceeds, excess liquidity will decline. The ECB's operational framework will move away from its current supply-driven floor system with abundant liquidity to a narrow (15 basis points) corridor within which the overnight rate can fluctuate. Banks' structural liquidity needs (related to minimum reserve requirements and autonomous factors) will be met through a combination of a structural asset portfolio and longer-term refinancing operations. Changes in the demand for liquidity will be met through the ECB's weekly main refinancing operations and 3-month longer-term refinancing operations, at a fixed rate against eligible collateral in amounts that banks demand (i.e., fixed rate full-allotment tenders). The new framework strikes a balance between limiting the volatility in overnight rates to ensure effective monetary transmission and reducing the Eurosystem's footprint in financial markets. The framework will mitigate risks of bank liquidity shortages, while the smaller ECB balance sheet than in the current supply-driven floor will reinforce the need for tighter bank liquidity management and enhance market discipline. However, the latter could lead to differentiation of financial conditions across the euro area. Accordingly, the framework should be complemented with progress toward completing the banking union to reduce fragmentation risks.[10]



23. The ECB has successfully mitigated sovereign bond market fragmentation risks during this cycle but needs to be prepared to deploy available instruments if risks resurface. Should fragmentation risks reemerge, the ECB should exercise flexibility in reinvesting PEPP redemptions as

[9] Belhocine, Nazim, Vina Nguyen, and Frederik Toscani, 2023, "Quantitative Tightening by the ECB: Why and How?" IMF Country Report No. 23/265.

[10] See Brandao-Marques and Ratnovski (2024), "The ECB's Future Monetary Policy Operational Framework: Corridor or Floor?", IMF WP 2024/056.

a first line of defense, retaining the Transmission Protection Instrument (TPI) as a backstop safeguard for clearly unwarranted and disorderly market dynamics.

Rebuilding Fiscal Buffers

24. Fiscal policy in 2024 is projected to be appropriately tighter compared with 2023, but quality consolidation measures are needed for 2025 and beyond. Under the baseline, the aggregate euro area fiscal deficit in 2024 is expected to narrow to 3 percent of GDP (from 3.5 in 2023), reflecting an expected improvement in the cyclically adjusted primary balance of close to 1 percentage point of potential GDP (up from 0.5 in 2023). Ninety percent of the euro area improvement comes from high-debt countries (making up around ½ of euro area GDP). Two-thirds of countries are implementing discretionary fiscal tightening in 2024. Under the baseline, fiscal consolidation is projected to slow substantially in 2025 and beyond. In a no-policy-change scenario, the euro area fiscal deficit would gradually decrease to around 2.4 percent of GDP and consolidated euro area debt would stabilize at around 88 percent of GDP by 2029.

25. Over the medium term, the new economic governance framework (Annex III) is likely to require fiscal consolidation that is significant in a historical perspective.

- If successfully implemented, the new EU economic governance framework has the potential to enhance the coordination of fiscal policy and strengthen fiscal sustainability. The pace of adjustment will be based on country-specific conditions. According to staff's preliminary simulations, the required fiscal adjustment appears realistic and measured, and will allow for public investment. The use of multi-year nominal expenditure paths as the single operational indicator is more transparent than the previously used (non-observable) cyclically adjusted parameters, which were often revised ex post. Country-specific fiscal adjustment requirements—derived from robust analyses of long-term debt sustainability, including aging costs—will enhance the macroeconomic justification of the targets, which, in turn, will build market confidence. The emphasis on the medium-term fiscal-structural plan as the basis for the agreement between member states, the Commission, and the Council, not only requires a comprehensive domestic policy plan underpinning the fiscal adjustment, but also captures in one process the fiscal and structural reforms that jointly improve long-term sustainability and growth.

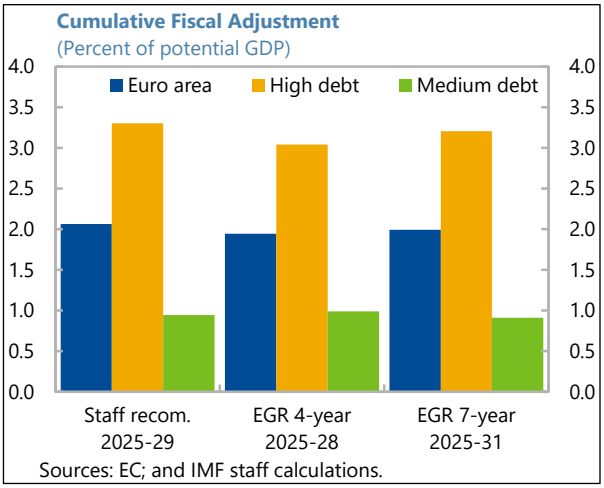
- For a successful implementation of the new framework, the Commission needs to provide guidance and clarity on all operational aspects. Ongoing work setting out the structure and contents of required reports, as well as interpretation of all methodological aspects, should be completed as quickly as possible.

- However, the framework is operationally complex, and will require significant capacity and political support to implement as envisioned. In particular, the Directive on Requirements for Budgetary Frameworks—which is part of the economic governance review—sets detailed rules for budgetary frameworks of member states, which if fully implemented will help countries deliver on commitments to adjust their public finances. The Directive requires strong medium-term budgetary frameworks, transparency, public accounting and reporting, and unbiased

macroeconomic and budgetary forecasts—including an analysis of macro-fiscal risks from climate change. The Directive also requires that independent fiscal institutions are established in all member states, and that they are given a role in macroeconomic forecasting and assessing national budgetary frameworks and national fiscal rules. Several member states need to advance reforms to their budgetary framework[11] and strengthen independent fiscal institutions[12], and should do so without delay.

- Member states should identify high-quality measures that will deliver on their required adjustment and commit to these in their medium-term fiscal structural plans, to be submitted to the Commission in September.

26. The cumulative fiscal adjustment called for by the new fiscal rules appears appropriate, though staff recommends more near-term adjustment than what is likely to be required in the four- or seven-year scenarios, particularly in high-debt countries. Most euro area countries—especially those with higher debt risks and sustainability concerns—need to start rebuilding fiscal buffers to protect against future adverse shocks and to meet long-term pressures (pensions, health, energy security, the green transition, and military spending).[13] Member states with moderate or low fiscal risks have more room for fiscal support if needed. In the baseline no-policy-change scenario, staff projects an annual improvement in the euro area structural primary balance over 2025-29 of only around 0.1 percentage point of potential GDP. This is less than what is likely to be mandated under the new EU fiscal rules and staff would recommend. In the four-year adjustment scenario, staff estimates that the annual improvement in the euro area structural primary balance over 2025–28 would be around ½ percentage point of potential GDP. In a seven-year adjustment, the annual improvement would be around 0.3 percentage point, but over the longer period of 2025–31. In both adjustment scenarios, between 80–85 percent of the euro area fiscal improvement would come from high-debt countries. Staff recommends cumulative 2025–29 adjustment similar to what appears to be generated by the new EU fiscal rules (text figure), also with a high-debt country contribution of 80–90 percent. However, staff recommends more near-term adjustment, with annual improvement of the structural primary balance in 2025 of around 0.6 percent of GDP, allowing the pace of consolidation to fall to around 0.3 percent of GDP in the outer years. More near-term adjustment in high-debt countries—in particular where output gaps are small—would demonstrate resolve, help establish market confidence, and create room for addressing future spending needs under net



Sources: EC; and IMF staff calculations.

[11] Radu, Diana, 2023, Domestic Medium-Term Budgetary Frameworks in the EU: Fit for Purpose and for the Future? European Economy Discussion Paper 189, July 2023.

[12] Caselli, Francesca, et al., 2022, The Return to Fiscal Rules, Staff Discussion Note 2022/002.

[13] See also Box 2 in the April 2024 *Regional Economic Outlook* for Europe.

expenditure paths. By focusing on measures with a low fiscal multiplier—e.g., removal of hiring subsidies and tax expenditures benefitting high-income households—such adjustment could be implemented with less adverse impact on activity. Over the medium term, the adjustment could diminish somewhat but would need to be sustained. Countries placed in the Excessive Deficit Procedure (EDP) should ensure they comply with the recommended corrective adjustment requirements, aimed at ending the EDP expeditiously.[14]

27. Medium-term fiscal adjustment should primarily rely on structural expenditure measures that protect priority spending, supported by broadening of tax bases and non-distortionary revenue measures. Fiscal adjustment should be tailored to country-specific circumstances but should in most cases rely on expenditure cuts rather than tax increases that widen the tax wedge and suppress labor supply. Near-term adjustment in high-debt countries can be achieved through the reversal of previous years' stimulus programs, and by drawing on already completed spending reviews. Additional permanent measures can rely on reviewing large social transfer and entitlement programs to strengthen targeting, which can contribute to permanent expenditure reductions—although changes of these programs require time and often new legislation. Initiating such reviews now enables countries to reflect savings in their medium-term fiscal plans. Many countries can also widen tax bases (by eliminating preferential treatments and tax exemptions—in particular on VAT), base property taxes on market valuation, and make better use of carbon taxes.

Managing Potential Risks in the Financial Sector

28. Policymakers should consider implementing positive neutral countercyclical capital buffers (PNCCyB), conserving banks' temporarily high profits in the process. While bank capital ratios in aggregate are very strong, to ensure robust credit provision in severely adverse macroeconomic scenarios, national authorities can ensure that banks lock-in profits into releasable capital by implementing PNCCyB rates on a case-by-case basis. While financial conditions are generally not buoyant, credit standards have stabilized after rapid tightening. With high banking sector profits at the current juncture, implementing PNCCyB is not expected to restrict credit supply as banks would have the ability to accumulate capital from profits.[15] Higher buffers would help banks maintain the flow of lending if profits moderate and NPLs rise more than expected later in the credit cycle (as the buffers provide insurance against possible shocks and can be released should there be evidence of impending financial stress, thereby supporting credit supply). Authorities should exercise caution with ad-hoc taxes on bank profits and ensure that these are not detrimental

[14] On June 19, 2024, the Commission recommended placing 7 member states in an EDP. These are countries where 2023 deficits were well above 3 percent of GDP and 2024 deficits were not expected to fall sufficiently. If adopted by the European Council, the EDP will require corrective fiscal adjustment which will be determined in the context of member states' draft budgetary plans and medium-term fiscal structural plans in October.

[15] See Miettinen, Paavo and Erlend Nier, "Rethinking Macroprudential Capital Buffers", Monetary and Capital Markets Departmental Paper, forthcoming. Some EU countries use other buffers, including the sectoral systemic risk buffer (SyRB), as a de-facto substitute to PNCCyB. While the use of SyRB is preferred to having no buffers, SyRB is conceived as a structural rather than cyclical tool and a shift in emphasis toward CCyB may be economically appropriate and furthermore help harmonize the type of buffers used for cyclical purposes in the EU.

to credit provision, bank capital accumulation, tax certainty, or confidence.[16] Borrower-based macroprudential measures (such as loan-to-value and debt-to-income limits) should be part of the macroprudential toolkit and calibrated to anchor long-term financial sector resilience and considering country-specific circumstances. Microprudential policies should be used to address weak banks with relatively lower capital buffers.

29. Policymakers should strengthen their ability to monitor nonbank sector risks, while continuing to develop a macroprudential toolkit for nonbanks. Strengthening the surveillance of risks and vulnerabilities in the NBFI sector, including real estate funds, is fundamental to reducing financial fragility risks. Yet, the monitoring of nonbanks and of their cross-border activities is challenging due to data gaps. During financial stress, the sector may be exposed to increased margin calls on derivative positions and/or investor outflows, which may be difficult to manage. Nonbank-oriented macroprudential tools, such as restrictions on leverage and the ability of funds or regulators to suspend investor withdrawals, are relatively under-developed. Consideration should be given to expediting the development of such tools where they currently do not exist and where risks are rising. Policymakers should also continue efforts to bridge data gaps and enhance data sharing among financial oversight agencies, which would bolster the ability to monitor risks across the financial sector.

30. Steps have been taken in implementing the 2018 FSAP recommendations (Annex VII), but some areas in supervision, resolution, and crisis management frameworks remain to be addressed. The EU Parliament adopted amendments to the Capital Requirements Regulation (CRR III) and the Capital Requirements Directive (CRD VI) in April 2024. Most deviations from Basel III have not been removed while more progress is needed in other areas including the framework for corrective and sanctioning powers and transactions with related parties. A package of reforms to the crisis management and deposit insurance (CMDI) regimes is under negotiation but further progress on centralizing deposit insurance and emergency liquidity assistance is needed.

Policy Response in an Adverse Scenario

31. If inflation turns out more persistent than expected, this would require tighter monetary policy and adjustments to both financial sector and fiscal policies. Increased geopolitical tension and regional conflicts or deeper geoeconomic fragmentation, for example, could lead to further supply chain disruptions and higher energy prices, possibly reversing recent disinflation gains and slowing growth further. Renewed inflation could trigger wage-price loops, which would lead to persistently above-target inflation and require the monetary policy stance to be tight for longer or even tighter. Should a slower-than-envisaged pace of rate cuts, or even renewed hikes, surprise financial markets, a disorderly downward adjustment in asset prices, including those of real estate, could ensue. Under such a scenario, closely monitoring and addressing any financial stability risks would be critical. If systemic financial stress arises, clear communication and targeted liquidity support would be warranted. Automatic fiscal stabilizers and support to vulnerable

[16] See Chen et al. (2024) "Bank Profitability in Europe: Not Here to Stay", IMF WP forthcoming, and Maneely and Ratnovski (2024), "Bank Profits and Bank Taxes in the EU", IMF WP forthcoming.

households should be allowed to address the distributional costs of tighter policy, but large increases in the structural deficits should be avoided to maintain a coherent monetary-fiscal policy mix and safeguard debt sustainability.

32. If sovereign markets are disrupted, concerns should be addressed through clear communication by national fiscal authorities on their commitment to fiscal sustainability, the ESM's macro-adjustment programs and the ECB's Outright Monetary Transactions. Countering a durable widening of sovereign risk premia induced by fiscal policy uncertainty would require national authorities to clearly communicate a credible commitment to fiscal sustainability. Should the widening of risk premia tighten financial conditions in ways that significantly slow activity and place downward pressure on inflation, a less restrictive monetary stance would be warranted. The Governing Council could reduce its policy rates, adjust its quantitative tightening (including by flexibly reinvesting the proceeds from maturing PEPP securities) or restart quantitative easing and targeted longer-term refinancing operations, as needed. In case confidence deteriorates significantly and market access is impaired, the European Stability Mechanism (ESM) can provide assistance to euro area countries facing severe financing problems that threaten the financial stability of the euro area. Provided ESM program conditionality is met, the Governing Council can deploy Outright Monetary Transactions (OMT) as needed to safeguard monetary policy transmission. Moreover, the Governing Council can step in if needed to counter unwarranted, disorderly market dynamics by activating its TPI.

Authorities' Views

33. The ECB viewed that its policy rate tightening contributed significantly to the ongoing disinflation process. It noted that the restrictive monetary policy stance is transmitting quickly to financing conditions, with the flow of credit to firms declining faster than in previous cycles. Transmission to real activity is also materializing and a large part of the effect on inflation is yet to come. The ECB emphasized that, similar to the approach for the tightening cycle, it will continue its meeting-by-meeting and data-dependent approach to set its policy rate and determine the appropriate level and duration of restriction in the coming easing cycle, based on its assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. It will avoid pre-committing to a particular interest rate path, especially given the still elevated level of uncertainty.

34. The ECB viewed the current pace of balance sheet reduction as appropriate. It reiterated that the primary tool for calibrating the monetary policy stance is the deposit facility rate, with quantitative tightening working in the background to decompress the term premium. The ECB agreed that a measured and predictable approach to balance sheet reduction was appropriate and emphasized that financial fragmentation related to the legacy of the pandemic, if it materialized, could be addressed, if needed, with the flexible reinvestment of PEPP's maturing assets over the second half of 2024. Other tools, such as TPI, are in place which could be deployed, if necessary, to address other sources of fragmentation that pose risks to the monetary policy transmission mechanism and are not warranted by deteriorating country fundamentals.

35. The authorities broadly agreed on the projected fiscal outlook and the need for fiscal adjustment in many—but not all—member states to reduce debt-sustainability risks. They noted that

the current contractionary fiscal stance—even after including the impulse to economic activity that resulted from expenditure financed by EU grants—could have a limited negative impact on output, as a considerable part of the fiscal adjustment was an anticipated discontinuation of temporary measures. With the legislation setting out the new economic governance framework having entered into force on April 30, there was a pressing need to finalize technical details related to the implementation of the new framework and start discussions with Member States on their medium-term fiscal-structural plans. The authorities were hopeful that most Member States—despite limited time—would be able to submit these plans in autumn. The Commission highlighted the importance of preserving public investment and reducing current spending when formulating the medium-term fiscal adjustment strategies set out in the plans. While the authorities generally agreed that more near-term fiscal adjustment could be appropriate—in particular in high-debt and high-deficit countries—they noted the negative risks to the growth outlook and that there was no basis in the legislation for the Commission to request a more front-loaded adjustment profile, although there were provisions to prevent a back-loading of the adjustment.

36. The authorities agreed on the need to monitor risks and address potential pressures in banks and nonbanks, keeping in mind the macroprudential perspective. The authorities supported the view that higher CCyB rates, also as part of the transition to a positive neutral level observed in many EU Member States, were one of the options for increasing macroprudential space, allowing banks to build releasable buffers that can be used to continue maintaining the flow of credit to the economy in crisis periods. While the overall level of capital requirements was deemed adequate, an increase in macroprudential space due to the use of the positive neutral CCyB rate can further strengthen the capacity of the banking sector to weather systemic shocks. Authorities indicated that sectoral systemic risk buffers (SyRB) may play a similar role in jurisdictions that lack the legal basis to increase CCyB rates in the absence of cyclical risks or jurisdictions that would see obstacles in applying a positive neutral CCyB rate. They saw borrower-based macroprudential measures as structural "guardrails" to improve loan origination and build financial sector resilience over time rather than tools for cyclical credit management. The authorities concurred on the need to close data gaps for nonbanks, develop nonbank-oriented macroprudential policy tools, improve data collection and foster data sharing and access between supervisors and central banks in the EU macroprudential framework for monitoring and supervisory purposes.

B. Boosting Productivity and Reinvigorating Growth

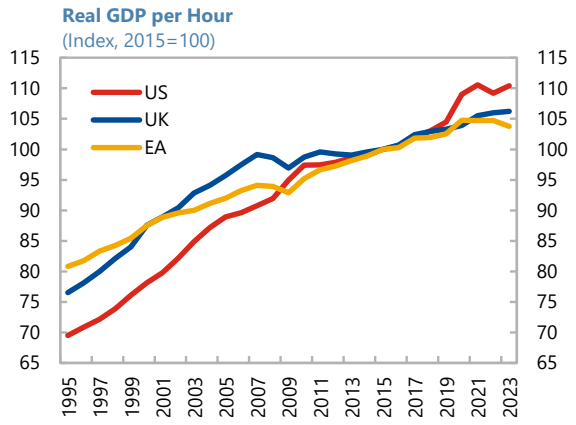
37. Europe's long-standing productivity challenge arises from a combination of factors. An important factor is insufficient public and private investment. R&D expenditures in crucial technologies (such as software and electronics) continue to lag those in the U.S. (Text Figure 6). Business dynamism has also structurally slowed since the early 2000s, with decreasing job reallocation and a falling share of employment in young, high-growth firms.[17] While the decline in business dynamism is not unique to Europe,[18] there is room for policies and institutions to boost it

[17] In addition, firm entry and exit rates have been declining across Europe across multiple sectors and firm sizes (Biondi et al., 2023). See also Box 1 for a discussion of the importance of young firms for employment creation and innovation. Despite this declining structural trend in business dynamism, 2024Q1 data show that registration of businesses in the EU is at the highest level since 2018 with an increase of 1.6 percent between 2024Q1 and 2023Q4.

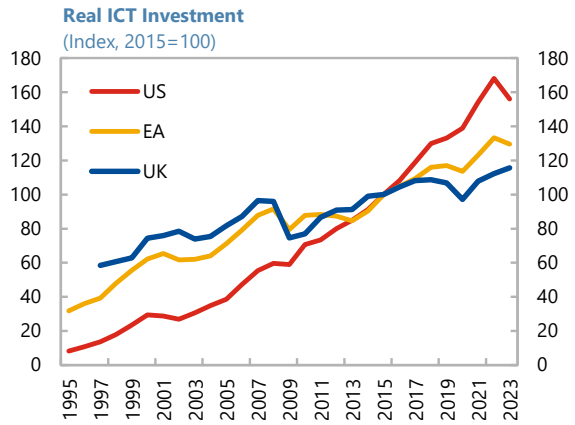
[18] See, for example, What Happened to U.S. Business Dynamism? FEDS Notes February 2020.

in Europe. Barriers to entry (e.g., higher administrative requirements for start-ups in many euro area countries compared to other advanced economies[19]) protect the rents of incumbents. Relative to the U.S., additional difficulties for new firms to scale up stem from remaining barriers to trade between euro area members.[20] Difficulties with commercializing scientific research (e.g., through patenting) impede technology diffusion. Lack of access to credit prevents new entrants from challenging incumbents. Heterogeneous and inefficient insolvency frameworks slow exit and reallocation.[21] The labor market challenges (such as skills mismatches and shortages,[22] an aging workforce, and still stringent labor regulations in some countries), along with social preferences and housing affordability difficulties, may discourage job reallocation needed to support productivity-enhancing structural change.

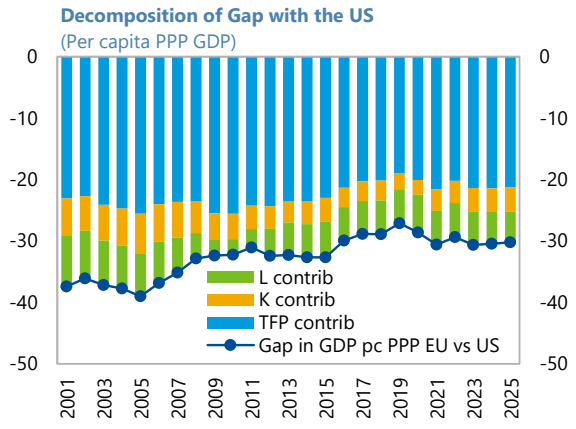
Text Figure 6. Euro Area: Productivity and Aging Challenges



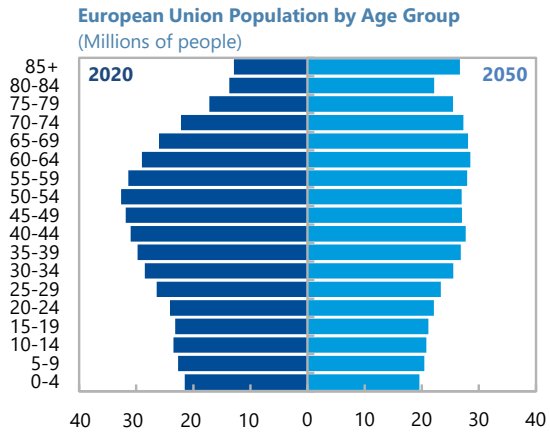
Sources: Bureau of Economic Analysis; Eurostat; and IMF staff calculations.



Sources: Bureau of Economic Analysis; Eurostat; and IMF staff calculations.



Sources: ECB; and IMF staff calculations.



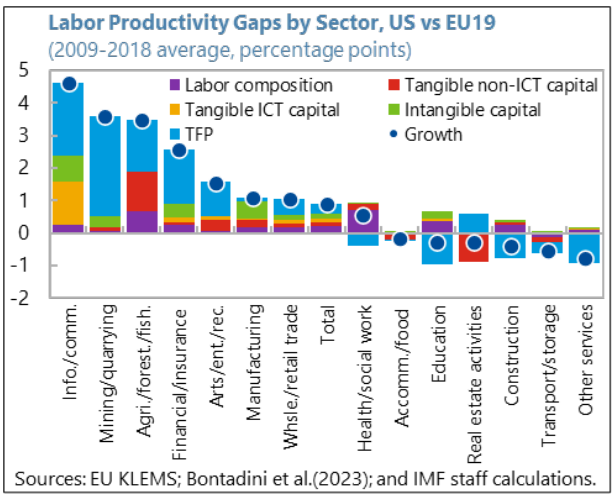
Sources: Eurostat; and IMF staff calculations.

[19] OECD, 2018, Indicators of Product Market Regulation.

[20] April 2024 *Regional Economic Outlook* for Europe.

[21] IMF survey of EU capital market practitioners in 2019 finds that market practitioners in about half of EU countries raised the insolvency practice as a concern (IMF, 2019). According to a European Banking Authority study published in 2020, the recovery time during insolvency proceedings ranges from 0.6 to 7 years on average across Member States, pointing to room for increasing efficiency in some countries.

[22] In the EU, about 80 percent of companies reported difficulties in recruiting employees with the right skills and over half expressed difficulties in maintaining skilled staff (European Commission, European Year of Skills 2023 Survey).



38. While Europe's lagging productivity is broad based across most sectors, services present the largest gap with the U.S.[23] Latest available comparable sectoral data suggest that market services—information and communication, financial and wholesale and retail trade, and health—together with mining and quarrying are the sectors accounting for the largest productivity gaps with the U.S. (text figure). While lower TFP in Europe is the main driver of this divergence across sectors,[24] labor composition[25] and intangible capital, which reflects R&D investments, also help account for the gaps.[26] Shortfalls in tangible ICT capital also contribute to the significant underperformance of the information and communication sector.

Fostering Productive Public and Private Investment

39. NextGenerationEU (NGEU) faces investment bottlenecks and some Recovery Resilience Facility (RRF) reforms are often delayed, indicating a need to strengthen capacity and streamline administrative processes. Following a swift disbursement in prefinancing, the pace of disbursements slowed and the RRF only disbursed about one-third of its funds (€225 billion) at the halfway point (end-2023). Plan revisions (to reflect the RePowerEU initiative and higher costs from inflation), public administrative capacity constraints, burdensome processes, and investment bottlenecks (including from skills shortages and lingering supply chain disruptions) have slowed the completion of milestones and targets. Improving absorptive capacity (e.g., through better coordination at all government levels) while maintaining the highest standards in using the funds must remain a priority to realize planned reforms and investments, in particular in member states that are large recipients of NGEU-funds and which have capacity constraints.[27] The Commission

[23] See also Bart van Ark, Mary O'Mahony, and Marcel P. Timmer, (2008), "The Productivity Gap between Europe and the United States: Trends and Causes", *Journal of Economic Perspectives*—Volume 22, Number 1—Winter 2008—Pages 25–44.

[24] For an analysis of TFP slowdown in advanced economies and its drivers—including resource misallocation and slower growth in efficient TFP— see IMF World Economic Outlook, April 2024, Chapter 3, Slowdown in Global Medium-Term Growth: What Will It Take to Turn the Tide?.

[25] The labor accounts include the shares of employment and labor compensation by type of worker cross-classified by gender, age, and educational attainment.

[26] The post-1995 upswing in U.S. productivity growth is almost completely explained by additional productivity growth in ICT intensive services rather than commodity producing sectors. On the contrary, Europe not only invested less in ICT but also failed to take advantage of its benefits even in ICT-intensive industries. For a discussion see Gordon, Robert J. and Hassan Sayed (2020). "Transatlantic Technologies: The Role of ICT in the Evolution of U.S. and European Productivity Growth," International Productivity Monitor, Centre for the Study of Living Standards, vol. 38, pages 50-80, Spring.

[27] It is estimated that if fully absorbed the NGEU can help raise the EU GDP by 1.4 percent by 2026 (European Commission, 2024).

should examine whether there might be benefits from streamlining administrative processes and reducing overlaps of EU and national reporting and control systems.

40. EU-level fiscal capacity should be enhanced and better focused to provide common public goods to address shared long-term challenges. Roughly 60 percent of the current EU budget goes to the Common Agricultural Policy (CAP) and cohesion funds, which finance a broad array of investments in poorer regions in EU countries. The NGEU package has temporarily boosted the size of the EU budget and oriented a large share of the spending to priorities such as mitigating climate change, but expires at the end of 2026. The next EU budget should be better oriented to addressing shared challenges, especially where acting at the EU level can help resolve coordination failures or internalize externalities. A prime example is in fighting climate change where cost-efficiencies could be reaped and coordination problems (e.g., for grid interconnectors) and externalities—both positive (e.g., R&D in clean-tech) and negative (e.g., free rider problem)—exist (see ¶61). To the extent that member states are seeking to increase defense spending to address common security concerns, coordinating the initiatives through a EU-level fiscal capacity with common procurement could reduce duplication and achieve cost savings. Providing more common public goods at the EU level could also potentially make it easier for member states to reduce national fiscal risks.

41. Developing a single market for financial services is critical to mobilize funding for investment and mitigate future financial fragility risks. Although the EU continues to improve its financial sector oversight architecture,[28] progress is needed in two key areas: the banking union (BU), a long-standing and much-delayed goal of the EU that could contribute to a more resilient and efficient banking sector; and the capital markets union (CMU), a key initiative to unlock the EU's growth potential, boost resilience, and increase private cross-border risk sharing. Completing the BU would require making progress with the crisis management and deposit insurance framework, moving toward a European Deposit Insurance Scheme, and achieving the final ratification of the amendments to the ESM Treaty that would enable the ESM to act as a backstop for the Single Resolution Fund.

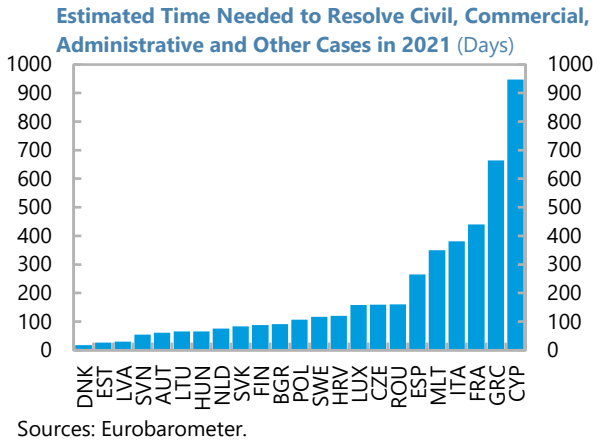
42. Building on steps already taken and on existing political support, the EU should advance further with reforms to strengthen the CMU. The Eurogroup statement of March 2024 identified as priority areas: (i) better access to private funding by EU businesses (which could boost growth and level the playing field in the single market), (ii) broader opportunities for EU households to participate in capital markets (to increase risk sharing and gain access to better saving opportunities), and (iii) a more competitive and efficient regulatory system (which could attract more cross-border investment). The agreement on the European Single Access Point for corporate information is positive, but the implementation timeline is too long. The review of Solvency II, aimed at increasing long-term and equity financing from insurance companies and to make the sector more resilient, is a similarly positive initiative, even if many details are yet to be worked out. In some

[28] The EU has recently completed the establishment of the Union-level anti-money-laundering authority (AMLA). An adequately staffed AMLA can become an effective line of defense in the EU's fight against illicit financial activities, money laundering and terrorism financing.

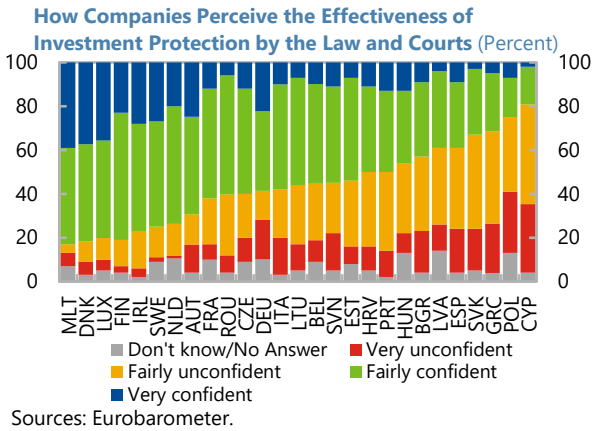
important areas, political negotiations are ongoing, such as on the harmonization of certain aspects of national corporate insolvency law and on proposals to simplify the procedures for withholding taxes (such as those on dividends and interest). Proposals in other areas, such as the "consolidated tape" (aimed at improving price transparency for traded securities) and the Retail Investment Package (aimed at increasing capital market participation by retail investors), are proving harder to move forward. In addition to these reforms, EU market supervision would benefit from further strengthening ESMA, including by considering reforming its governance to make it more independent and better able to coordinate across national authorities within the common financial market. Looking ahead, greater harmonization of the EU's capital markets oversight would be desirable, possibly by promoting a common rulebook or more common supervision.[29]

43. More ambitious steps in the areas of insolvency, taxation, accounting, securities law, and supervision would further the CMU. For example, a "28th corporate regime" would allow firms to choose to be incorporated under fully harmonized EU-level law covering corporate governance, insolvency, and elements of labor relations. In contrast to the full harmonization of national laws, the 28th regime would operate alongside the national frameworks, offering firms and countries opt-in flexibility. The 28th regime would rely on its own system of courts, offering effective judicial support that would especially benefit firms in countries with relatively less effective judicial systems (Text Figure 7). It would represent a significant expansion of the current "*Societas Europaea* (SE)" arrangements and can be complemented by the "European Business Code" (EBC) – a harmonization of overall business transactions law along the lines of U.S. Uniform Commercial Code (UCC).

Text Figure 7. Euro Area: Heterogeneity of the Effectiveness of Commercial Judiciary in the EU



Sources: Eurobarometer.



Sources: Eurobarometer.

44. CMU will help lower the cost of finance and improve access to funding, including for innovative start-ups—which can spur faster productivity growth. Europe has been able to generate many innovative new businesses, but European startups lag their counterparts in the U.S. in access to funding (Box 1). Some of this gap can be attributed to the fact that banks are not well

[29] See Bhatia et al., 2019. "A Capital Market Union for Europe." IMF Staff Discussion Note 19/007, and 2023 Annual Consultation on Euro Area Policies, Annex IV.

suited to finance innovative startups with limited physical collateral. To overcome this market failure, national regulatory, tax and legal frameworks should reduce constraints that inhibit venture capital (VC) investment, including across borders. In the meantime, well-calibrated, preferential tax treatment for VC investment as well as public VC investment made on commercial terms alongside private investors can help too. At the EU level, the European Investment Fund (EIF) could develop a fund-of-funds for institutional investors (and provide due diligence as a public good) to allow scaled-up VC investment across the EU. Among pension funds and insurers, criteria for VC investment should be aligned for all fund sizes, as current regulatory fragmentation impedes investing in larger VC funds.[30] Greater stock market integration, a key CMU priority would improve liquidity and market depth, which in turn would positively impact valuations.

45. A comprehensive policy framework is needed to improve digitalization, business dynamism and innovation across the EU. Policy should prioritize reducing red tape (e.g., administrative complexity for start-ups, as noted in ¶37) and improving access to financial resources—particularly for SMEs—to stimulate startup growth and innovation. Investing in workforce education and skills development are important to adapt to new technologies (see also ¶47). Fostering partnerships between academia, research institutions, and the private sector can accelerate the commercialization of innovative research. Increasing public investment in infrastructure and public support for research and development is also important.[31]

46. The introduction of the digital euro as a central bank digital currency (CBDC) requires careful planning by the ECB and the EC. The ECB is currently in the "preparatory phase" of the digital euro. The ECB plans to limit an individual's digital euro holdings to a level consistent with potential transaction needs, which may alleviate the concerns that an abrupt shift by households to digital euros from bank deposits could compromise bank credit provision at times of stress. A CBDC has the potential benefit of providing a legal tender in a digitalized world, retaining monetary sovereignty by avoiding currency substitution toward foreign CBDCs and private coins, and increasing competition in the financial sector.

[30] Currently, VC funds smaller than 500 million euros are regulated under the less onerous European venture capital funds (EuVECA) regulation, while those funds of 500 million euros or more are regulated under the more stringent Alternative Investment Fund Managers Directive (AIFMD).

[31] See Samila and Sorenson, 2010. "Venture capital as a catalyst to commercialization", Research Policy, vol 39 (10) p. 1348-60.

Box 1. Euro Area: Improving Access to Finance by Startups

Europe lags the U.S. in financing innovative firms, which undermines productivity and growth, in part because of a lack of venture capital (VC) financing. From concept development, scaling-up of operations, and business expansion to a mature phase of market expansion and diversification, startups fund themselves through successive rounds (i.e., seed finance leading up to initial public offerings). By participating in many of these rounds of funding, the VC industry is an important source of financing for fast-growing, innovative, and potentially risky startups. However, possibly because of the lack of deep-pocketed, long-term investors, VC funding in the EU lags that of the U.S. (Box Figure 1.1, panel 1).

Startups are an important source of job creation and innovation. Empirical studies have shown that young firms (i.e., startups), regardless of size, are responsible for most net job creation. Startups are also responsible for productivity growth because they are more innovation-driven and nimbler when it comes to seizing expansion opportunities.[1]

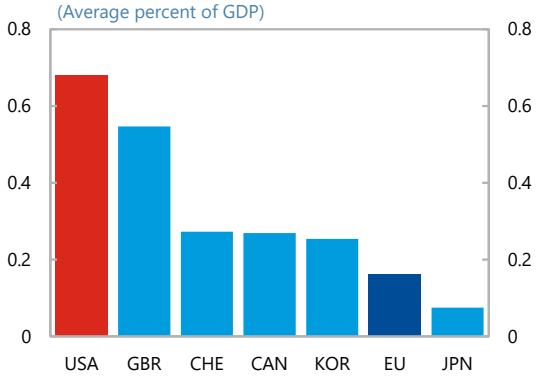
European startups face greater difficulties to access finance than their U.S. counterparts. Most of the difference between European and U.S. startups in terms of innovation and scale can be attributed to the latter's better access to funding.[2] For example, startups in the EU raise less money when tapping markets to scale up than similar firms domiciled in the U.S. (scale-ups in the EU are only 38 percent of those in the U.S.).[3] The lack of access to finance by startups is reflected in aggregate investments in R&D and ICT, where the EU invests nearly 2 percentage points of GDP less than the US (Box Figure 1.1, panel 3). Moreover, it contributes to U.S. productivity outpacing that in Europe (Box Figure 1.1, panel 4).

The VC industry is a major source of finance for startups in most advanced economies, but less so in Europe. Although VCs fund only a small share of all startups, even in the U.S., they are much more important in financing startups that are major creators of employment or those with high growth potential.[4] But the VC industry is smaller and less developed than in the US (Figure 1.1, panel 2), with far fewer funds and smaller funds accounting for most of the capital in the sector. And, unlike other segments of capital markets, which are more globalized, VC markets are to some extent local.[5] This makes it more difficult to provide firms that are scaling up quickly with the capital they need, leading to fewer large high-tech firms in Europe. As a consequence, promising European startups often relocate to the U.S. in search of VC funding, thus reducing innovation diffusion in the EU.

Smaller pools of long-term investors and more fragmented capital pools limit the amount of investible capital available for startup financing. Institutional investors play a much smaller role in Europe than in the US (Box Figure 1.1, panel 5), while the fragmentation of pools of capital exacerbates the more limited availability of investible capital. Banking is fragmented along national lines and important institutional investors, such as pension funds and insurers, exhibit significant home bias in their asset allocations.[6] This fragmentation makes it more difficult to create larger VC funds in Europe, which could provide more capital to larger and capital-intensive start-ups during the scale-up phase. This in turn reduces EU "exit" options for VC investors, which ultimately impacts valuations and potential returns. US equity markets are significantly larger and more liquid than their EU counterparts, providing better valuations for listing firms (Box Figure 1.1, panel 6). As a result, nearly one-third of European start-ups that list, do so outside of the EU.[7]

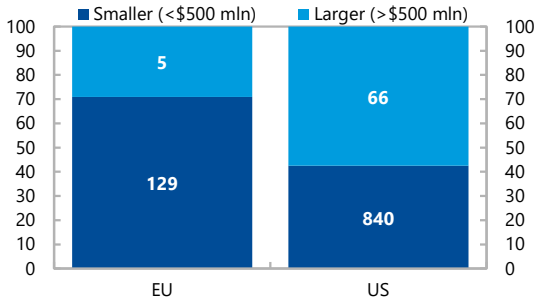
Box Figure 1.1. Stylized Facts about Venture Capital

Venture Capital Investments, 2013-2023
(Average percent of GDP)



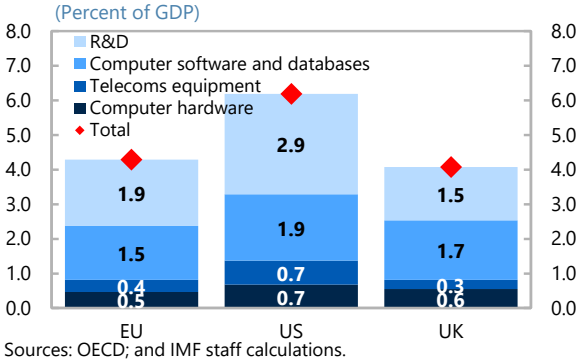
Sources: PitchBook; IMF WEO; and IMF staff calculations.

VC Raised by Fund Size, 2020-2023
(Average in percent of total VC raised)



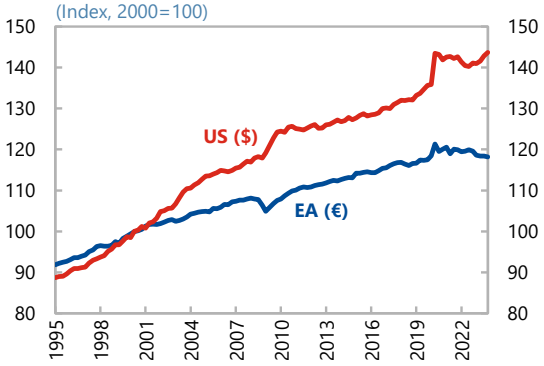
Sources: Pitchbook; and IMF staff calculations.
Note: Numbers on each bar is a fund count for each size category (averaged 2020-2023).

IP and ICT Investments Breakdown, 2000-2020
(Percent of GDP)



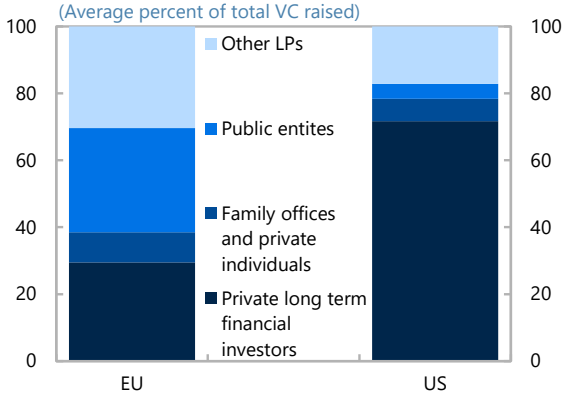
Sources: OECD; and IMF staff calculations.
Notes: EU excludes Cyprus and Malta due to lack of data and Ireland because multinationals' accounting practices excessively inflate its numbers. Denmark and Poland 2020 data is unavailable.

Real GDP Per Hour Worked, 1995-2023
(Index, 2000=100)



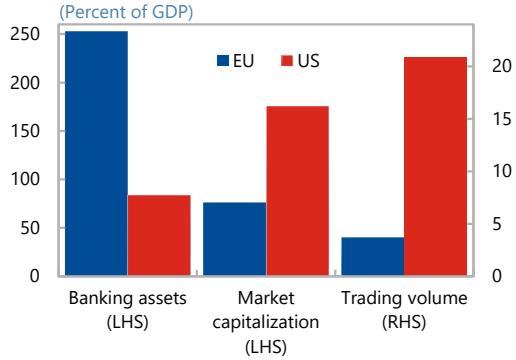
Sources: BEA; BLS; ECB; Eurostat; Haver Analytics; and IMF staff calculations.

Investor Types in the EU and US, 2013-2023
(Average percent of total VC raised)



Sources: Pitchbook; and IMF staff calculations.

EU and US Equity Market Size and Depth, 2023
(Percent of GDP)



Sources: Haver Analytics; World Federation of Exchanges; and IMF staff calculations.

[1] Haltiwanger, John, Ron S. Jarmin, and Javier Miranda, 2013, "Who creates jobs? Small versus large versus young," *Review of Economics and Statistics* 95, no. 2: 347-361, show that, in the United States, it is firm age, not necessarily size, which explains net job creation. Adelino, Manuel, Song Ma, and David Robinson, 2017, "Firm Age, Investment Opportunities, and Job Creation," *The Journal of Finance*, Vol. LXXII, No. 3: 999-1038, show that this job creation happens in response to local investment opportunities. A useful survey is found in Decker, Ryan, John Haltiwanger, Ron Jarmin, and Javier

Miranda, 2014, "The role of entrepreneurship in US job creation and economic dynamism," *Journal of Economic Perspectives* 28, no. 3: 3-24.

[2] Weik, Stefan, 2023, "The Startup Performance Disadvantage(s) in Europe: Evidence from Startups Migrating to the U.S." Available at SSRN: https://ssrn.com/abstract=4504653 or http://dx.doi.org/10.2139/ssrn.4504653.

[3] Data from European Commission, 2024. *The 2024 Annual Single Market and Competitiveness Report*. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, and the Committee of the Regions, February 14, 2024.

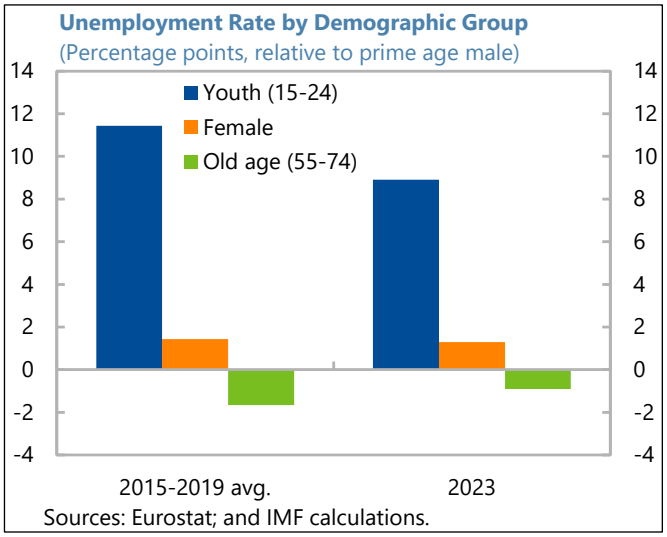
[4] See Puri, Manju, and Rebecca Zarutskie, 2012. "On the Life Cycle Dynamics of Venture-Capital and Non-Venture- Capital Financed Firms." *The Journal of Finance* 67, no. 6: 2247-2293.

[5] See Chen et al., 2010. "Buy local? The Geography of Venture Capital." *Journal of Urban Economics* 67 (1), 90–102.

[6] Bhatia et al., 2019. "A Capital Market Union for Europe." IMF Staff Discussion Note 19/007.

[7] Krämer-Eis, Helmut, and Annalisa Croce. "EIF VC Survey 2023: Market Sentiment, Scale-Up Financing and Human Capital." EIF Working Paper No. 2023/93. European Investment Fund (EIF), Luxembourg.

Countering A Shrinking Workforce



47. Reskilling and upskilling workers should remain a priority, accompanied with further labor market reforms to increase labor supply. This would improve the labor market's responsiveness to technological transitions and address local skills shortages—an important obstacle to innovation.[32] Recent national labor market reforms have supported labor participation (e.g., apprenticeship and unemployment benefits reforms in France) and improved contractual stability (e.g., in Spain, especially for youth and migrants). Further reforms that provide incentives for longer and less fragmented career (e.g., by reviewing the eligibility and duration of unemployment benefits in France), remove remaining obstacles to female labor force participation or full-time employment (e.g., by enhancing provision of childcare and elderly care facilities and closing gender wage gaps in Austria and in Italy, reducing the effective marginal tax rate on second earners in couples in Germany),[33] or speed up the transition from unemployment to employment (e.g., by strengthening the job take-up incentives of unemployment assistance recipients in Spain) can directly counter the decline in the workforce, while the NGEU can support increased educational infrastructure. A timely assessment of the achievements made against the European Skills Agenda (2020-2025) would help

[32] See 2023 Annual Consultation on Euro Area Policies.

[33] See also Fabrizio et al., 2020, "Women in the Labor Force: The Role of Fiscal Policies." IMF Staff Discussion Note. The Note suggests that halving childcare costs for middle-class working mothers of preschool children significantly enhances female labor force participation, especially among low-income families, who are predominantly women with high school or lower education, facing high childcare costs relative to their earnings.

guide future efforts in skills investments and enhance the effectiveness of training at the national level.[34]

48. Lowering barriers to labor mobility across the European Union can help balance labor demand and supply. The European labor market is considerably less integrated than the U.S. labor market, with only 5 percent of European citizens having lived as of 2019 in a country different from their birth country.[35] There is evidence that workers who move within the EU have a better labor market outcome and are increasingly employed in the ICT sector.[36] Language barriers, lack of (or slow) recognition of professional qualification (illustrated by higher overqualification among migrant workers), the large heterogeneity in social security systems (increasing uncertainty about pension benefits, especially for frequent movers across countries whose work period may not satisfy any country's minimum qualifying period for national independent pensions),[37] and differences in the degree of labor market flexibility constitute major obstacles to within-EU migration and successful labor market integration (Text Figure 8).[38] Building on progress made so far,[39] EU-wide reforms should aim to facilitate faster recognition of academic and professional qualifications, improve the effectiveness and efficiency in the coordination of pension systems across the EU regarding mobile workers, and provide easier access to language training.

[34] The European Social Fund Plus (ESF+) is the EU's main instrument for investing in people with an expected amount of €87.3 billion for the 2021-2027 programming period. In addition, the RRF and the Multi-annual Financial Framework provide EU funding for member states to invest in skills.

[35] Dorn, David, and Josef Zweimüller. 2021. "Migration and Labor Market Integration in Europe." *Journal of Economic Perspectives*, 35 (2): 49-76. The share of state-to-state migrants in the U.S. population has been close to one-third (Molloy, Raven, Christopher L. Smith, and Abigail Wozniak, 2011, "Internal Migration in the United States." *Journal of Economic Perspectives*, 25 (3): 173-96).

[36] Annual Report on Intra-EU Mobility 2023 finds that: (i) the number of persons moving to another EU country or returning to their country of nationality had rebounded to pre-pandemic levels, (ii) these mobile workers had an employment rate of 77 percent in 2022, surpassing those of nationals (75 percent) and of third country nationals (62 percent), and (iii) the education level of EU movers has risen with 32 percent of them having higher education degrees (compared to 28 percent in 2016). The employment of movers in ICT sector has increased by 56 percent since 2017.

[37] See also Annual Report on Intra-EU Mobility 2023.

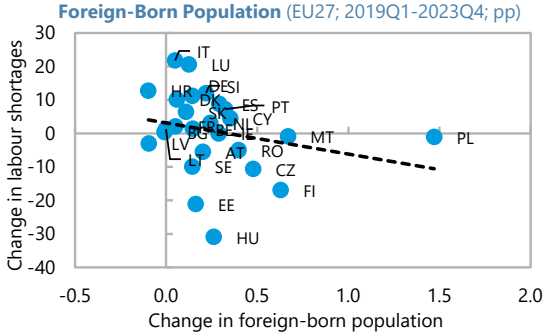
[38] Poor language proficiency is found to have a significant negative effect on labor earnings of immigrants (see Chiswick, Barry R., and Paul W. Miller. 2014. "International Migration and the Economics of Language." In *Handbook of the Economics of International Migration*, Vol. 1A, edited by Barry R. Chiswick and Paul W. Miller, 211–69. Amsterdam: Elsevier). Due to lack of (or slow) recognition of degrees obtained in another country, immigrants tend to work in jobs inferior to their previous education and labor market experience (Dustmann, Christian, Tommaso Frattini, and Ian Preston. 2013. "The Effect of Immigration along the Wage Distribution." *Review of Economic Studies* 80 (1): 145–73.). There is also considerable cross-country heterogeneity in successful labor market integration of skilled migrants in Europe (Holloood, Ella, Justin-Casimir Braun, Jude Weber, and Sérgio Aníbal, 2024, "The 'brain waste' of skilled migrants in Europe," *Financial Times*, April 19, 2024).

[39] The Bologna and follow-up agreements have harmonized degrees, study cycles, and study credits, making the tertiary education system more homogenous across countries. Similar agreements to promote international mobility of students and teaching staff, and to harmonize the standards and quality of study programs, also exist. "Coordination Regulations" have been established to facilitate the portability of social insurance rights across countries, and to prohibit discrimination against immigrants (European Commission, 2019 and Dorn, David, and Josef Zweimüller, 2021). EU legislation has also sought to standardize and facilitate the process of occupational recognition.

49. A better integration of migrants into the labor market will support labor supply. Net migration has provided an important source of labor supply in recent years (Box 2). Structurally, immigration can help dampen the effects of an aging population on potential growth. Nevertheless, unemployment rates among migrants are notably above those of native workers, suggesting that there is scope to better attune migration to the skills needs of the economy. Policies are needed to make sure migrants are successfully integrated into the labor market and adequate public services are provided in response to the expanding population, given, for example, likely pressures on housing markets and the health services.[40] Given upfront fiscal costs of migration—which are unequally distributed across the EU—there could be room for reallocating some of EU funds to facilitating migrants' integration, such as those under the Asylum, Migration, and Integration Fund.

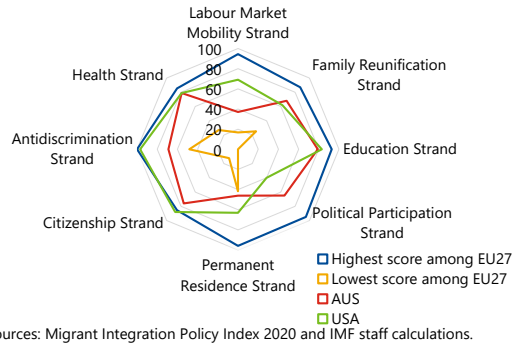
Text Figure 8. Euro Area: Cross-Border Labor Mobility and Labor Market Integration

Correlation Between Labor Shortages and Change in Foreign-Born Population (EU27; 2019Q1-2023Q4; pp)



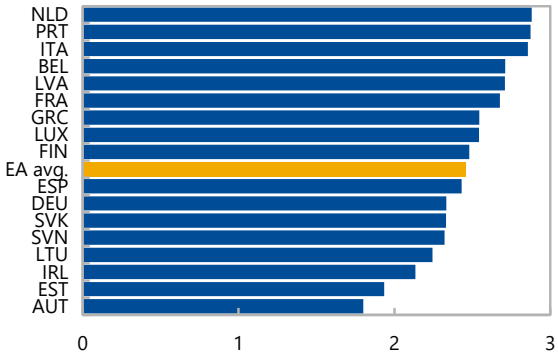
Sources: European Business and Consumer surveys; Eurostat; IMF staff calculations.
Note: Change are over the period 2019Q1-2023Q4. Labour shortages are averaged across industry, construction and services.

Migrant Integration Policy Scores
(Comparison across selected countries, 2019)



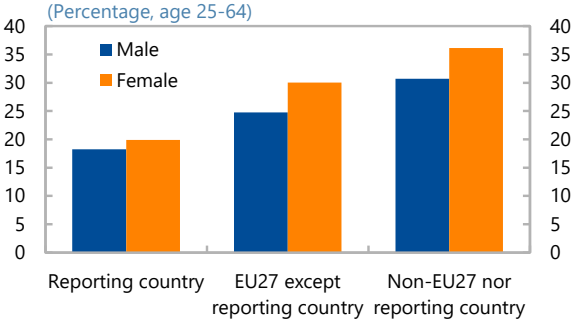
Sources: Migrant Integration Policy Index 2020 and IMF staff calculations.

OECD Strictness of Employment Protection
(Index, individual and collective dismissals-regular contracts)



Sources: OECD Employment Protection (Version 4); and IMF staff calculations.

Overqualification by Country of Birth, 2022
(Percentage, age 25-64)



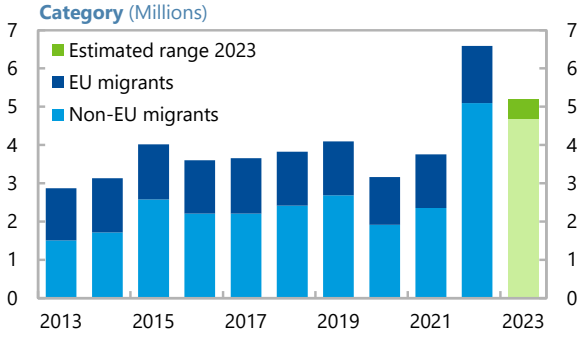
Sources: Eurostat; IMF calculations.
Note: the over-qualification rate is the rate of employed persons with a tertiary level of education employed in a low-or medium-skilled occupation.

[40] Active labor market and retraining policies, together with policies aimed at better integrating migrants, are found to be associated with improved labor market outcomes following large immigration flows (IMF World Economic Outlook April 2020, Chapter 4, "The Macroeconomic Effects of Global Migration"). There is evidence that residential mobility is higher where housing supply is more responsive to changes in demand (OECD, 2021, Brick by Brick: Building Better Housing Policies.)

Box 2. Euro Area: Role of Migrants in the European Union Labor Market

Immigration reached record levels in the EU in recent years. In 2022, 7 million people immigrated to an EU country, roughly 2.5 million more than the previous high in 2019 and about 3 million more than in 2015. The increase was entirely driven by migration from outside the EU, with migration from Ukraine under the temporary protection scheme being the key contributor. While comprehensive data for 2023 is not yet available, rough estimates suggest immigration dropped relative to 2022 while remaining at historical highs.[1]

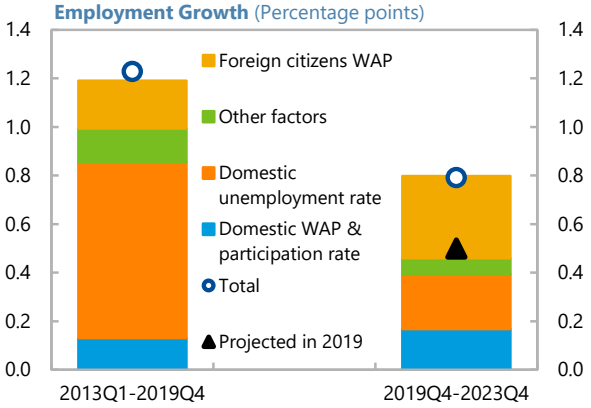
European Union: Total Immigration by Year and Category (Millions)



Sources: Eurostat; and IMF staff calculations.
Note: Official data for 2025 will only be available in Spring 2025. The darker green shaded range estimates a staff estimate based on available data for asylum seekers, the temporary protection scheme and prior trends.

Immigration has expanded labor supply. Foreign workers roughly doubled their share in total employment from 5 to 10 percent over 2005–2023. The growth in the migrant working-age population accelerated in the years just prior to the pandemic, and together with a sharp drop in unemployment and a rise in the participation rate of native workers (which more than offset a decline in the native working-age population) led to robust employment growth of 1.2 percent per year. This was expected to slow to 0.5 percent over 2020–2023 as demographics dragged even more and the unemployment rate margin was exhausted. Instead, employment grew by 0.8 percent—translating to 3 million more jobs than in the pre-pandemic projections—to an important extent due to the increased foreign working-age population.

European Union: Decomposition of Annual Employment Growth (Percentage points)



Sources: Eurostat; IMF WEO; and IMF staff calculations.

The literature highlights that the initial and longer run impacts of immigration on native workers can differ, with a possible negative short-term impact disappearing in the longer run. Immigration tends to worsen the wages of competing workers and improve those of complementary workers generating some heterogenous effects on the native population. Some studies find that in the short run low-educated native workers can experience employment losses due to immigration, whereas high-educated ones are more likely to experience employment gains. In the context of the current tight labor markets, the former effect was likely contained during 2022-23. Immigrants can also affect productivity through their contribution to human capital formation and innovation in the receiving economies. Finally, dynamic regions can better absorb immigrant workers, resulting in negligible effect on the native labor force.[2]

---

[1] See also Caselli et al., forthcoming, "Taking stock of recent migration in the EU: An economic perspective."
[2] Edo, A. and C. Özgüzel, 2023. "The impact of immigration on the employment dynamics of European regions", *Labour Economics*, Volume 85, 2023, 102433. A. Edo, L. Ragot, H. Rapoport, S. Sardoschau, A. Steinmayr, A. Sweetman, 2020. "An Introduction to the Economics of Immigration in OECD Countries", *Canadian Journal of Economics*, Vol. 53, Issue 4, pp. 1365–1403. A. Edo, 2019. "The Impact of Immigration on the Labor Market", *Journal of Economic Surveys* 2019, Vol. 33, Issue 3, pp. 922–948.

Authorities' Views

50. The authorities agreed on the urgency to boost productivity and further invest in re-skilling and upskilling to support the twin transitions. They pointed to subdued capital deepening, sectoral misallocation, lagging innovation, and slower adoption of innovative technologies as factors explaining the labor productivity gap with respect to the United States. However, they viewed that muted labor productivity growth in the euro area was lately largely due to cyclical reasons and linked to highly resilient labor demand amidst high labor and skills shortages, despite low output growth. While reforms such as individual learning accounts, aimed at improving workers' skills and employability, are ongoing, the digital transition heightens the need for continued upgrading of workers' skills, particularly in the professional and technical services sectors. The authorities highlighted that investments in upskilling and re-skilling can alleviate labor and skills shortages and promote the adoption of new technologies, boosting labor productivity growth and competitiveness among European firms.

51. The authorities agreed that migration can improve labor market prospects, and that continued migrant integration efforts are needed. They stressed that recent migrants supported labor supply growth, partly alleviating labor shortages, in sectors such as construction, hospitality and ICT. They pointed to differences in the characteristics of this migration wave compared with previous influxes, namely in terms of the level of education, gender composition, and ties with existing migrants. These factors, together with a combination of policies—such as the recognition of previous education/professional qualifications and an EU-wide framework to provide legal status—led to better labor market integration than in previous migration surges. Nevertheless, the provision of public goods such as housing, access to childcare, transportation, and healthcare remain areas where reforms efforts are needed.

52. The authorities expected disbursements under the Recovery and Resilience Facility to accelerate in 2024. They argued that limited disbursements to date reflected efforts to revise plans to refocus them on energy issues as part of the RePowerEU initiative and tackle implementation bottlenecks, including due to supply chain disruptions and high inflation, and that implementation was picking up. The authorities agreed that there was some scope to clarify the distribution of roles and responsibilities, as well as to streamline control and audit arrangements, but emphasized that assurances on the legality and regularity of payments and protection of the financial interest of the Union were paramount, and that improved country capacity would help speed disbursements.

53. The authorities stressed that developing the CMU is critical for strengthening competition and innovation and for achieving Europe's green and digital transition goals. However, they cautioned that translating the reinvigorated political momentum for CMU progress into tangible reforms will require a careful reconciliation of divergent national positions. In this context, while the authorities preferred rapid progress toward the CMU based on an EU-wide approach, they viewed "enhanced cooperation" and "28th regime"-style arrangements—provided that they are attractive enough to encourage opt-in—as potential stepping stones, while acknowledging that there are legal complexities that will have to be worked out. The authorities also agreed on the need to urgently complete outstanding banking union initiatives.

C. Addressing Fragmentation, Enhancing Energy Security and Advancing Climate Goals

Addressing Fragmentation

54. Europe is grappling with an increasingly shock-prone and fragmented world. The EU has prospered from open trade and capital flows within a predictable, rules-based international system, and its commitment to open trade remains strong. However, the supply chain disruptions caused by the pandemic and Russia's war in Ukraine, escalating geopolitical tensions, trade frictions, and industrial policies, are all posing challenges. More fundamentally, the global trading system is experiencing major upheavals. The growing recourse to trade restrictions is generating uncertainty and diverting trade flows[41] and generating concerns about supply-chain resilience.

55. Geoeconomic fragmentation threatens the European economy by potentially dampening external demand, increasing energy costs, decreasing financial flows and disrupting supply chains. Given that exports to non-EU countries account for over 25 percent of EU GDP, trade fragmentation—trade barriers, supply chain decoupling, and diverging technological standards—is a threat. A significant decoupling from major trade partners would directly affect European exporters. Global value chains would fracture, disrupting established production networks that rely on intermediate goods (including in the automotive, electronics, machinery, semiconductors, and pharmaceuticals sectors) from various countries. This would hurt European production, especially in sectors such as automobiles and machinery, which depend on components from East Asia. The energy sector, particularly fossil fuels, also faces significant exposure due to its dependence on imports. Production costs would increase more broadly, making European goods less competitive in global markets. Additionally, the trend toward localization and the promotion of domestic industries over foreign competitors in various countries could further diminish the EU's market share abroad. Geopolitical fragmentation has already affected the European economy through various channels such as international trade,[42] energy prices,[43] FDI flows,[44] asset prices,[45] and firms' balance sheets.[46]

56. The EU's strategic autonomy initiatives respond to several of these challenges, aiming to boost economic resilience and strengthen EU competitiveness. The EU's main initiatives span a range of areas. The Green Deal Industrial Plan (GDIP) aims at incentivizing investment in green

[41] See IMF World Economic Outlook, April 2024, Chapter 1; Alfaro and Chor 2023, "Global Supply Chains; The Looming 'Great Reallocation'. " Freund et al., 2023. "Is US Trade Policy Reshaping Global Supply Chains?", Policy Research Working Paper 10593, World Bank. Gopinath et al., 2024. "Changing Global Linkages: A New Cold War?", IMF WP/24/76.

[42] Gopinath et al., 2024. "Changing Global Linkages: A New Cold War?", IMF WP/24/76.

[43] Emiliozzi et al., 2024. "The European Energy Crisis and the Consequences for the Global Gas Market", VoxEU.org

[44] Aiyar et al., 2024. "Investing in Friends: The Role of Geopolitical Alignment in FDI Flows", European Journal of Political Economy, 102508

[45] IMF Global Financial Stability Report, April 2023, Chapter 3.

[46] D'Orazio et al., 2024. "Geoeconomic fragmentation and firms' financial performance", VoxEU.org

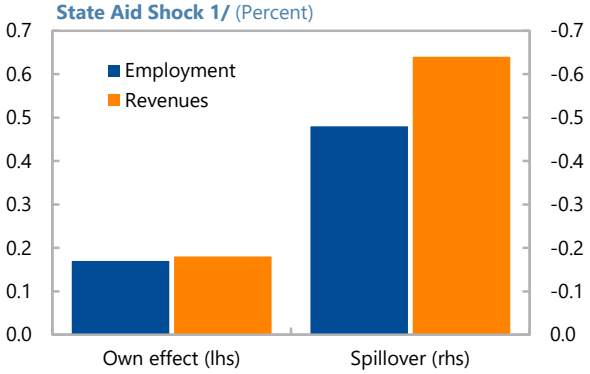
technologies and innovation. This plan is supported by other strategic actions such as (i) the Critical Raw Materials Act, designed to secure access to essential materials necessary for renewable energy technologies; (ii) the European Chips Act, which seeks to strengthen Europe's position in the semiconductor industry, vital for green technologies; (iii) the Net Zero Industry Act, aimed at accelerating the domestic development and production of net-zero technologies; and (iv) the Temporary Crisis and Transition Framework, which relaxes—until end-2025—conditions on the provision of state aid in response to the energy crisis and to facilitate the green transition. REPowerEU aims to strengthen energy security and reduce dependencies on Russian gas. The European Economic Security legislative package from January 2024 proposes measures to tighten inbound and outbound investment screening, upgrade research security, and heighten export control conformity in the EU.

Box 3. Euro Area: Firm-Level Effects of Industrial Policy in Europe

State aid involves government interventions in the economy through subsidies and other financial assistance to companies or sectors to change the sectoral composition of the economy. State aid, a form of industrial policy, can help address market failures such as externalities, information asymmetries, and an insufficient provision of public goods. However, it can also have potential drawbacks, such as distorting competition, creating inefficiencies, decreasing innovation, and disadvantaging smaller economies that lack the resources to provide comparable state support. In the EU, there has been an increase in total state aid distributed by member states in recent years, from around €100 billion in 2015 to €300 billion in 2022 (EU State Aid Scoreboard), in part because of the pandemic, the green transition, and a surge in energy prices.

Staff analysis finds that national-level state aid improves recipient firms' employment and revenue, but it also entails significant negative spillovers to nonrecipient firms.[1] Among listed firms from Germany, France, Spain, Italy, Belgium, the Netherlands, and the U.K. between 2016 and 2022, a one standard deviation increase in an appropriately identified state aid policy shock increases the number of employees and revenues of recipient firms by 0.17 and 0.18 percent in the year following the receipt of aid. However, the provision of unexpected state aid leads firms in the same sector that did not receive such aid to decrease the number of employees by 0.48 and revenues by 0.64 percent, respectively. The magnitude of the spillovers suggests that any positive effect on employment or revenues from state aid received by a firm would be more than undone by state aid awarded to its competitors.[2] Such adverse spillovers could weaken the level playing field in the EU's single market.

Impact of a One Standard Deviation Increase in State Aid Shock 1/ (Percent)



Sources: Bloomberg Financial L.P.; EC; Orbis; and IMF staff calculations.
1/ State aid shock is defined as the excess return of a recipient firm on the granting date relative to the overall stock market. Data coverage is from 2016 to 2022 for Belgium, France, Germany, Italy, Netherlands, and Spain. Data for the United Kingdom is included in the sample until 2020.

[1] See Brandao-Marques, Luis and Hasan Toprak, 2024, "Firm Effects and Spillovers of State Aid in Europe," IMF Working Paper, forthcoming.

[2] A thorough analysis of the net aggregate effects of state aid requires a general equilibrium approach, which is beyond the scope of this box.

57. If member states need to use state aid, they should do so in a coordinated manner at the EU level and keep it narrowly targeted to specific objectives to minimize trade and investment distortions. The EU seeks to shore up resilience, including by expanding domestic capacity in certain key sectors through the use of industrial policy to support the green and digital transitions. Aspects of the industrial policy strategy such as streamlining regulatory and permitting processes and enhancing skills can help foster innovation. These should be supplemented with efforts to diversify supplies of critical materials and technologies, reduce trade costs, and prioritize public investment in human capital and physical infrastructure. Industrial policy initiatives, including state aid, should address market failures, be targeted, time-bound, and consistent with WTO rules. They should follow a rigorous cost-benefit analysis that considers their immediate and long-term effects on the fiscal space and competitiveness of the European economy. State aid could be counterproductive if it takes the form of protectionist measures which threaten the integrity of the single market, inhibit business dynamism within the EU, and exacerbate geoeconomic fragmentation. National state aid is found to increase employment and revenues of recipient firms, but at a cost of affecting adversely those outcomes of non-recipient firms in the same and other EU countries (Box 3).[47] This underscores the need to design industrial policy and state aid in a coordinated manner at the EU level. Relaxed state aid rules should not, in effect, distort the single market in favor of larger countries that can spend larger sums on state aid, and it is important to consider the potential spillovers to both EU and non-EU countries.

58. Europe can take several policy actions to mitigate potential negative impacts of geoeconomic fragmentation. First, strengthening the EU single market by harmonizing regulations, reducing administrative and legal barriers (e.g., by reviving the discussion on the European Cross-Border Mechanism that aims to remove legal barriers to cross-border cooperation with neighboring regions), streamlining trade procedures, and improving cross-border infrastructure will create a more resilient and competitive EU economy. This would translate into more competitive exports. Second, there is scope for removing remaining barriers to goods and services trade (e.g., recognition of academic and professional qualifications across the Union), in addition to completing the banking and capital markets unions. Staff simulations indicate that lowering internal barriers by 10 percent could boost EU output by up to 7 percent.[48] Given regional differences, with some countries at the forefront of innovation and others serving as manufacturing centers, further integration would help build resilience should global fragmentation deepen. Europe should continue to advocate for the rules-based international trading system, including by supporting the restoration of the WTO dispute settlement system, finding common ground with partners in areas such as industrial subsidies and services trade, and concluding new WTO-based market opening agreements. Working with its trading partners, the EU should continue to resolve trade and

[47] The EU's Temporary Crisis and Transition State aid Framework has significantly loosened state aid rules for national governments. Germany, France and Italy are the largest users in nominal terms, accounting for 64 percent of EU state aid in 2022 (EU State aid scoreboard, 2023).

[48] See Baba, C., T. Lan, A. Mineshima, F. Misch, M. Pinat, A. Shahmoradi, J. Yao, and R. van Elkan, 2023. "Geoeconomic Fragmentation: What's at Stake for the EU." IMF Working Paper No. 2023/245.

investment disagreements[49] consistent with WTO procedures and avoid tit-for-tat escalation of trade measures.[50] In this regard, the European Commission's announcement of additional tariffs on Chinese-made electric vehicles following an anti-subsidy investigation consistent with WTO procedures risks a further intensification of global trade tensions.[51] Finally, strengthening the EU's digital sovereignty by incentivizing investments (while continuing to lead in regulatory standard setting) in key technologies such as artificial intelligence, quantum computing, and cybersecurity can also reduce dependencies.

Enhancing Energy Security and Advancing Climate Goals

59. The EU has increased its climate mitigation ambitions in the context of the European Green Deal. The 2021 European Climate Law sets two targets—reducing net greenhouse gas emissions by at least 55 percent by 2030 relative to 1990 (up from 40 percent on a gross basis) and net-zero emissions by 2050. The Fit for 55 package gives a central role to carbon pricing, a reduction in the Emission Trading System (ETS) emissions cap, extension of the scheme to the maritime sector, and the introduction of a new ETS covering mainly road transport and buildings. The European Commission's proposal of a 90 percent net emission reduction target for 2040 can help unlock low-carbon investments and facilitate the green transition, if supported by appropriate carbon pricing. Still, a successful green transition will demand significant private and public investment, which will require a strong effort in the prioritization of government spending and acceleration of structural reforms to promote growth.

60. Meeting energy security and climate change mitigation goals will require coordinated actions on multiple fronts. Public and private investment needs in renewable energy, such as wind and solar power, upgrading transmission infrastructure, and transitioning industries away from fossil fuels, are large (Annex IV). Moreover, adjustment costs of the green transition can reduce Europe's competitiveness in the short term, even if reduced medium-term fossil-fuel dependence and better access to cost-efficient green energy ultimately offset the near-term negative effects. Prioritizing investment in smart grids would facilitate more efficient energy distribution and usage by incorporating renewable energy sources into the grid more seamlessly. Diversifying sources of critical materials essential for renewable energy technologies and electronics could mitigate supply chain disruption risks and crowd in private investment. Through enhancing the integration of the single market by removing barriers to the free movement of goods, services, capital, and labor, the EU can facilitate easier access to green technologies, services, and expertise across its member states. Expanding the EU's Emissions Trading System could facilitate further emissions reductions.

[49] The EU has initiated investigations on certain imports and market access by foreign firms; Foreign Subsidies Regulation investigations into solar panels, wind turbines, and railways; and International Procurement Instrument investigation into medical devices.

[50] When the U.S., EU or China impose measures, there is a high likelihood of retaliation by one of the other countries. Simon Evenett, Adam Jakubik, Fernando Martín, and Michele Ruta, 2024, "The Return of Industrial Policy in Data," IMF Working Paper, No 2024/001.

[51] On June 12, 2024, the European Commission announced that EU tariffs on Chinese-made EVs would be raised from the pre-existing 10 percent to between 27.4 and 48.1 percent.

61. An EU Climate and Energy Security Facility (CESF) could help deliver the EU's climate and energy security goals more cost effectively. Such a mechanism for EU-level public spending, for instance through the EU budget, could help accelerate the green transition and reduce the transition cost by pooling resources and coordinating investments at the European level. This approach would allow for targeted investments in countries and sectors where carbon reduction is most cost-effective, provided that a comprehensive, cross-country assessment of investment needs is conducted at the country-sector level to identify where the most cost-efficient emission reduction investment opportunities are. This would then help achieve a more cost-effective allocation of investments and emissions reductions than current targets. The analysis in Annex IV shows that introducing a CESF that allows for a more cost-effective allocation of emission cuts reduces the total investment costs by 7 percent. Based solely on the additional annual investment estimate of €480 billion a year until 2030, this would translate into a reduction in costs of at least €235 billion over 2024-30. A CESF could also create economies of scale and facilitate investments in cross-border energy infrastructure, R&D, and public support for clean-tech sectors. The EU's goal of increasing its energy security would be enhanced by reducing its reliance on imported fossil fuels and increasing electricity market integration within the Union.[52]

62. Trade policies that favor an open environment for cross-border goods and services commerce can help reduce the costs of the green transition. Lower tariffs and trade barriers can help reduce the costs of goods and services essential for the green transition. In this regard, the possibility of additional tariffs on imports of certain low carbon technologies arising from EU trade defense measures could slow efforts to support the green transition. To counter these effects, the EU could continue to promote multilateral discussions on the liberalization of tariff and non-tariff barriers in environmental goods, as well as continuing to promote deep and comprehensive regional trade agreements. The EU should also ensure that new trade initiatives, such as bilateral Critical Minerals Agreements and agreements on steel and aluminum, are not used as tools that discriminate across trade partners and contribute to geoeconomic fragmentation. The EU has an extensive trade negotiation program that has concluded or is advancing talks for the establishment of free trade agreements with several countries and economic blocks (e.g., New Zealand in November 2023, Chile in February 2024). Expanding the current network of free trade deals, while striving for a broad coverage of counterparts and goods and services, and not raising new trade barriers could contribute to a stable and diversified supply chain.

63. Climate-related industrial and trade policies should be designed and implemented in ways that maintain the integrity of the single market and minimize distortions. The relaxation of state aid rules under the Temporary Crisis and Transition Framework to incentivize green transition investments should be carefully monitored to reduce potential negative spillovers that undermine the single market. More generally, EU green industrial policy should seek to avoid a wasteful subsidy race that could lead to trade discrimination and higher fiscal costs.

[52] See Dolphine, Geoffroy, et al. (2024) "The Energy Security Gains from Strengthening Europe's Climate Action", IMF DP/2024/005.

64. A well-designed and well-communicated EU Carbon Border Adjustment Mechanism (CBAM) has the potential of avoiding carbon leakage and incentivizing more ambitious mitigation action globally. CBAM imposes a CO2 emissions-based charge on imports of key energy/carbon intensive goods unless a carbon price equivalent to EU-based production is levied in the country of origin. This is aimed at mitigating the risk that EU-based companies move production of carbon intensive goods to or source such production from countries with less stringent climate policies. The CBAM began a transitional reporting stage in October 2023. Through end-2025, EU importers are only required to report their greenhouse gas contents. The overall cost of CBAM to EU countries when fully implemented in 2026 is estimated to be modest, although it could increase as the scope of CBAM is extended and could already be more sizable for specific products (e.g., iron and steel, aluminum) and trade partners in the EU's neighborhood. The EU Regulation on Deforestation-free Products (DFP) which, like CBAM, also has the potential for global spillovers, entered into force in June 2023 and becomes operational in December 2024, when firms in the EU will have to conduct due diligence to ensure that their products do not originate from recently deforested land or have contributed to forest degradation.[53] It is therefore critical that the EU continues to engage with its trading partners to ensure that CBAM and the DFP regulation are implemented consistently with WTO rules, minimize administrative costs, clearly promote environmental outcomes, and avoid protectionism. An initial assessment of the experience learned from the transitional phase could provide evidence-based support and allow the EU to better assist trading partners in adjusting to its environmental sustainability policies.

Addressing Distributional Impacts of Structural Changes

65. Addressing distributional impacts of structural changes is key to ensure these changes benefit all, which in turn will help bolster public support. The structural transitions that the EU economy is undergoing will disproportionately affect carbon-intensive industries and regions and relatively lower-skill workers. Appropriate measures can alleviate inequality concerns and strengthen social cohesion.

- It is important to recognize, supported by the Commission's distributional impact analysis tool, that gains and losses from eliminating trade barriers between the EU member states will likely be concentrated in different sectors, jobs, and regions. Policies that facilitate business dynamism (¶37), skills development (¶47), and labor mobility (¶48), as well as those aimed at reducing regional and sectoral disparities (e.g., EU cohesion policy) can help maximize gains and reduce losses from increased within-EU trade. Continued implementation of the Action Plan for the European Pillars of Social Rights will help improve people's overall well-being, while the planned review of its implementation in 2025 will help identify new priority areas for policy support.

[53] The regulations will apply to commodities of cattle, wood, cocoa, soy, palm oil, coffee, rubber, and some of their derived products, such as leather, chocolate, tires, and furniture.

- Climate action needs to be complemented with measures to offset the costs to vulnerable households across the EU. Strengthening targeted social programs early on could help gather and maintain the broad political support needed for decarbonization and green transition.

- Policies aimed at integrating migrants should consider the impact on the native population. For instance, the possible near-term effects of migration on lower-skilled workers may warrant additional temporary spending (such as on vocational training and adult education for upskilling/reskilling, or on active labor market policies to facilitate job searching) to achieve a more equitable distribution of aggregate gains. There is also a need to ensure the large immigration flows do not worsen the per capita provision of (local) public goods or housing affordability that weighs on low-income households disproportionally (see also ¶49).

- Growing AI adoption has the potential to exacerbate both cross- and within-country inequality.[54] While euro area countries rank high in terms of AI preparedness, AI adoption could affect the workforce unequally, with near-term job displacement and worsening of income distribution. This is especially the case for older workers who may face higher challenges in reemployment, adapting to new challenges, mobility, and acquiring new skills. Policies must promote the equitable and ethical integration of AI and facilitate training in these new technologies.

Authorities' Views

66. The authorities emphasized that global trends increase the risk of geoeconomic fragmentation and require robust but measured responses. The EU has developed analytical tools to assess its vulnerabilities—particularly strategic dependencies, including for critical raw materials—followed by a policy toolkit to address such vulnerabilities. They stressed that the EU approach is aimed at diversifying sources of supply, and that the objective is de-risking rather than de-coupling. The EU's Economic Security Strategy aims to strengthen its toolkit along several dimensions, including investment screening and export controls, as well as more broadly developing measures along the *promote*, *protect,* and *partner* pillars of the strategy. The authorities continue to view the WTO as a critical institution for maintaining a rules-based system of global economic governance. They were encouraged by the commitment of the last Ministerial Conference (MC13) to continue work toward reforming the organization, though talks in other areas (e.g., environment, state intervention, agriculture) showed limited progress.

67. The authorities considered the use of subsidies an important lever to address challenges such as the green transition, but recognized the associated risks for the single market and are seeking to mitigate them. They highlighted the EU's state aid rulebook as an important tool to help limit subsidies that would have detrimental effects on the single market and trade partners. Over the past years, the State aid rulebook has been streamlined and updated to take account of green transition priorities. The authorities recognized the risks that the increased use of subsidies, and industrial policies more broadly, could pose to the single market and trade

[54] See Cazzaniga et al., 2024, "Gen-AI: Artificial Intelligence and the Future of Work", IMF Staff Discussion Note 2024/001.

partners. They considered using EU-level instruments as potentially more efficient and less distortive alternative to national state aid provision.

68. The authorities viewed that climate policies to meet the 2030 emissions target are largely complete, with implementation now being key. The authorities highlighted a raft of legislation that has been passed as part of the Fit-for-55 package (aimed at reducing EU net greenhouse gas emissions by 55 percent, relative to 1990 levels, by 2030). They argued that the ensuing policies—combined with those at the national level—should achieve the goal. However, they conceded that without revisions the draft National Energy and Climate Plans submitted last year would fall short of the targets and noted that countries are currently working on revised plans. They also pointed to the risk that carbon sinks are not absorbing as much as forecast, so there may be a need to do more in land use, land use change and forestry management. The authorities highlighted that the Social Climate Fund—aimed at mitigating the impact on vulnerable households and businesses of imposing a carbon price on fuels for buildings and road transport—is an important tool to mitigate the distributional impacts of that policy. Similarly, the Just Transition Fund will target regions disproportionately affected by climate policies (e.g., coal producing regions). On CBAM, the authorities noted that the policy is still in the information gathering phase and they will review the experience in 2025 before the actual charges start to apply in 2026. They are working with trade partners to provide more information and reduce frictions related to CBAM.

STAFF APPRAISAL

69. A modest growth pickup is projected for 2024, strengthening further in 2025, while inflation is expected to decline to target in the second half of 2025. Increasing real wages and the fading effects of past energy shocks are expected to lift consumption, while easing financial conditions are anticipated to support a recovery in investment. Over the medium term, however, growth is held down by population aging and lackluster productivity. The 2022-23 monetary policy tightening is helping to bring down inflation and will continue to do so for some time to come. Declines in commodity prices are also expected to contribute to the reduction in inflation. Risks to growth remain on the downside, while for inflation they are two-sided.

70. The ECB can continue the easing of the monetary policy stance that started in June, at a pace that depends on incoming data. The currently projected disinflation path and balanced inflation risks imply that interest rates can be gradually lowered, 25 bps every quarter, to reach a neutral stance—consistent with a terminal policy rate of about 2.5 percent—by the end of the third quarter of 2025. However, the pace of monetary easing should depend on the inflation outlook, which can change with incoming data. Hence, the calibration of monetary policy should be determined meeting-by-meeting. The aim should be to strike a balance between keeping inflation expectations anchored if upside risks materialize, and avoiding an overly restrictive policy stance if inflation falls quicker than projected.

71. Sustained political support will be needed to successfully implement the fiscal adjustment required by the new EU economic governance framework. While significant fiscal adjustment will be needed in many high-debt and high-deficit member states under the framework,

those with moderate or low fiscal risks will have more room for fiscal support if needed. It is important that medium-term fiscal-structural plans, due in September 2024, are underpinned by a clear fiscal strategy, growth- and resilience-enhancing structural reforms, and high-quality measures. The cumulative fiscal adjustment called for by the new fiscal rules appears appropriate, provided the new framework is implemented as envisaged. Nonetheless, in high-debt countries with small output gaps and where measures with low fiscal multipliers are available, more near-term fiscal adjustment than the framework's default linear annual adjustment path would demonstrate resolve, support market confidence, and create room for future expenditure surprises.

72. Policymakers should continue to safeguard euro area financial stability and expand the macroprudential toolkit. With strong bank capital ratios and ample liquidity, the authorities should encourage banks to use temporarily high profits to build safeguards, including by increasing countercyclical capital buffers requirements. Such capital buffers can later be released to support credit provision in a severe downturn. Ad-hoc taxes on temporary bank profits should be avoided as they create an uncertain business environment, while also reducing the scope to build capital buffers. It would be advisable for policymakers to develop nonbank macroprudential tools—such as restrictions on investment funds' leverage and the ability to suspend investor withdrawals —while continuing efforts to bridge data gaps and enhance data sharing among financial oversight agencies.

73. Strengthening the single market, including through further financial market integration, is vital for achieving Europe's large transformative goals. Europe's economic prospects rest on revitalizing productivity growth and attracting the investment needed for the green and digital transitions. A stronger and deeper single market with capital markets union as the centerpiece is essential for advancing on these objectives. Integrating fragmented national capital markets in a capital markets union would boost financing for innovative long-term investment projects. A capital markets union would also increase the possibilities for risk-sharing, expand savings opportunities for households, and enhance the allocation of savings within the EU. Important steps include—further convergence of taxation, accounting, and insolvency frameworks; strengthening ESMA's ability to coordinate across national authorities; and greater harmonization of financial markets oversight. This could be achieved for instance through a "28th regime" for corporate law, to which firms inside the Union could opt in. The authorities should also give priority to initiatives to further develop the Banking Union—such as those aimed at strengthening the crisis management toolkit and introducing European deposit insurance—and the ratification of the ESM Treaty to enact the backstop for the Single Resolution Fund.

74. The EU budget needs to be enhanced to increase and better target public investment. The next Multiannual Financial Framework offers an opportunity to increase investment in EU public goods. Greater prioritization of climate and energy security goals in the budget—for instance through a Climate and Energy Security Facility (CESF)—can address shared long-term challenges in a coordinated manner, including to help achieve EU emissions reductions goals in a more cost-effective way. It can also facilitate investments in cross-border energy infrastructure, R&D, and public support for clean-tech sectors. Staff analysis shows that introducing a CESF that allows for a more cost-effective allocation of emission cuts reduces the total investment costs by 7 percent.

Based solely on the additional annual investment estimate of €480 billion a year until 2030, this would translate into a reduction in costs of at least €235 billion over 2024-30.

75. Labor market policies at both national and EU levels should aim to foster productivity and mitigate adverse impacts of structural change and counter the effects of a shrinking workforce. Reskilling and upskilling programs, apprenticeships, unemployment benefit reforms, incentives for a longer career, and support for female labor force participation can all counter the effects of a shrinking workforce. Fostering labor mobility across the EU, through faster recognition of professional qualifications, more portable pension and social security benefits, and greater labor market flexibility, can help balance labor demand and supply. Better integration of migrants into labor markets will support labor supply and help address labor shortages.

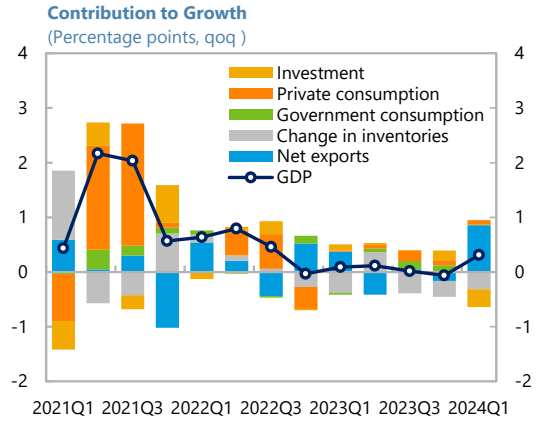
76. The EU should continue to promote an open and rules-based international trading system while avoiding distortive trade and industrial policies. Measures aimed at protecting the EU's economic resilience and competitiveness in response to the fragmentation of international trade and protectionism should avoid creating distortions that may hurt Europe's economy and provoke tit-for-tat retaliation by trading partners. An intensification of trade restrictions on low carbon technologies, even when imposed consistently with WTO rules, can raise prices for consumers and slow progress in the green transition. The EU should continue to promote efforts to strengthen the rules-based international system and engage with partners as it implements trade-related environment and climate policies. Where state aid may be justified in response to market failures, its use should be judicious and temporary, limited in scope and coordinated at the EU level to preserve a level playing field. Barriers to entry that hold back competition and economic progress, should be addressed by policies aimed at ensuring a level playing field.

77. Policy must internalize the fiscal, efficiency, distributional, and cross-border effects of the EU's climate goals. Achieving the EU's emissions reductions targets requires significant private and public investment. While reduced fossil-fuel dependence and increased energy efficiency can strengthen Europe's competitiveness over the medium term, it can hurt it in the short term. Nonetheless, EU green industrial policies should avoid contributing to a wasteful global subsidy race.

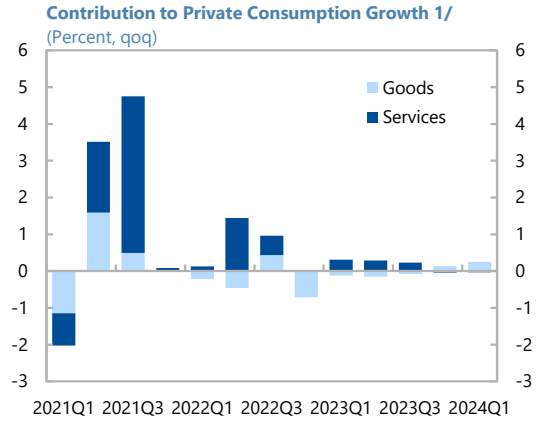
78. It is proposed that the next consultation on euro area polices in the context of the Article IV obligations of member countries follow the standard 12-month cycle.

Figure 1. Euro Area: Real Sector Developments

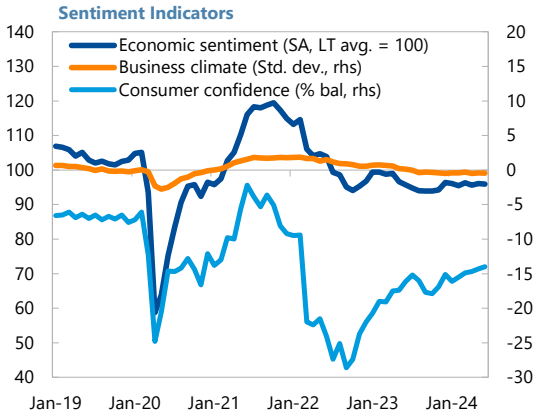
After several quarters of weak performance, net exports were the main driver of the rebound in the beginning of the year, with the destocking trend and subdued consumption continuing, ...



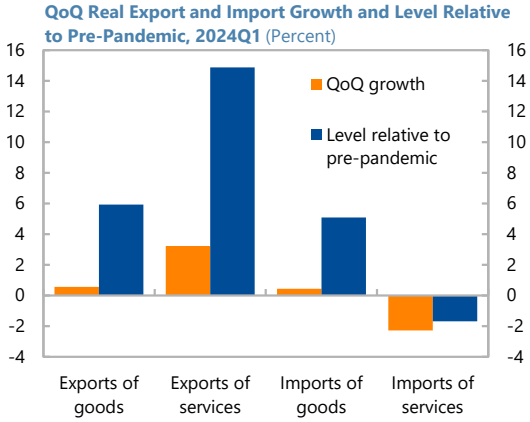
... which has been muted for several quarters for both goods and services...



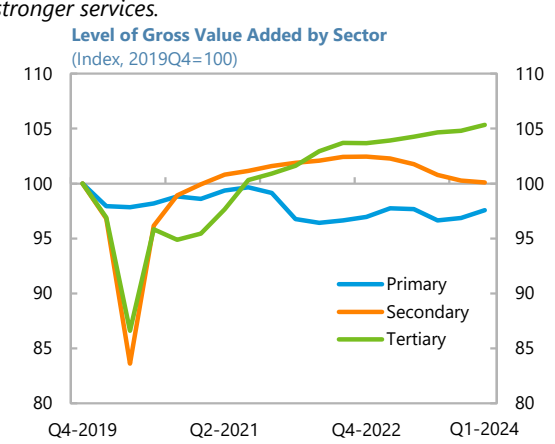
...as consumer sentiment is recovering from very low levels.



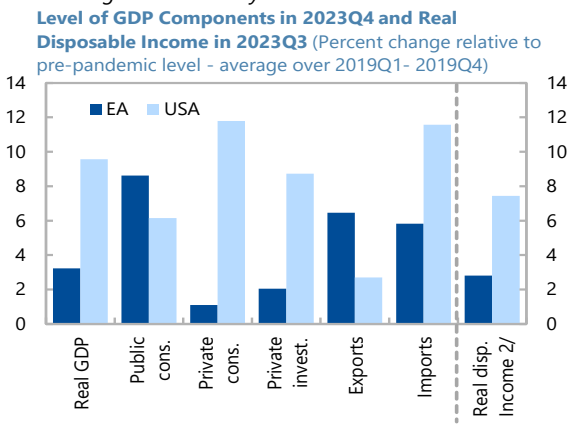
Exports of services have been driving the overall positive net exports contribution to growth and have been the main driver of the latest rebound in exports in 2024Q1.



Manufacturing performance remains weak, partly offset by stronger services.



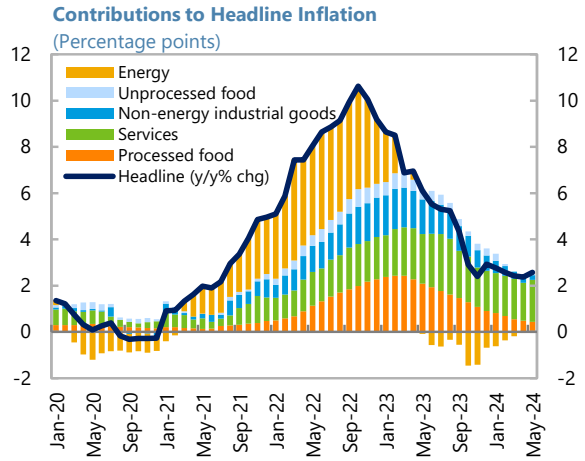
The weak domestic demand has been an important driver to the divergence in activity with the US.



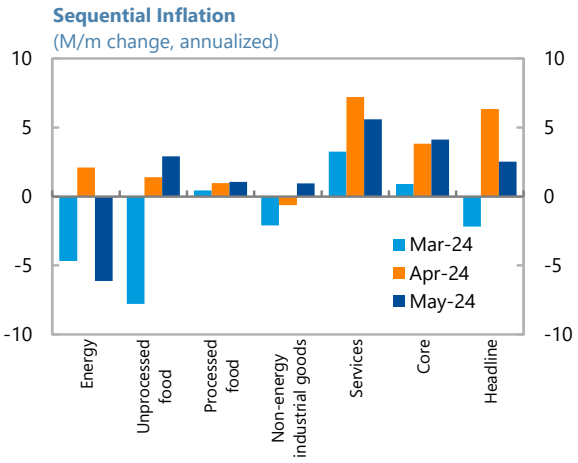
Sources: Bureau of Economic Analysis; European Commission; Eurostat; Haver Analytics; and IMF staff estimates and calculations.
1/ Euro area is proxied by the sum of the countries which publish disaggregated quarterly consumption data.
2/ Disposable income is deflated using the personal consumption deflator.

Figure 2. Euro Area: Inflation Developments

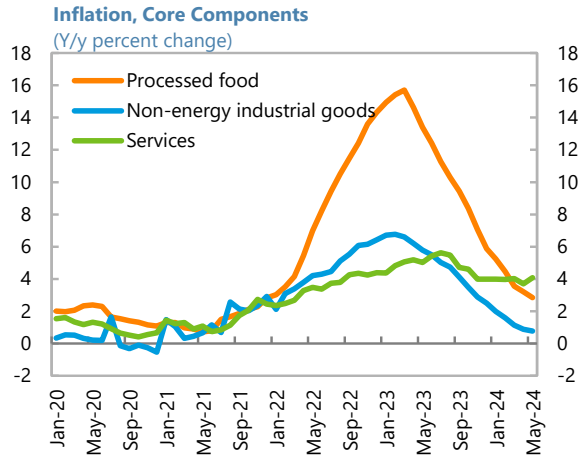
Annual euro area inflation rebounded to 2.6 percent in May vs 2.5 percent Consensus. Core inflation (excluding energy and unprocessed food) also rebounded to 2.9 percent, from 2.8 percent in April.



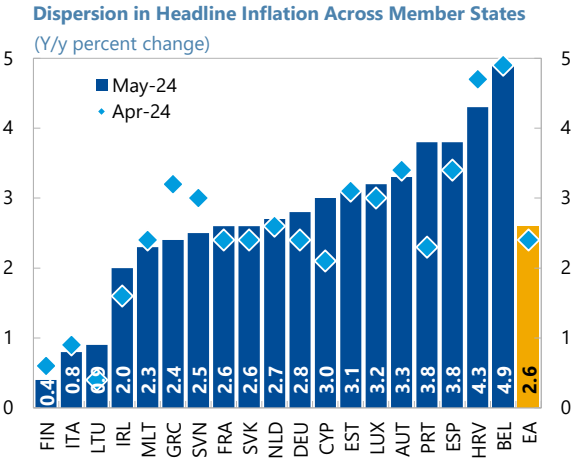
Apart from the negative energy reading, the increase in sequential inflation in May was broad based, with the largest spike in unprocessed food.



After the brief slowdown in April, services inflation rebounded to 4.1 percent in May, which is a seven-month high, on a yoy basis.



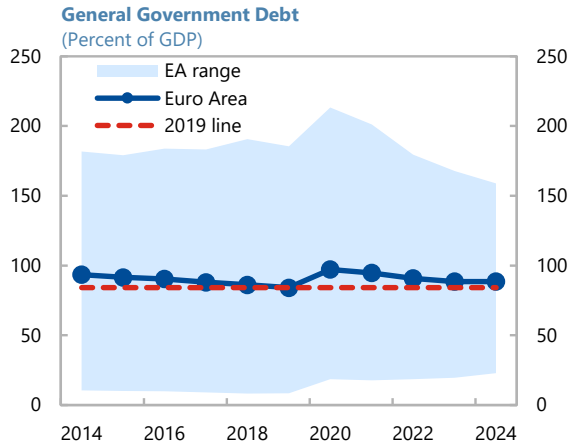
The increase in headline inflation was widespread across countries, with increases in large economies such as Germany and France, offset by large decreases in Greece and Slovenia.



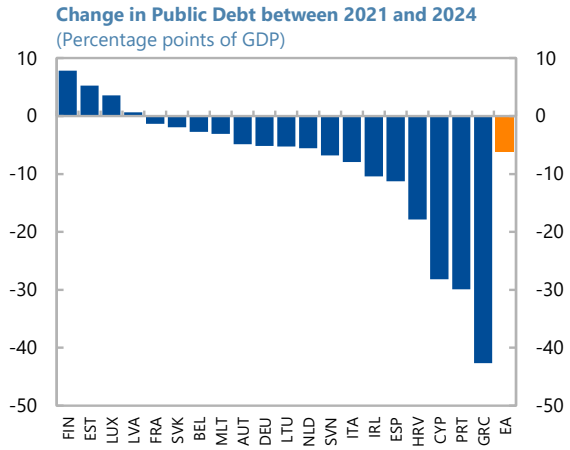
Sources: European Commission; Eurostat; Haver Analytics; IMF WEO; and IMF staff calculations.

Figure 3. Euro Area: Public Sector Accounts

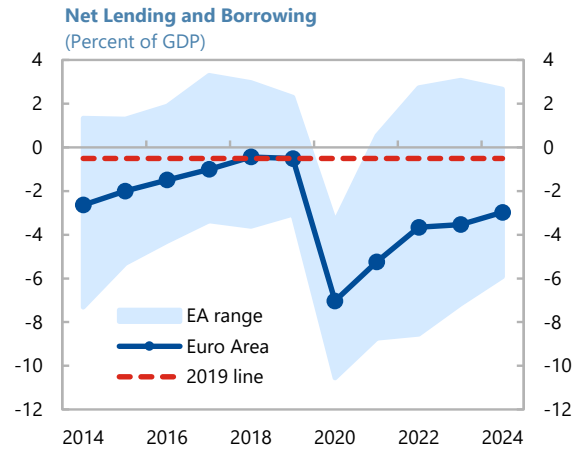
Public debt has fallen since the 2020 peak, and is now back close to 2019 levels, but with large divergence.



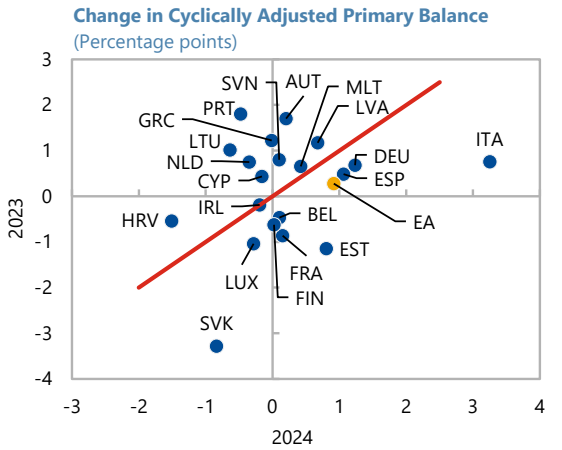
Most countries have reduced debt ratios, in some cases as a result of favorable debt dynamics.



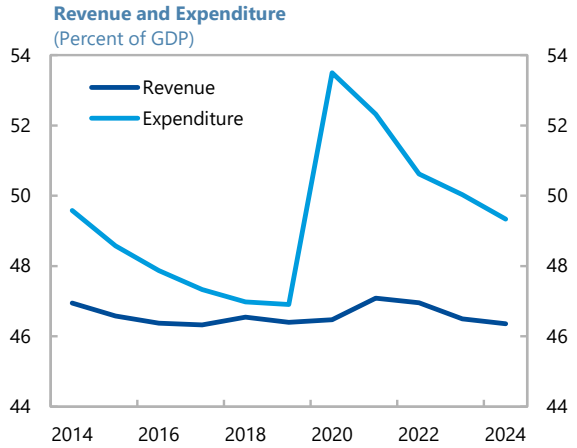
Fiscal deficits are falling, but are still substantially above pre-pandemic levels



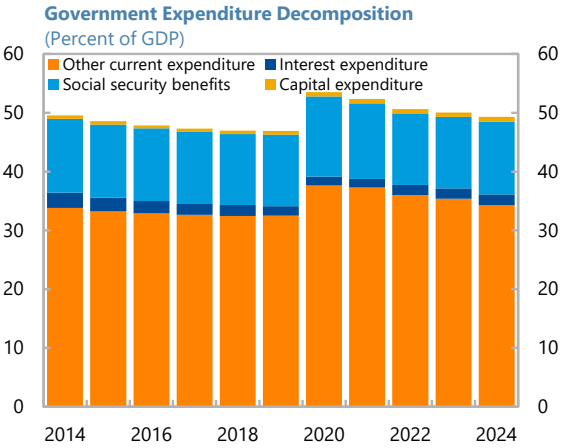
On aggregate, the euro area consolidation accelerates in 2024, but slows in many countries from 2023.



The fiscal improvement has been driven by expenditure reduction …



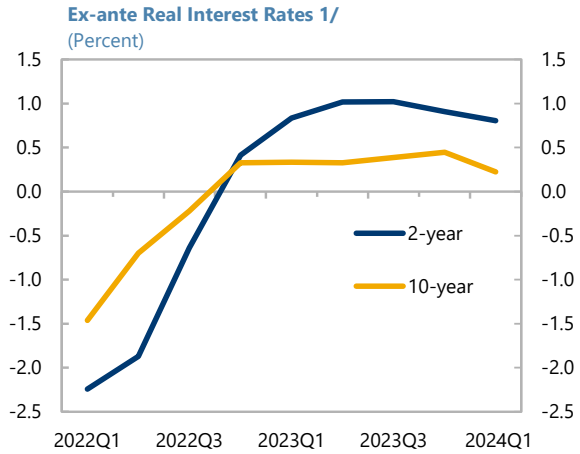
… primarily in non-social security primary current spending (discretionary expenditure).



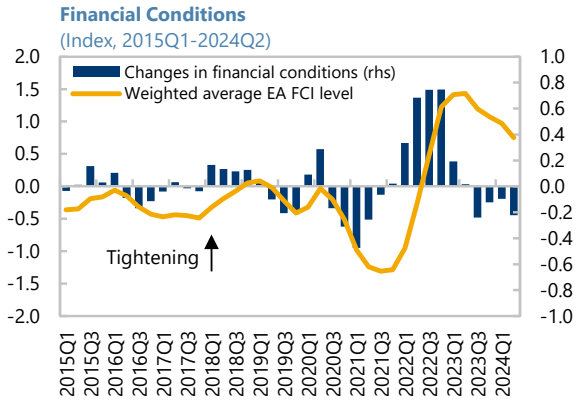
Sources: IMF staff estimates and calculations.

Figure 4. Euro Area: Financial Stability Risks

The rapid monetary policy tightening....

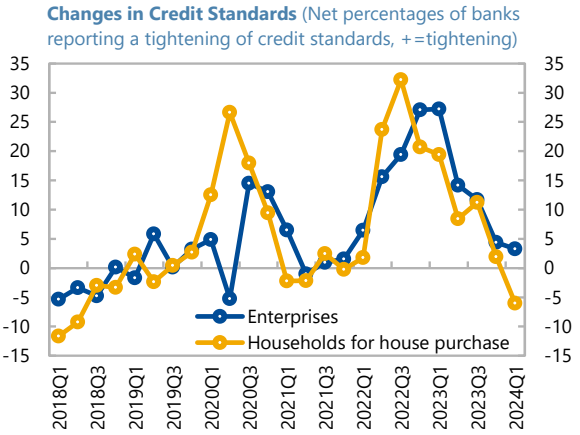


induced a tightening of financial conditions...



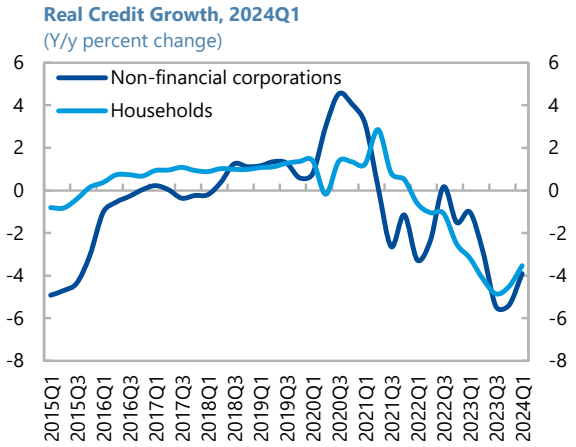
Note: Chart shows the liability-weighted average of the Euro area countries' Financial Condition Indexes. 2024Q1 and 2024Q2 are forecasts.

...as captured by restrictive credit standards...

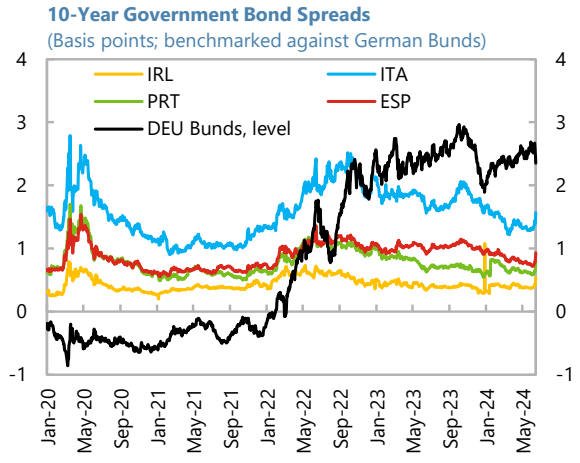


Source: ECB Bank Lending Survey.

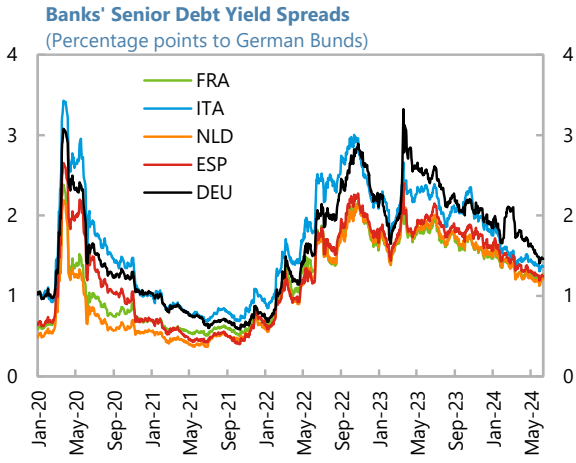
...and negative real credit growth.



Nevertheless, sovereign spreads remained contained...



as did spreads of senior bank bonds.

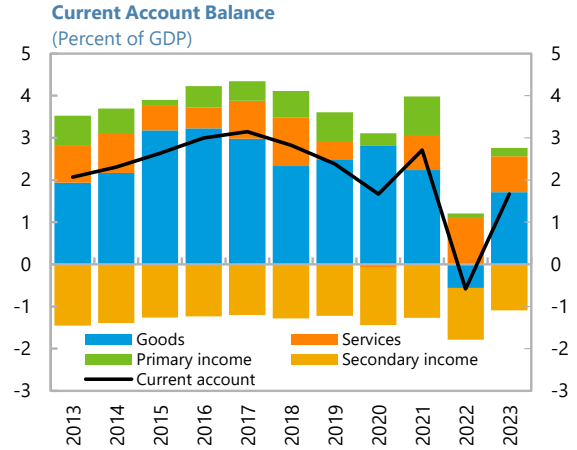


Sources: Bloomberg Finance, L.P.; Borraccia et al., 2023, IMF Working Papaer 23/209; ECB; IHS Market; Refinitiv; Tullet Prebon Information; and IMF staff calculations.

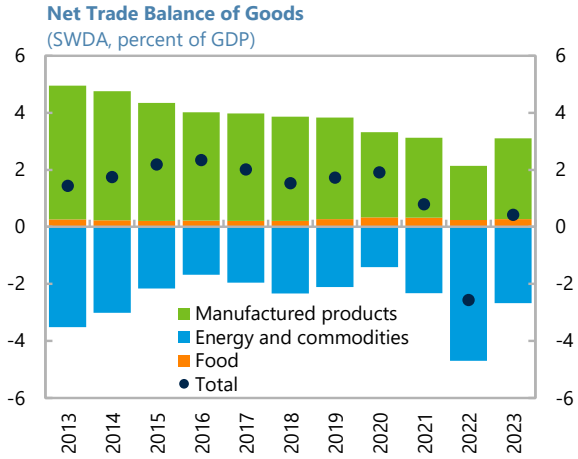
1/ Ex-ante real rates are the differences between the euro area OIS rates and market-implied inflation expectations for the same time horizon.

Figure 5. Euro Area: External Sector Developments

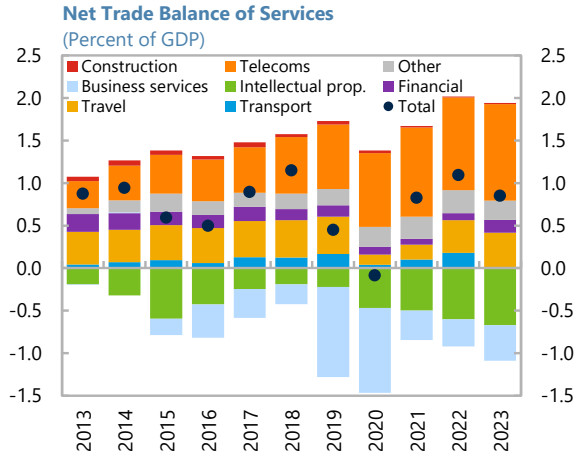
The current account recorded a surplus in 2023 as the trade balance improved



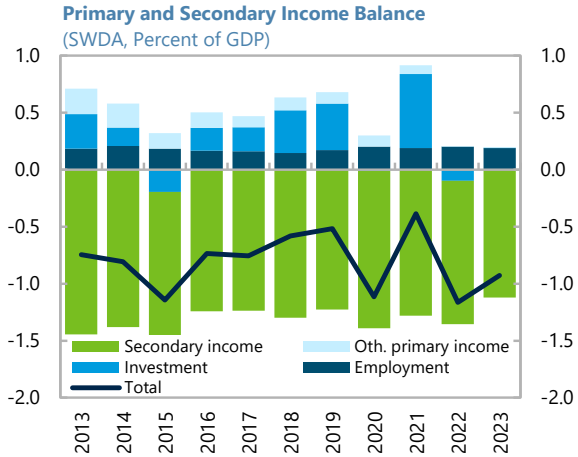
...driven by higher net exports of manufacturing and lower net imports of energy and commodities.



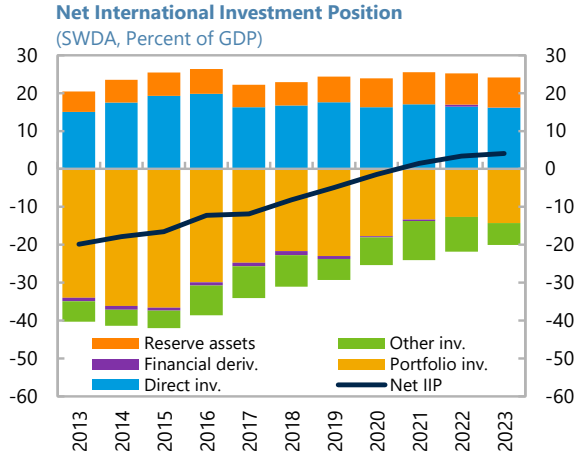
Net trade surplus in services declined due to widening deficits of business services and intellectual property.



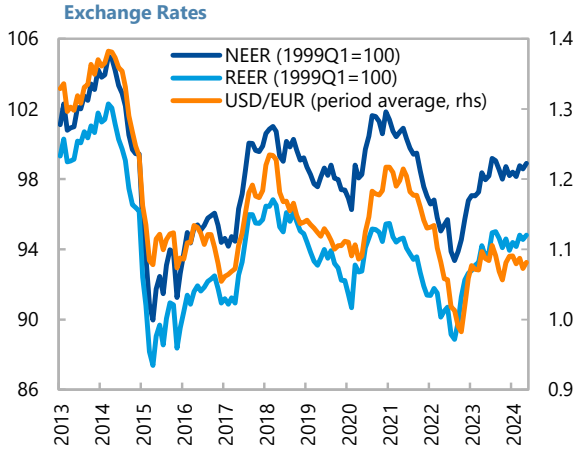
The primary and secondary income balances also improved.



The net international investment position continued to strengthen.



The REER and NEER appreciated slightly in 2023 and remain stable in 2024.



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

Table 1. Euro Area: Main Economic Indicators, 2020–2029 1/

(y/y percent change, unless otherwise specified)

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
					Proj.	*Proj.*	*Proj.*	*Proj.*	*Proj.*	*Proj.*
Demand and Supply										
Real GDP	-6.1	5.9	3.4	0.5	0.9	1.5	1.5	1.3	1.3	1.2
Private consumption	-7.7	4.4	4.2	0.5	1.3	1.7	1.7	1.5	1.4	1.3
Public consumption	1.1	4.2	1.6	0.9	0.9	0.6	0.7	0.8	0.8	0.8
Gross fixed investment	-5.9	3.5	2.5	1.2	-0.2	2.0	1.6	1.1	1.5	1.5
Final domestic demand	-5.4	4.1	3.2	0.8	0.9	1.5	1.4	1.3	1.3	1.2
Stockbuilding 2/	-0.3	0.6	0.4	-0.6	-0.1	-0.1	0.0	0.0	0.0	0.0
Domestic demand	-5.7	4.7	3.6	0.2	0.8	1.4	1.4	1.3	1.3	1.2
Foreign balance 2/	-0.6	1.4	0.0	0.3	0.2	0.1	0.1	0.1	0.0	0.0
Exports 3/	-9.1	11.5	7.2	-0.8	1.7	2.8	3.0	3.0	2.9	2.9
Imports 3/	-8.5	9.2	7.9	-1.4	1.3	2.9	3.0	3.0	3.1	3.0
Resource Utilization										
Potential GDP	-1.4	2.8	1.3	0.9	1.1	1.4	1.3	1.3	1.2	1.2
Output gap 4/	-4.6	-1.7	0.3	-0.1	-0.4	-0.3	-0.1	-0.1	0.0	0.0
Employment growth	-1.4	1.4	2.3	1.4	0.5	0.4	0.1	0.0	0.0	0.0
Unemployment rate 5/	8.0	7.8	6.8	6.6	6.5	6.4	6.4	6.4	6.4	6.4
Prices										
GDP deflator	1.8	2.2	4.7	6.0	2.8	2.5	2.0	1.9	2.0	1.9
Consumer prices	0.3	2.6	8.4	5.4	2.4	2.1	1.9	1.9	1.9	1.9
Public Finance (percent of GDP)										
Overall fiscal balance	-7.0	-5.2	-3.7	-3.5	-3.0	-2.8	-2.6	-2.5	-2.4	-2.4
Primary balance	-5.7	-3.9	-2.1	-2.1	-1.3	-1.0	-0.7	-0.5	-0.3	-0.2
Structural balance 4/	-4.0	-4.0	-3.5	-3.4	-2.7	-2.6	-2.5	-2.4	-2.4	-2.4
Structural primary balance 4/	-2.7	-2.7	-2.0	-1.9	-1.1	-0.8	-0.6	-0.4	-0.3	-0.2
Gross public debt	97.2	94.8	90.8	88.6	88.6	88.3	88.1	88.1	87.9	87.7
External Sector (percent of GDP) 6/										
Current account balance	1.7	2.7	-0.6	1.7	2.1	2.0	2.0	2.1	2.1	2.2
Interest Rates (percent, end of period) 7/										
Euro short-term rate (€STR)	-0.6	-0.6	1.9	3.9	3.9	...	...	...	...	...
10-year government benchmark bond yield	-0.1	0.3	3.0	2.9	3.1	...	...	...	...	...
Exchange Rates (end of period) 7/										
U.S. dollar per euro	1.2	1.1	1.1	1.1	1.1	...	...	...	...	...
Nominal effective rate (2005=100)	101.3	96.5	96.2	97.7	98.4	...	...	...	...	...
Real effective rate (2005=100, ULC based)	90.7	86.3	84.3	88.1	85.4	...	...	...	...	...

Sources: IMF staff estimates; and European Central Bank.
1/ Projections for 2024-29 are based on aggregation of the latest projections by IMF country teams, unless otherwise indicated.
2/ Contribution to growth.
3/ Includes intra-euro area trade.
4/ In percent of potential GDP.
5/ In percent.
6/ Projections are based on member countries' current account aggregations excluding intra-euro flows and corrected for aggregation discrepancy over the projection period.
7/ Latest monthly available data for 2024.

Table 2. Euro Area: External Sector Assessment

Overall Assessment: *The external position in 2023 was broadly in line with the level implied by medium-term fundamentals and desirable policies.* The CA balance increased to 1.7 percent of GDP in 2023 from -0.6 percent of GDP in 2022, due to the reversal of the negative terms of trade shock. Over the medium term, the euro area's CA balance is projected to increase further (though still below its historical average) as external demand improves and structural reforms to improve competitiveness are implemented. National external imbalances are expected to remain sizable.

Potential Policy Responses: Improving productivity—through increased public investment, reskilling and upskilling of the labor force, and structural reforms to foster a business environment that encourages private investment and technology diffusion—will help build resilience and lift growth potential, mitigating the headwind from aging. Strengthening the EU single market—by harmonizing regulations, reducing administrative barriers, and streamlining trade procedures—will create a more resilient domestic economy, thereby helping address challenges from an increasingly shock-prone and fragmented global economy. It is also critical to avoid a trade-distorting, fiscally costly subsidy race and other trade-distorting measures, which would undermine resource allocation and productivity. Trade and investment disagreements with other countries should be resolved in a manner that supports an open, stable, and transparent rules-based trading system. As historical policy gaps at the national level in the EU are projected to persist, countries with excess CA surpluses should increase investment, while countries with weak external positions should undertake reforms to raise productivity, reduce structural and youth unemployment, and commence growth-friendly fiscal consolidation. Euro-area-wide initiatives to make the currency union more resilient (for example, completing the banking and capital markets unions and establishing the central fiscal capacity for some common public goods) would deepen public and private sector risk sharing, supporting external stability of high-debt countries.

Foreign Asset and Liability Position and Trajectory	**Background**.After falling to –20.5 percent of GDP in 2009, the NIIP of the euro area rose substantially to 4.1 percent of GDP by the end of 2023, reflecting accumulated CA surpluses. Relative to 2022, the NIIP increased in 2023 by 0.8 percentage points of GDP, primarily reflecting valuation effects from the weaker euro and improvement in the current account balance. Gross portfolio investment assets and liabilities have both declined sharply, reflecting impact of higher interest rates and financial market repricing. Direct investment assets and liabilities have also declined though more moderately. The gross values of derivative positions have increased with higher financial market volatility. Gross foreign assets were 243.0 percent of GDP and liabilities 238.9 percent of GDP as of the end of 2023. Net external assets (including those vis-a-vis other euro area member states) remain elevated in external creditor countries (e.g., Germany), whereas net external liabilities remain high in debtor countries (e.g., Portugal and Spain). **Assessment**. Projections of continued CA surpluses over the medium term suggest that the NIIP-to-GDP ratio will rise further, at a moderate pace. While the region's overall NIIP financing vulnerabilities appear low in aggregate, large net external debtor countries bear an elevated risk of a sudden stop of gross inflows.				
2023 (% GDP)	NIIP: 4.1	Gross Assets: 243.0	Debt Assets: 89.7	Gross Liab.: 238.9	Debt Liab.: 86.6

Current Account	**Background**. The CA balance for the euro area increased to 1.7 percent of GDP in 2023 from -0.6 percent of GDP in 2022. The improvement is driven by a significant improvement in the goods balance (from declines in import prices especially of natural gas and oil) and, to a lesser extent, an increase in the income balances, which more than offset the reduction in the services surplus. Large creditor countries, such as Germany and the Netherlands, continued to have sizable surpluses, reflecting high corporate and household saving and weak investment. **Assessment**. The EBA model estimates a CA norm of 0.7 percent of GDP, against a cyclically adjusted CA of 1.7 percent of GDP. This implies a gap of 1 percent of GDP. Adjustments of -0.4 percent of GDP were made to the underlying CA reflecting CA measurement issues in Ireland and the Netherlands to account for activities of multinational enterprises and portfolio retained earnings bias respectively. Considering these factors and uncertainties in the estimates, including the cyclical adjustment, staff assesses the CA gap to be 0.6 percent of GDP in 2023, with a range of 0 to 1.2 percent of GDP (considering a standard error of 0.6).					
2023 (% GDP)	CA: 1.7	Cycl. Adj. CA: 1.7	EBA Norm: 0.7	EBA Gap: 1	Staff Adj.: -0.4	Staff Gap: 0.6

Real Exchange Rate	**Background.** The euro area CPI-based REER appreciated by 4.5 percent between 2015 and 2021 following a depreciation of nearly 20 percent in the post global financial crisis period. In 2023, the CPI-based REER appreciated by 3.5 percent compared to 2022, reflecting an appreciation of 3 percent against the USD. The ULC-based REER appreciated by 4.4 percent. As of April 2024, the CPI-based REER was 0.4 percent above its 2023 average. **Assessment.** Consistent with the IMF staff CA gap, the IMF staff assesses the REER gap to be -1.7 percent in 2023, with a range of -3.4 to 0 percent, based on the estimated CA-REER elasticity of 0.35.[1] As with the CA gap, the aggregate REER gap masks a large degree of heterogeneity in REER gaps across euro area member states, ranging from an undervaluation of 7.5 percent in Germany to an overvaluation of about 11.5 percent in Italy. The EBA REER index and level models suggest overvaluations of 5.5 percent and 3.9 percent, respectively.
Capital and Financial Accounts: Flows and Policy Measures	**Background.** The euro area experienced a capital account surplus of 0.3 percent of GDP and a financial account surplus of 1.9 percent of GDP in 2023, mirroring the CA surplus. **Assessment.** Gross external indebtedness of euro area residents decreased by 7.4 percentage points of GDP in 2023 as lower external debt of the Eurosystem, and the nonfinancial sector has offset higher debt of deposit-taking institutions and governments.
FX Intervention and Reserves Level	**Background.** The euro has the status of a global reserve currency. **Assessment.** Reserves held by euro area economies are typically low relative to standard metrics, but the currency is free floating.

1/ The export and import elasticities are obtained as the average of estimates from Consultative Group on Exchange Rate Issues (CGER)-inspired export and import equations using REERs relevant for the euro area with an ADL (2,2,2) model on quarterly data 2000–19. The trade balance elasticity is calculated using the share of exports and imports in extra-EU trade in GDP.

Table 3. Euro Area: Risk Assessment Matrix[1]

Sources of Risk	Likelihood of Risk (High, Medium, Low)	Expected Impact of Risk (High, Medium, Low)	Policy Responses
Global Risks			
Intensification of Regional Conflict	**High** Escalation or spread of the conflict in Gaza and Israel, Russia's war in Ukraine, and/or other regional conflicts or terrorism disrupt trade (e.g., energy, food, tourism, supply chains), remittances, FDI and financial flows, payment systems, and increase refugee flows.	**High** Increased uncertainty weakens consumer and business confidence, reducing consumption and investment. Spikes in energy prices and supply disruption reduce the purchasing power of households.	• Accelerate the energy transition. • Provide targeted support to vulnerable households to mitigate the impact of higher energy prices.
Commodity Price Volatility	**High** A succession of supply disruptions (e.g., due to conflicts, export restrictions, and OPEC+ decisions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, cross-border spillovers, and social and economic instability.	**High** Higher commodity import prices lead to higher energy prices that fuel inflationary pressures. Export competitiveness of European firms is adversely affected which in turn slows down activity. High energy prices have an adverse impact on households, leading to lower domestic demand.	• Maintain a flexible and data-dependent monetary policy. • Allow automatic stabilizers to operate and provide fiscal support to vulnerable households. • Safeguard energy security by accelerating the green transition.
Abrupt Global Slowdown or Recession	**Medium** Global and idiosyncratic risk factors cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation triggering sudden stops in EMDEs. **Medium** In Europe, intensifying fallout from Russia's war in Ukraine, supply disruptions, tight financial conditions, and real estate market corrections exacerbate economic downturn.	**Medium** While direct financial linkages are limited, slower export growth, combined with weaker consumer and business confidence, will weigh on the corporate sector and result in lower investment, higher unemployment, and a slower recovery in private consumption. Lower growth will lead to a further deterioration in public debt sustainability in some high-debt countries.	• Increase the pace of monetary policy rate cuts depending on the prospects for inflation and aggregate demand. • Allow automatic stabilizers to operate and provide fiscal support to vulnerable households. • Promote high quality public investment in infrastructure, and advance structural reforms. • Enhance liquidity support to financial institutions and markets with strong coordination between the ECB and the national authorities on financial stability risks.

Table 3. Euro Area: Risk Assessment Matrix (Continued)			
Sources of Risk	**Likelihood of Risk** (High, Medium, Low)	**Expected Impact of Risk** (High, Medium, Low)	**Policy Responses**
Monetary policy miscalibration	**Medium** Amid high economic uncertainty, major central banks loosen policy stance prematurely, hindering disinflation, or keep it tight for longer than warranted, causing abrupt adjustments in financial markets and weakening the credibility of central banks.	**Medium** Premature easing leads to persistently high inflation and triggers wage-price feedback. Persistently high rates and tight financial conditions generate larger economic impact through lower investment, consumption, and weaker confidence.	• Maintain meeting-by-meeting and data-dependent approach to monetary policy. • Fiscal policy should avoid adding to inflationary pressures. • In case of an abrupt slowdown, allow automatic stabilizers to operate and provide temporary support to vulnerable households.
Systemic financial instability	**Medium** High interest rates and risk premia and asset repricing amid economic slowdowns and political uncertainty (e.g., from elections) trigger market dislocations, with cross-border spillovers and an adverse macro-financial feedback loop affecting weak banks and NBFIs.	**Medium** Tighter financial conditions negatively affect leveraged households and firms triggering NPLs and insolvencies. GDP growth is negatively affected. A sharp correction in residential and commercial real estate (CRE) prices could impair banks' balance sheets, lead to financial market disruptions, and weigh on firms' financial health and economic activity.	• Enhance liquidity support to financial institutions and markets to avoid contagion and prevent liquidity shortages morphing into insolvencies. • Ensure strong coordination between the ECB and the national authorities on financial stability risks. • Use countercyclical financial policy to support viable financial institutions. • Rely on bank resolution systems to address unsound banks. • Activate EU support lines for high-debt countries under stress. • Allow automatic stabilizers to operate and provide temporary support to vulnerable households.
Structural risks			
Deepening Geoeconomic Fragmentation	**High** Broader conflicts, inward-oriented policies, and weakened international cooperation result in a less efficient configuration of	**High** Trade barriers and supply disruptions lead to shortages in crucial inputs, higher inflation and production bottlenecks that reduce	• Diversify energy production and secure supply chains to avoid shortages of critical raw materials.

Table 3. Euro Area: Risk Assessment Matrix (Continued)			
Sources of Risk	**Likelihood of Risk** (High, Medium, Low)	**Expected Impact of Risk** (High, Medium, Low)	**Policy Responses**
	trade and FDI, supply disruptions, protectionism, policy uncertainty, technological and payments systems fragmentation, rising shipping and input costs, financial instability, a fracturing of international monetary system, and lower growth.	economic activity and decrease confidence.	• Slow down the loosening of monetary policy stance if disinflation proceeds slower than expected. • Allow automatic stabilizers to operate and provide targeted fiscal support to vulnerable households.
Cyberthreats	**Medium** Cyberattacks on physical or digital infrastructure and service providers (including digital currency and crypto assets) or misuse of AI technologies trigger financial and economic instability.	**Medium** Depending on the country level of digitalization and exposure to digital infrastructure, cyberattacks could disrupt the financial system as well as the real economy.	• Advance crisis preparedness to cyberattacks. • Further strengthen coordination at the European/international level. • Strengthen the operational resilience of the financial system.
Extreme climate events	**Medium** Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.	**Medium** Productivity declines or shortages leading to price increases. EU members may receive migrants from economies facing severe climate disruptions.	• Build fiscal space that can be activated to alleviate large discrete climate shocks. • Establish a central fiscal capacity with the remit to finance mitigation of extreme climate events. • Accelerate green transition to meet emission targets.
Disorderly energy transition	**Medium** A disorderly shift to net-zero emissions (e.g., owing to shortages in critical metals) and climate policy uncertainty cause supply disruptions, stranded assets, market volatility, and subdued investment and growth.	**Medium** Higher energy prices could lead to higher inflation and decreased real incomes. Increased climate policy uncertainty could negatively affect investments in green technology.	• Provide targeted fiscal policy support to households and businesses severely affected by energy transition. • Promote public investment and accelerate structural reforms to improve energy efficiency and facilitate labor reallocation.

Table 3. Euro Area: Risk Assessment Matrix (Continued)			
Sources of Risk	**Likelihood of Risk** (High, Medium, Low)	**Expected Impact of Risk** (High, Medium, Low)	**Policy Responses**
Euro Area Domestic Risks			
Realization of Financial Sector Vulnerabilities	**Medium** A shift in market perception, along with high-for-longer interest rates, undermines high-debt countries' ability to roll over and service debt, re-igniting financial fragmentation and adversely affecting the banking system.	**High** Higher funding costs and a shift in risk sentiment lead to bond repricing and financial tightening, a reduction in credit growth. Insolvencies increase, resulting in deterioration of bank balance sheets and profitability. Rates staying high for longer will also lead to housing market corrections. Sovereign spreads increase, straining fiscal sustainability in high-debt countries.	• Enhance liquidity support to financial institutions and markets to avoid contagion and prevent liquidity shortages morphing into insolvencies. • Ensure strong coordination between the ECB and the national authorities on financial stability risks. • Use countercyclical financial policy to support viable financial institutions. • Rely on bank resolution systems to address unsound banks. • Allow automatic stabilizers to operate and provide temporary support to vulnerable households. • Activate EU support lines for high-debt countries under stress.
A Shift in Market Sentiment Against some High-debt Euro Area Countries	**Medium** Policy slippages with weak growth outturns in some high-debt euro area countries, along with high-for-longer interest rates, could raise concerns over debt sustainability in high debt countries.	**Medium** Sharp increases in funding costs strain high-debt countries' ability to service their debt resulting in adverse real-financial feedback loops and financial fragmentation that weighs on economic activity and impairs monetary policy transmission.	• Activate EU support lines for high-debt countries under stress. • Enhance liquidity support to financial institutions and markets with strong coordination between the ECB and the national authorities on financial stability risks. • Exercise flexibility in reinvesting PEPP.
Social discontent	**Medium** Political uncertainty following elections, high inflation, real income loss, and worsening inequality lead to detrimental populist policies and potential social unrest. This exacerbates imbalances, slows growth,	**Medium** Social tensions around economic adjustments cause disruptions and erode trust in policy makers. Political instability complicates reaching consensus on policies, including to fight inflation.	• Expand targeted support to most vulnerable households. • Use active labor market policies to facilitate reallocation of workers toward expanding sectors and limit labor market hysteresis.

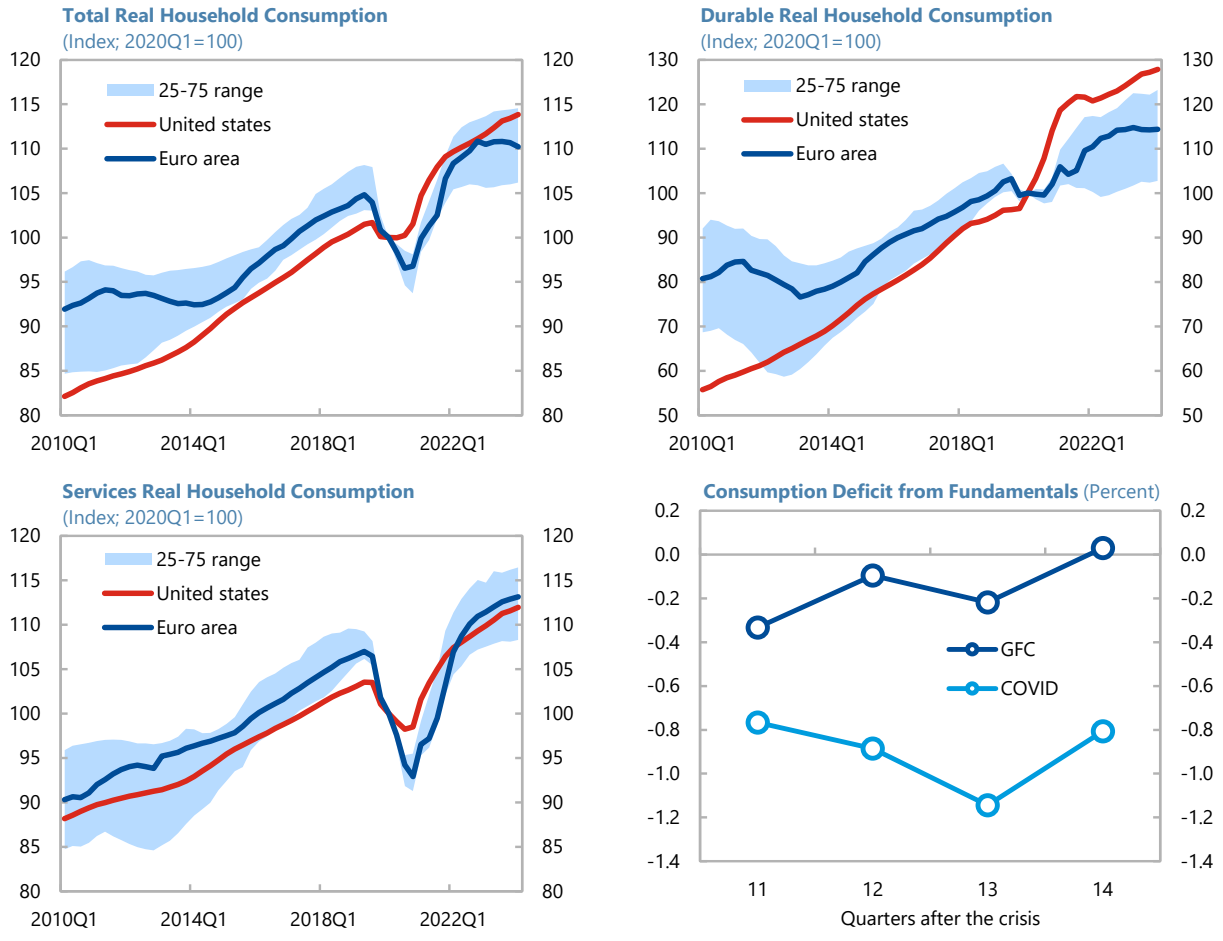
Table 3. Euro Area: Risk Assessment Matrix (Concluded)			
Sources of Risk	**Likelihood of Risk** (High, Medium, Low)	**Expected Impact of Risk** (High, Medium, Low)	**Policy Responses**
	and leads to policy uncertainty and market repricing.		

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

Annex I. Possible Drivers of Weak Private Household Consumption in the Euro Area

1. Following the energy shock in 2022, some weakness in consumption was expected, as the substantial rise in inflation—the most significant in recent decades—squeezed real incomes. However, with energy prices stabilizing, real wages starting to recover, and inflation nearing the target, there was a partial recovery in real disposable income. It was then expected that this improvement would bolster consumer confidence and spur a revival in private consumption, potentially driving a broader economic recovery last year. This annex explores the reasons behind the sluggish rebound, and shows that most of the weak consumption in 2023 can be attributed to the 2022 negative terms of trade (TOT) shock. It concludes offering some insight on possible future developments.

Annex I. Figure 1. Euro Area: Consumption Dynamics in the Euro Area and the U.S.



Sources: Bureau of Economic Analysis; Eurostat; and IMF staff calculations.

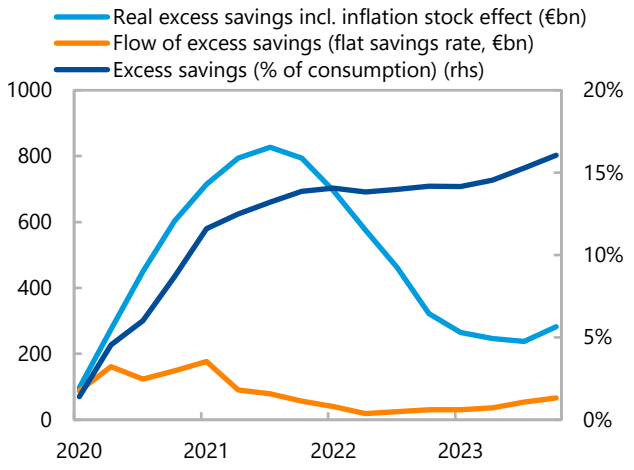
2. Household consumption continues to underperform its fundamentals in the euro area, despite the reversal of the energy shock and the partial recovery in real incomes. Both total consumption and consumption of durable goods remain at subdued levels with respect to those in

the United States, while services consumption rebounded strongly post-pandemic and is outperforming that of the US (Figure 1, panel a, b, and c). An error correction model (ECM) is estimated to measure how consumption has responded to its traditional determinants. Private consumption is primarily influenced by expected lifetime income, represented by disposable income and wealth. Specifically, the long run equation is given by:

$$C_t = \alpha + \beta^1 Y_t + \beta^2 W_t + \epsilon_t, \quad (1)$$

where C_t, is private real consumption, Y_t, is real disposable income and W_t is real wealth. The observations during the COVID period, from 2020Q1 to 2021Q4, are excluded from the estimation. The result suggests that actual consumption is below what it would be expected given real disposable income and wealth developments (Figure 1, panel d). In particular, the level of real private consumption is currently 0.8 percent lower than what fundamentals would suggest. However, the literature has shown that other factors, such as uncertainty about the future, interest rates, and consumer debt are also significant drivers of private consumption (Coibion et al. 2024), and consistent with other factors, savings rates in numerous countries continue to rise. This in turn affect the level of excess savings which continues to accumulate (Figure 2).

Annex I. Figure 2. Euro Area: Excess Savings vs. 2010–2019 Trend

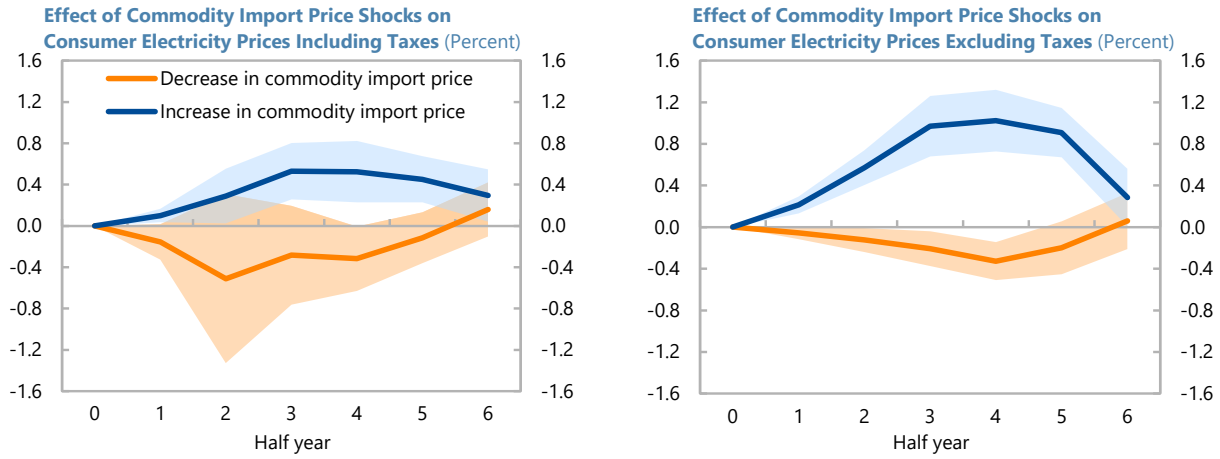


Sources: Eurostat; and IMF staff calculations.

Energy Price Shocks on Households' Prices and Consumption

3. A lower pass-through to domestic prices during periods of commodity import price declines suggests that lingering effects from the recent TOT shock are still weighing on consumption. A panel local projection analysis of 19 European countries is estimated to assess whether the pass-through from energy prices is asymmetric during periods of positive vs negative changes (for an on the asymmetry of energy shocks on firms' producers' prices see Joussier et al. 2023). The effect of a change in a country-specific commodity import price index on household electricity prices is estimated relying on a country-specific index developed by Gruss et al. (2019). The variable is arguably exogenous for European countries that are commodity price takers. The model controls for lags of the dependent variable and of the commodity terms of trade variable to take into account any possible serial correlation, the European News Index, labor, property and transfers income and both financial and non-financial wealth, and country fixed effects. Standard errors are clustered at the country level. Consistent with the previous section, the estimation excludes 2020 and 2021. The pass-through from imported commodity prices shocks to domestic electricity prices is asymmetric when comparing periods of prices increases versus decreases.

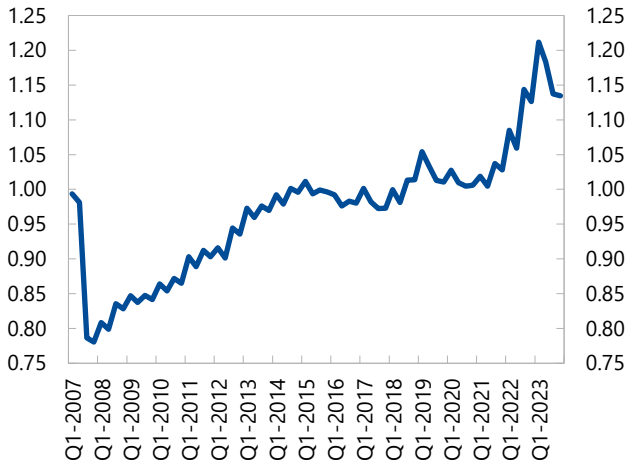
Annex I. Figure 3. Euro Area: Asymmetric Commodity Import Prices Pass-Through to Consumer Electricity Prices



Sources: Eurostat; Gruss et al. 2019; and IMF staff calculations.

The peak pass-through from commodity TOT shocks to domestic electricity prices, excluding taxes and levies, is more than twice as large when commodity import prices increase than when they decrease (Figure 3). Similar effects are found for broader energy prices and PPI. However, the asymmetry is significantly reduced when considering electricity prices including taxes and levies, suggesting governments act to smooth international price hikes. The lingering effects from the recent shock are confirmed by the fact that consumer electricity prices remain above pre-pandemic levels in early 2024 (Figure 4).

Annex I. Figure 4. Euro Area: Ratio of Consumer Electricity (including taxes) to Core Prices (Index, 2015=1)



Sources: Eurostat; and IMF staff calculations.

The 2022 Energy Price Shock and its Effect on Consumption

4. A time-varying VAR is used to assess whether the 2022 energy shock had a different effect on consumption than previous shocks. A standard VAR model is adapted to include varying parameters B_t (Chan and Jeliazkov 2009). The time-varying parameters follow a simple autoregressive process. The full model is characterized by the equations below:

$$y_t = X_t B_t + \epsilon_t, \qquad \epsilon_t \sim N(0, \Sigma_t)$$

$$B_t = B_{t-1} + v_t, \qquad v_t \sim N(0, \Upsilon)$$

$$\Sigma_t = F\Lambda_t F$$

This version of the model also allows the residual covariance matrix, Σ_t, to be period-specific. Following Edelstein and Kilian (2009), a recursive identification method is adopted to identify the impacts of purchasing power changes derived from an energy shock on household consumption. The purchasing power variable is based on the relative price of energy over consumer prices. This variable is used to avoid a potential source of structural instability in the relationship between energy prices and the economy. Similar to Edelstein and Kilian (2009), our variable is defined as below:

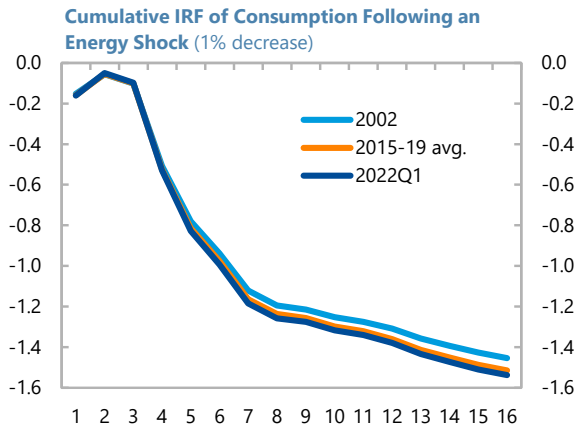
$$pp_e = -\eta_e \%\Delta\left(\frac{P_t^E}{P_{t+1}^{PCE}}\right),$$

Where $-\eta_e$ is the nominal expenditure share for energy (that is the weight of the energy goods in the HICP basket), P_t^E is the HICP energy price and P_{t+1}^{PCE} is core price inflation excluding energy and unprocessed food inflation.

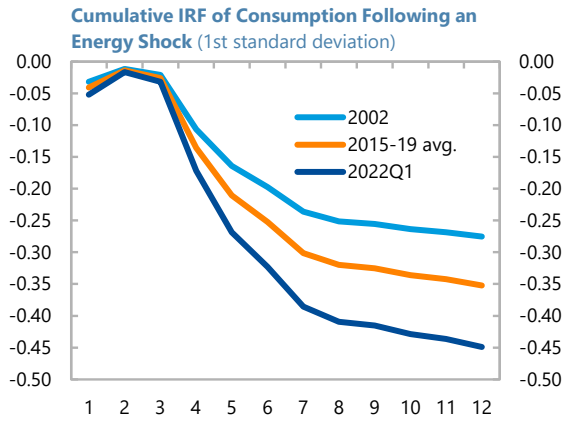
5. The 2022 energy shock had a much larger impact compared to past episodes. Figure 5 presents the estimated time-varying IRFs that allow the comparison to previous time periods. The results show that when the shocks are rescaled to represent a 1 percent decrease in purchasing power, the effect on consumption is almost identical to the 2015-2019 average. However, the standard deviation of the shock was much larger during the 2022 episode implying a much larger impact on consumption, as the right panel of Figure 5 shows.

6. The 2022 shock dampened private consumption by also increasing precautionary savings. Following Edelstein and Kilian (2009), this annex estimates that the elasticity of consumption to a 1 percent increase in energy prices is -0.139 (vs - 0.15 for the US in Edelstein and Kilian, 2009) after 1 year. This implies that the loss in purchasing power attributable to a 1 percent increase in energy prices is estimated at -0.056 percent. Using these numbers, the precautionary savings associated with a 1 percent increase in energy prices is estimated at 0.083 percent. This means that about 60 percent of the drop in consumption caused by an energy shock is explained by an increase in precautionary savings. About 25 percent of the stock of excess savings accumulated in the EA since the pandemic can be attributed to precautionary savings caused by the 2022 energy shock. This estimate is likely a lower bound, as the shock was initially thought to be much more persistent than previous energy shocks, which the VAR framework cannot capture.

Annex I. Figure 5. Euro Area: The 2022 Energy Shock Compared to Previous Shocks



Source: IMF staff calculations.

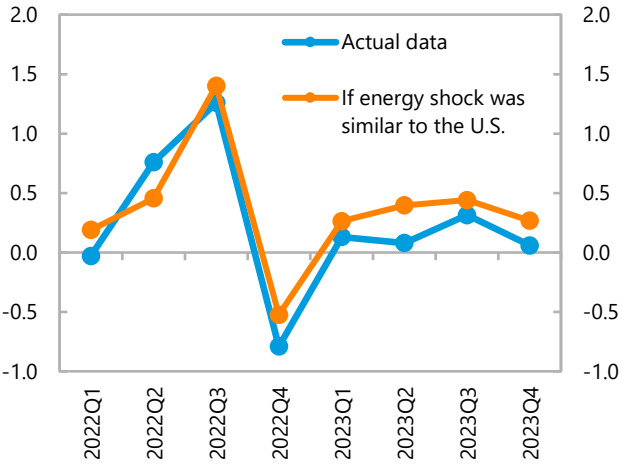


Source: IMF staff calculations.

Sources: Eurostat; IMF WEO; and IMF staff calculations.

7. The model suggests that only a minor underperformance in consumption would have happened had energy prices in the euro area behaved as in the USA. The model is used to answer the following counterfactual question: how would private consumption have evolved in the euro area in the last two years had the energy prices matched the prices in the United States in the last two years? The answer is that consumption would have been broadly similar until the 2022Q4 and would have rebounded more strongly in 2023 (Figure 6). Putting this in a historical context, consumption would have grown on average by 0.36 percent if energy prices had behaved as in the USA, which compares to an average consumption growth of 0.4 percent in the 2015-19 period. That is, most of the underperformance in consumption in the last year can be attributed to the effects of the large energy price shock.

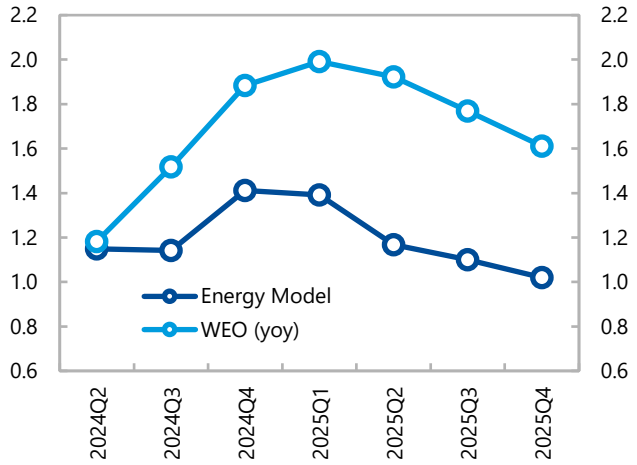
Annex I. Figure 6. Euro Area: Energy Shock Effect on Consumption Growth (Q/q Percent Change)



Source: IMF staff calculations.

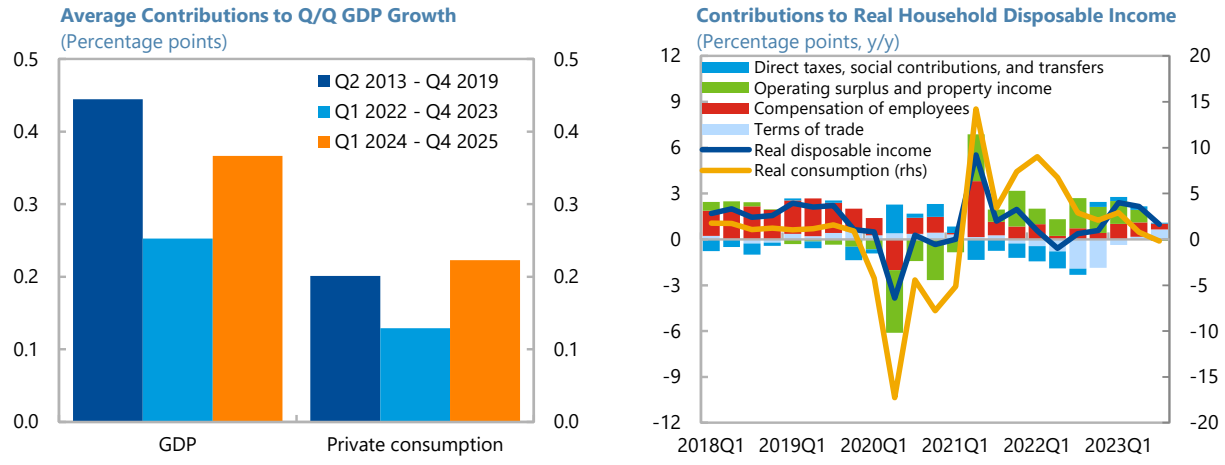
8. Consumption is expected to rebound as consumer energy prices continue the normalization process. This estimated model can also be deployed to forecast private consumption developments given expectations on energy prices and the expected pass-through to what consumers pay. Using the April WEO forecast for international energy prices and expectations for the energy component in the HICP, the model projects a recovery in private consumption for the later part of 2024 and the early part of 2025. Figure 7 shows that a large part of the IMF staff's projected private consumption recovery can be explained by lower energy HICP inflation in the later part of the year, which in turn is driven by lower international energy prices. Moreover, as the expectation is for energy prices to normalize and rebound slightly in 2025, the model predicts lower consumption for the later part of 2025. Moreover, it should also be noted that not all the increase in private consumption can be explained by lower energy prices, with some of the increase also driven by the projected easier monetary policy stance. In particular, the underperformance in durable consumption could be linked to the tighter monetary policy in 2023 compared to 2022 (see Annex II for the analysis of monetary policy on growth). A decomposition exercise confirms that households' income is set to increase if real compensation recovers (Figure 8). As the energy shock hit Europe in 2022, the TOT shock pushed incomes down despite an increase in profits. With the reversal of the TOT shock, real incomes are set to recover if real wages behave as expected. A further income recovery should boost consumption going forward.

Annex I. Figure 7. Euro Area: Energy Prices Will Be Supportive of Consumption Growth (Y/Y Percent Change)



Sources: IMF WEO; and IMF staff calculations.

Annex I. Figure 8. Euro Area: The Reversal of the Energy Shock and a Recovery in Real Compensation Should Support Consumption



Sources: Eurostat; IMF WEO; and IMF staff calculations.

Annex II. Monetary Policy Transmission in the Euro Area

Monetary policy was tightened significantly in the euro area since July 2022, after a long period at the effective lower bound. This constituted the fastest tightening in historical context, although in a global environment where all major central banks were also tightening. This analysis empirically compares the current MP tightening episode with past tightening episodes to assess the strength of the transmission mechanism. It then discusses, using a modeling approach, the optimal monetary policy stance under a scenario when agents have adaptive inflation expectations. Overall, transmission of monetary policy in the euro area appears to be comparable to the past, in particular for economic activity, while for core inflation transmission is comparable or stronger. Monetary policy restrictiveness is expected to contribute substantially to returning inflation to target in the second half of 2025. Results are somewhat assumption and model dependent.

Monetary Policy Transmission

1. Monetary tightening, all else equal, should reduce inflationary pressures by reducing demand pressures. In an environment where other countries are also tightening this channel would be strengthened through weaker global growth as well. Lower commodity prices would be contributing factor too.

2. Looking at the euro area, the transmission of monetary policy to economic activity has been comparable to previous periods. A Bayesian Vector Autoregression (BVAR) model with structural identification techniques (sign restrictions, Cholesky), estimated for both the period 1990Q1-2023Q4 and 1990Q1–2025Q4 (and subsample periods), Figure 1, shows no evidence of difference in the transmission of monetary policy for growth.[1] In that, the solid orange line and red dashed line fall within the confidence bands of the pre-covid subsample (green shaded area). Instead, transmission to core inflation seems to be comparable (red dashed line) or stronger (orange solid line), depending on how the pandemic period is treated.[2]

3. A historical shock decomposition for the Euro Area shows that about 80-90 percent of the transmission to growth occurred up to 2023Q4/2024Q1.[3, 4] Instead, for core inflation it shows evidence of lags in the transmission, with more than half of the transmission remaining in the

[1] The endogenous variables include: real GDP (100log), core price index (100log), the policy rate, while for the full sample analysis we also include two Covid dummies to capture the large drop in real GDP growth and subsequent increase.

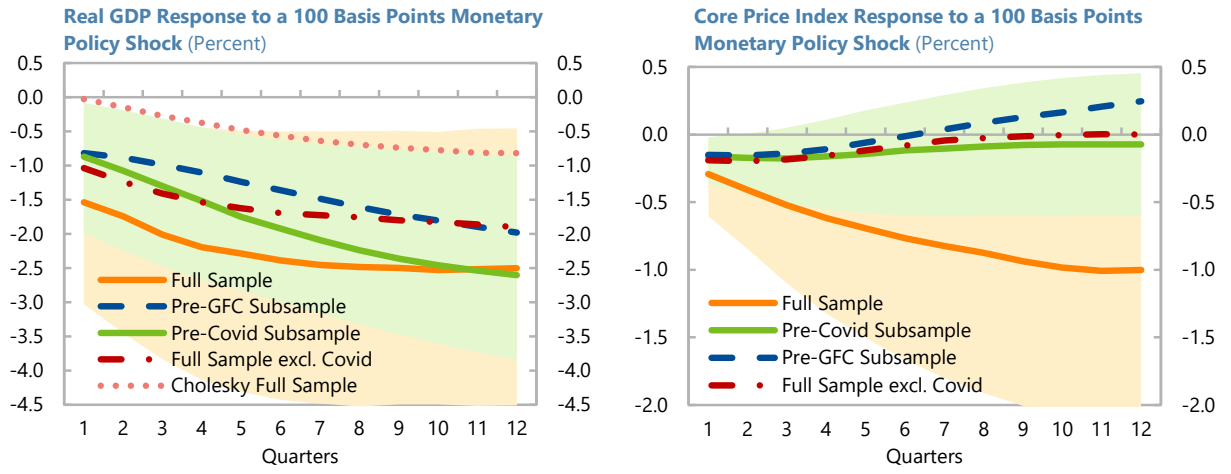
[2] The full sample excluding Covid (red dashed line) puts limited weight on the Covid period (see Lenza and Primiceri, 2023), while the Full Sample (orange line) includes Covid dummies as indicated above.

[3] Historical decompositions allow us to understand the effects of different shocks (and their lags) together in the system, rather than in isolation as when looking into impulse response functions. For example, this can justify the positive contributions seen from the real monetary policy shocks to growth and inflation in 2022 and 2023 considering the long real accommodative stance of monetary policy and its lagged effects.

[4] Transmission is defined as the ratio of the cumulative sum of negative contributions to growth or inflation that have already occurred to the total cumulative sum of negative contributions that have occurred and are expected to occur.

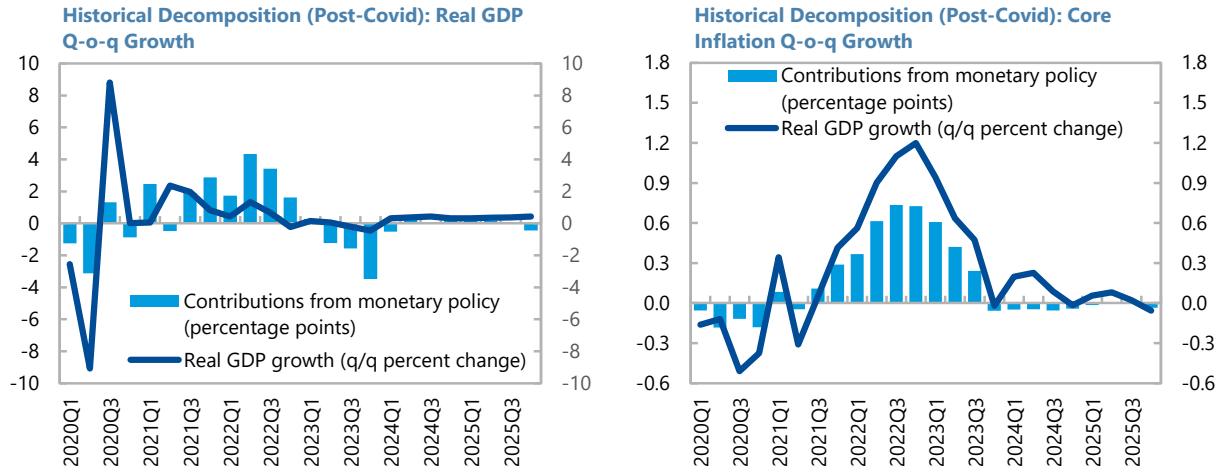
pipeline.[5] To better understand the longer lags in monetary policy transmission to core inflation compared to GDP growth, in the next sections we look at the role for two potential channels: market interest rates faced by agents and the inflation expectations formation process.

Annex II. Figure 1. Euro Area: BVAR Impulse Response Functions to a Monetary Policy Shock



Source: IMF staff calculations.
Note: The green and orange shaded areas reflect the confidence bands for the pre-covid subsample and full sample respectively

Annex II. Figure 2. Euro Area: BVAR Historical Decompositions



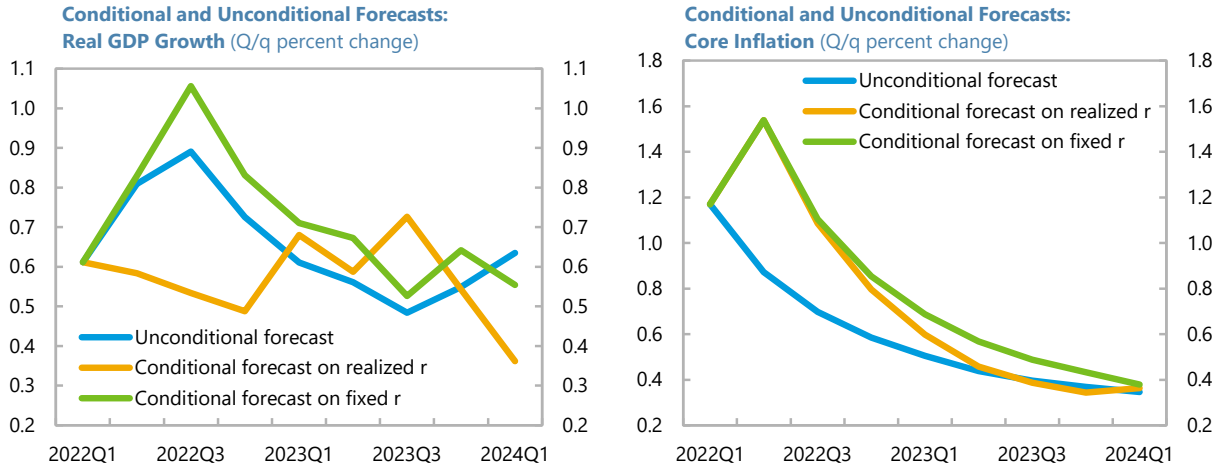
Source: IMF staff calculations.

4. The ECB's monetary policy action on average has been able to dampen demand (Figure 3). A comparison of model unconditional forecasts to conditional forecasts shows that

[5] The historical decompositions and conditional forecasts for growth and core inflation are based on the same BVAR approach described earlier, with the only difference that it shows the contribution of real monetary policy shocks. Using the real rate generates stronger results. At the same time, results on the size of the contribution coming from monetary policy versus supply and demand depend on the estimated sample, Covid period treatment and inclusion of other exogenous variables.

monetary policy transmission has been on average stronger, in particular for growth but somewhat for inflation as well, compared to a scenario of the ECB taking no action.

Annex II. Figure 3. Euro Area: BVAR Conditional and Unconditional Forecasts



Source: IMF staff calculations.

Pass Through to Market Interest Rates

5. We find that monetary policy pass-through to market interest rates has been weaker for some rates compared to historical tightening.[6] Table 1 shows the channels through which monetary policy pass-through works to other interest rates.

- The post-pandemic tightening cycle has been more rapid and of a larger magnitude than the comparator cycle. The cumulative policy rate increases in the post-pandemic cycle amounted to a cumulative 450 bps, compared to 175 bps in the comparator cycle. In addition, the pace of the increase averaged around 45 bps per month, compared to 25 bps per month.
- More and faster tightening was accompanied by weaker pass-through per percentage point increase in the policy rate (Figure 4) when looking the beta ratios of the two tightening cycles, especially for deposits and mortgages.[7]
- This is also confirmed when looking into the IRFs within a local projections model which compared the transmission in the two cycles (Figure 5).[8] For NFC loans instead, there is no evidence of a difference in the transmission compared to earlier tightening episodes.

[6] A past tightening cycle with the largest policy rate increase covered by the data is referred as the 'comparator cycle.' For the ECB, the comparator cycle covers the Jan. 2006–Sept. 2008 pre-GFC monetary policy tightening.
[7] The beta ratios refer to the ratio of the pass-through of the two tightening cycles. Betas are defined as the ratio of the cumulative increase in bank interest rates to the cumulative increase in the policy rate.

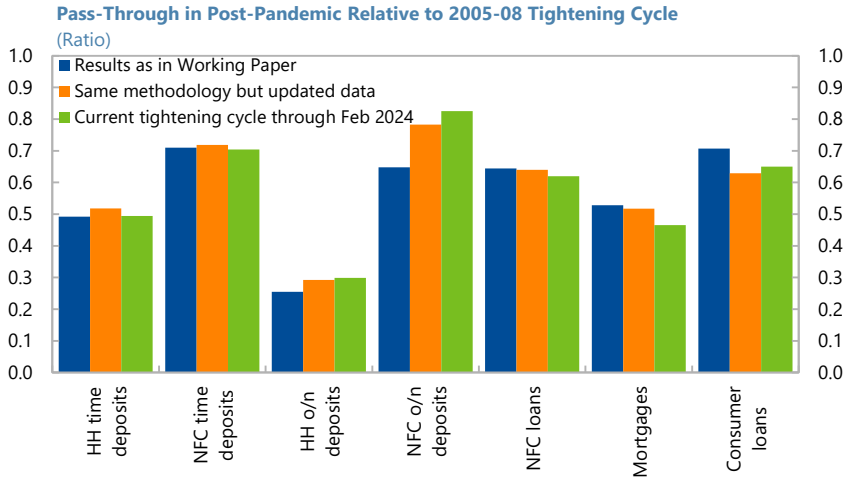
[8] Following Jorda (2005), this analysis looks into the speed of pass-through of the policy rate change into changes into lending and deposit rates. IRFs are estimated for policy rate hikes (month over month increase in monetary policy rates) and compare the post-pandemic cycles to the previous tightening cycle. For more details on the specification see Beyer et al. (2024).

Annex II. Table 1. Euro Area: Effects of Monetary Policy Pass-through to Bank Interest Rates

Channels that directionally weaken the effects of monetary policy tightening shown in orange

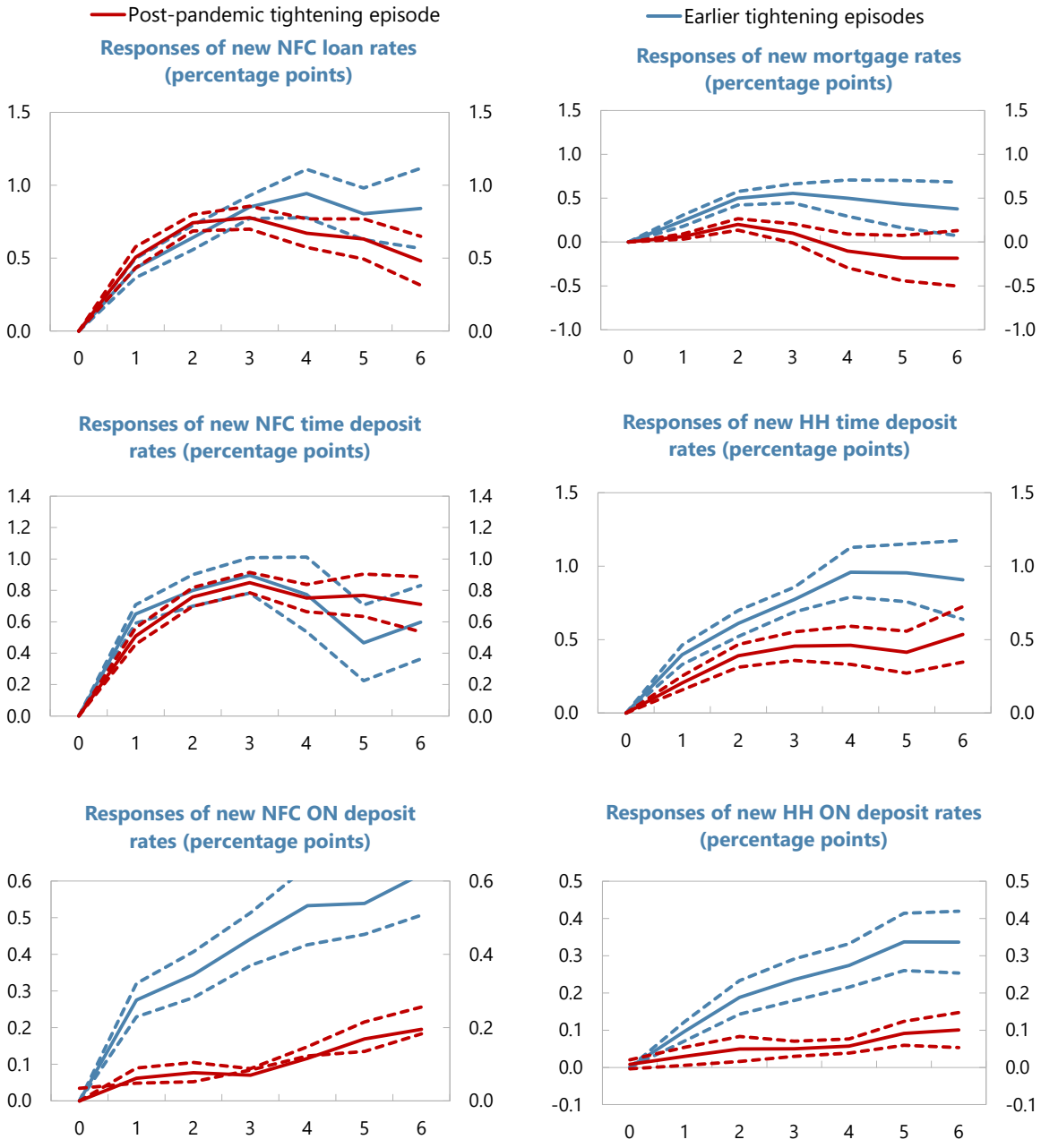
Channels of MP transmission	Mechanism of channel during MP tightening	Effects of higher pass-through during MP tightening	
		Effects of higher pass-through to loan rates	Effects of higher pass-through to deposit rates
Interest rate channel	Higher hurdle rate for new investment	Less investment	More saving → Less consumption
Cash flow channel	Higher interest income and debt services cost for existing exposures	Lower cash flow → Less consumption and investment	Higher cash flow → more consumption and investment
Balance sheet channel	Lower value of collateral	Tighter non-price credit conditions → Less investment	
Banking channel	Lower banks' net worth	Tighter bank funding conditions → Less lending	
	Higher cost of bank funding		More supply of deposits → More lending

Annex II. Figure 4. Euro Area: Interest Rate Pass-through to Market Interest Rates



Source: IMF staff calculations.
Note: Results as in Working Paper refers to the results of Beyer et al. (2024).

Annex II. Figure 5. Euro Area: Impulse Response Functions to an Interest Rate Shock



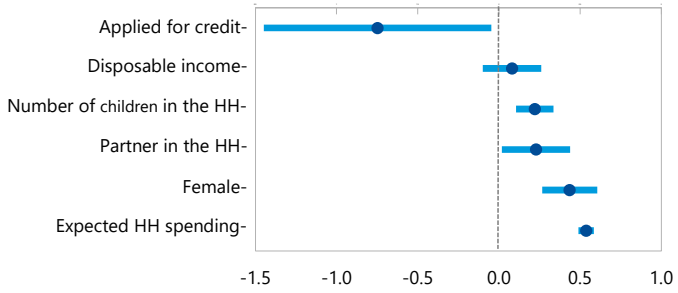
Source: IMF staff calculations.

What Role for Monetary Policy? Household Level Analysis

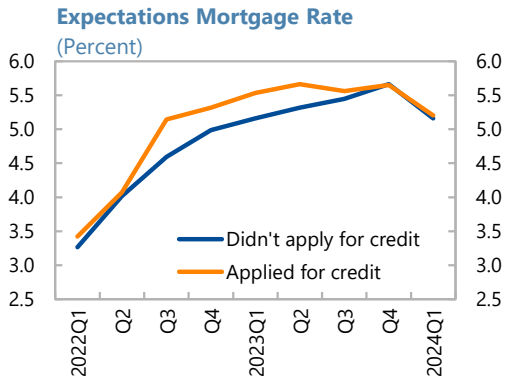
6. Tightening monetary policy might have also contributed to the weakness in private consumption. The section exploits household level data from the ECB Consumer Expectations Survey to study the effect of monetary policy on household consumption decisions, accounting for individual level characteristics and comparing households who applied for credit during the tightening period with those who did not.

7. Individual-level regressions show that borrowers decreased their consumption more than non-borrowers in 2022-2023. This suggests that the tightening in monetary policy recently also played a role in dampening private consumption. The impact of monetary policy can also be seen in the evolution of household expectations for mortgage rates, with the individuals who applied for credit expecting higher mortgages rates during the 2022Q2 and 2023Q3 period. Going forward, consumption should be boosted, as households expect interest rates to go down.

Annex II. Figure 6. Euro Area: Role of Credit in Household Spending



Sources: ECB Consumer Expectations Survey; and IMF staff calculations
Note: the regression includes survey waves fixed effects and the standard errors are clustered at the country level. The sample include 2022-2023.



Sources: ECB's Consumer Expectation Survey: and IMF staff calculations.

Expectations Formation

8. The previous analysis suggested that sticky core inflation cannot be explained by weaker monetary policy pass-through to interest rates. In fact, the faster policy rate tightening in the current cycle has resulted in a weaker pass-through relative to the past for most lending rates. The weaker pass-through—relative to the past—for deposit rates should strengthen the effect of monetary tightening on inflation reduction through greater pressure on incomes, although substitution effects (between savings and consumption due to lower deposit rates) could somewhat weaken the channel.

9. In this section, we look at the implications of a more backward-looking inflation expectations channel. In the current juncture, while long-term inflation expectations have been well-anchored, short-term expectations (in particular, household expectations) have drifted up and shown more stickiness. This raises questions about whether expectations formation may become more backward looking, influenced by previous high inflation prints (see also October 2023 WEO Chapter 2).

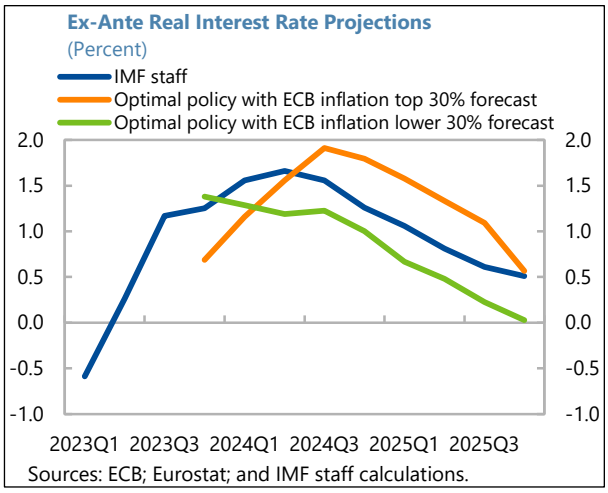
10. We therefore assume that agents update their beliefs about the underlying economic relations when new data becomes available through a learning mechanism (also known as adaptive learning). The analysis can be regarded as determining a risk-resilient monetary policy stance that accounts for potentially adaptive expectations behavior by economic agents. The model assumes that economic agents form their expectations based on a simple statistical model, rather than the standard rational expectations assumption. It extends the standard dynamic stochastic general equilibrium model with expectational learning by Alvarez and Dizioli (2023) and includes

price and wage Philips curves (relating price and wage inflation to expectations, the gap between real wages and productivity, and economic slack), an IS curve (relating output to the nominal interest rate and inflation expectations), and a monetary policy function. In addition, it considers heterogeneous agents, a mix of backward- and forward-looking learners with different information sets. Backward-looking learners form their expectations based on recent events, while forward-looking form their expectations rationally based on full information about the economy, including the share of backward-looking learners. As the share of backward-looking learners increases, it means that the forward-looking ones will act more as backward-looking. As a last assumption, the model considers that near-term inflation expectations are influenced by long-term inflation expectations, and vice versa.

Optimal Monetary Policy

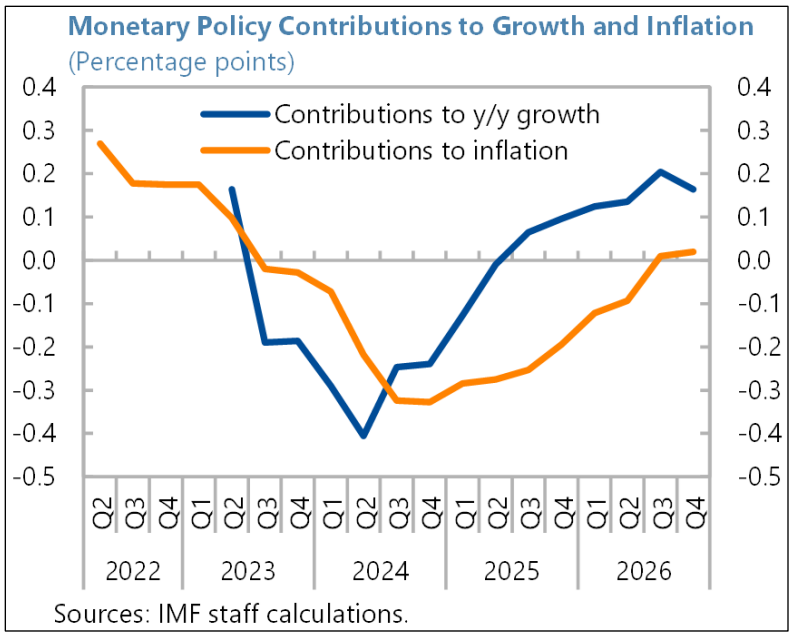
11. In the estimated model, the central bank has three channels to influence inflation. The standard direct channel in which a tighter policy cools demand, lowering the output gap and hence inflation. The other two channels operate through inflation expectations. By tightening policy, the central bank lowers current inflation that enters the forecasting equation, lowering next period expectations. Finally, the central bank can also affect the agents' learning. By seeing lower-than-expected inflation in a given period, households update their model of how past inflation matters for future inflation.

12. The optimal monetary policy path is defined as the interest rate path in which the central bank minimizes its loss function. This is a function of the output gap and inflation deviations from the 2 percent target. Other implicit assumptions are that the central bank has full knowledge of the current shocks hitting the economy, knows all the future shocks that will hit the economy, and has full knowledge of how its actions impact expectations. Moreover, it is assumed that the real neutral rate is 0.5 percent. Considering staff's projections for GDP and inflation up to 2025Q4, and data outturns until 2023Q4, the model's conditional forecast suggests that monetary policy should stay on hold until 2024Q1, before reversing slowly from 2024Q2 (text figure). To check the uncertainty around this baseline scenario, this annex uses the ECB's forecast published in March 2024. In particular, the ECB publishes a 30 percent band around its baseline forecast for inflation. Using this band, the optimal monetary policy is derived under these alternative inflation paths. The result from this exercise shows that staff's monetary policy baseline is broadly at the middle of the range, suggesting balanced risks to our inflation and monetary policy paths. It is important to highlight that this path is dependent on the assumed neutral rate position, which is still highly uncertain given several recent large structural shocks.



13. This model can be used to assess the contribution of monetary policy to growth and inflation. The standard way to use a DSGE model for a historical decomposition only measures the non-systematic contributions from monetary policy. In other words, it only measures the shocks to the monetary policy reaction function. However, one might want to assess the whole contribution from monetary policy, which would include the systematic response too. The way to calculate that depends on building a proper policy counterfactual. Of course, this decomposition is counterfactual dependent but at least partially incorporates the role of the systematic response from monetary policy. This annex assumes that the counterfactual is for the ECB to keep its policy rate at a neutral level since 2021Q1 throughout the forecasting period. That is, the ECB abandons the estimated monetary policy reaction function and just keeps the ex-ante real interest rate at the estimated neutral level. In particular, the neutral rate moves linearly from -1.1 percent at the beginning of 2021 to 0.5 percent at the end of the forecast horizon. The way that this is implemented is through interest rate shocks, that is, agents interpret policy decisions as shocks to the monetary policy reaction function. The total contribution from monetary policy is then estimated after simulating a path for monetary policy and subtracting the outcomes for growth and inflation from the ones derived when the central bank follows this counterfactual.

14. Monetary policy is expected to contribute decisively to bring inflation back to target in the second half of 2025. Using the counterfactual detailed in the previous paragraph, and considering staff's projections for GDP and inflation, and the previously derived optimal path for monetary policy, the model predicts that the peak effect on year-over-year growth will be reached in the second quarter of 2024 at around 0.4 percentage points. After that, the projected easing of monetary policy should start positively contributing to growth from 2025Q2 and reaching a peak of 0.2 percentage points in 2026Q3. Regarding inflation, the peak effect of monetary policy on inflation is reached later in 2024Q3 at -0.3 percentage points, and it continues to contribute negatively to inflation all the way to 2026Q3. In other words, without the contribution from monetary policy, inflation would not be back to target before 2026. It is important to highlight that this exercise uses the euro area short-term policy rate to assess the monetary policy contribution and hence does not capture forward guidance that policy makers have been using in the last two years. Longer-term rates started to tighten sooner than short term rates and already started to ease. This suggests that the peak effects of monetary policy could have been earlier than suggested in this exercise had forward guidance been included.



Sources: IMF staff calculations.

References

Alvarez, Jorge, and Allan Gloe Dizioli, 2023. "How Costly Will Reining in Inflation Be?" IMF Working Paper No. 23/21. International Monetary Fund.

Beyer, Robert, Ruo Chen, Claire Li, Florian Misch, Ezgi O. Ozturk, and Lev Ratnovski, 2024. "Monetary Policy Pass-Through to Interest Rates: Stylized Facts from 30 European Countries." IMF Working Paper No. 24/09. International Monetary Fund.

International Monetary Fund, 2023. "Managing Expectations: Inflation and Monetary Policy." *World Economic Outlook*, Chapter 2, October 2023.

Lenza, Michele, and Giorgio E. Primiceri, 2022. "How to Estimate a Vector Autoregression After March 2020." *Journal of Applied Econometrics* 37, no. 4: 688-699.

Annex III. Reformed European Economic Governance Framework

1. The new EU economic governance framework, which entered into force on April 30 2024, is aimed at promoting sustainable public finances while encouraging growth-enhancing reforms and investments. Countries facing long-term fiscal risks are required to submit adjustment plans that have a high likelihood of restoring fiscal sustainability and are gradual and realistic, while allowing countercyclical policy. In line with this, member states with deficits or debt levels exceeding the framework's reference values—currently 17 of the 27 EU member states—are asked to agree with the Commission and the Council a fiscal-structural plan, relying on net primary expenditure as the single operational indicator.[1] The implementation of this plan will be monitored through annual progress reports, allowing the Commission to verify compliance. The baseline adjustment period is four years. However, countries committing to structural reforms and investments that enhance economic resilience/potential growth or strengthen fiscal sustainability can be allowed to extend the adjustment period to seven years, thereby reducing the pace of annual fiscal adjustment.

2. Restoring and entrenching fiscal sustainability—the primary objective of the framework—is specified along two dimensions: (i) a debt criterion—public debt should be plausibly placed on a downward path, or, if already below the Treaty reference value, maintained at prudent levels; and (ii) a deficit benchmark—fiscal deficits should, if high, be reduced and subsequently be kept moderate.

- The debt criterion is assessed based on a debt-sustainability analysis (DSA) covering a 10-year post-adjustment debt trajectory phase during which—for the sake of the analysis—the primary fiscal balance is assumed to be constant, with the exception that aging-related costs are added. The DSA—using an established methodology—examines the evolution of debt under various prespecified scenarios and shocks (e.g., lower GDP growth or higher fiscal deficits). In the DSA, if debt is above 60 percent of GDP it should decline with a high probability. If below 60 percent of GDP, it should not exceed this threshold.
- The deficit benchmark requires that, by the end of the adjustment period, the fiscal deficit is below 3 percent of GDP and projected to remain below this level for the entire10-year debt trajectory phase.

3. In addition to the debt criterion and the deficit benchmark, the framework includes two minimum adjustment safeguards. According to a debt sustainability safeguard, over the adjustment period the debt-to-GDP ratio should fall on average by no less than 1pp of GDP annually if debt is above 90 percent of GDP and 0.5pp of GDP annually if debt is between 60 and 90 percent of GDP. According to the deficit resilience safeguard, if the general government structural balance is less than –1.5 percent of GDP, the annual improvement of the structural primary balance should not be less than 0.4pp of GDP for countries with a four-year adjustment period, and 0.25pp for those with a seven-year adjustment period.

[1] Defined as general government expenditure, net of interest expenditure, discretionary revenue measures, expenditure on EU programs fully matched by EU funds revenue, national expenditure on co-financing of programs funded by EU, cyclical elements of unemployment benefits, and on-offs and other temporary measures.

4. Member states that violate the fiscal requirements under the framework—either by having a general government deficit exceeding 3 percent of GDP or by failing to implement the agreed net expenditure path—can be placed in an Excessive Deficit Procedure (EDP). Unless the adjustments agreed in the medium-term fiscal-structural plan are higher, in an EDP the country is required to make a minimum annual improvement of the structural fiscal balance of 0.5 percent of GDP. Although the minimum adjustment is generally defined in terms of the structural balance, as a transition measure, during 2025–27 it can be adjusted to take into account higher interest expenses. During the time a country is in the EDP, it is excluded from the annual debt-reduction requirement under the debt sustainability safeguard.

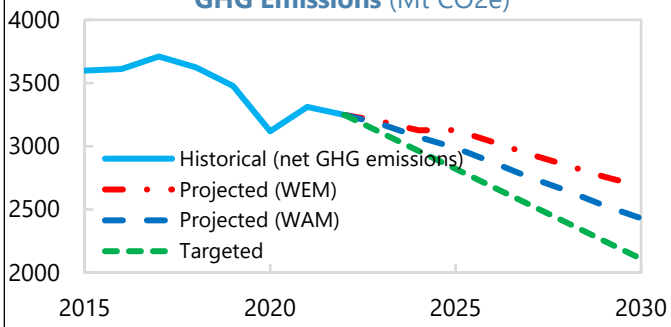
5. The reform also includes requirements on national budgetary frameworks—including medium-term fiscal planning—analysis of macro-fiscal risks, and country-specific numerical fiscal rules. Member states are also required to ensure the existence of independent fiscal institutions with sufficient competence, autonomy, and resources. These institutions should—at a minimum—be tasked with macroeconomic forecasting, fiscal rules monitoring and evaluation of budgetary frameworks. Member states are required to comply with the recommendations of the assessments of the independent fiscal institutions or provide a public explanation of why they do not.

Annex IV. Achieving the Green Transition in Europe: Proposal for an EU Climate and Energy Security Facility

An EU level instrument—a Climate and Energy Security Facility (CESF)—that could help to finance more cost-efficient emission reducing investments—and correspondingly reallocate emissions reduction targets across sectors and countries—could reduce the aggregate cost of achieving the EU's climate change mitigation goals. Introducing a CESF that allows for a more cost-effective allocation of emission cuts, reduces the total investment costs by 7 percent. Based solely on the additional annual investment estimate of €480 billion a year until 2030, this would translate into a reduction in costs of at least €235 billion over 2024-30.

1. The EU has been a leader on climate policies to reduce greenhouse gas (GHG) emissions. The introduction of the Emissions Trading System (ETS) for GHG emissions from the power and large industry sectors was a historic step toward reducing emissions. More recently, the EU committed in 2021 to the ambitious goal of reducing its net GHG emissions relative to 1990 levels by 55 percent by 2030 and achieve net zero by 2050. The set of legislative proposals and initiatives to achieve the 2030 target is known as the "Fit for 55" package.

Annex IV. Figure 1. Euro Area: EU-27 Total Net GHG Emissions (Mt CO2e)



Source: European Environment Agency (EEA); and IMF staff calculations.
Note. 'Projected (WEM)' shows EEA projections "with existing measures" and 'Projected (WAM)' is "with additional measures" planned but not implemented. 'Targeted' is a linear interpolation between 2022 and the 2030 target of 55 percent emissions cut (vs. 1990 levels).

2. But is at risk of missing its emissions targets. However, projections from the European Environment Agency (EEA) from 2023 show the EU falling short of meeting the 2030 target by between 5 and 15 percentage points, depending on whether additional national measures are taken into account (Figure 1).[1] Moreover, in February 2024, the Commission proposed a 90 percent net emissions reduction by 2040 (relative to 1990 levels). This still needs to be negotiated, but if adopted, it would be an ambitious goal. The European Commission estimates the additional annual investments needed would increase further after 2030 (European Commission, 2024). This could increase the risk the goal would not be met.

3. Some of the difficulties in meeting the targets stem from the different emission reduction policies between sectors covered by the ETS and those covered by the Effort Sharing Regulation (ESR). The ETS provides a carbon price for the sectors it covers (about 40 percent of EU emissions). Other sectors, including transport, buildings, small industry and agriculture, are covered by the ESR. This regulation sets annual national limits for the total emissions

[1] EU member states lag even further in meeting targets for the share of renewables in the energy mix (42.5 percent) and for energy efficiency, which would require more than tripling annual efforts in these areas compared to the period 2005-2022 (EEA 2023).

from the ESR sectors, but largely leaves choices on how to achieve emission reductions to the national level. The emission limits in the ESR are largely determined by GDP per capita, so many central and eastern European countries have to make proportionally smaller cuts to their emissions than richer countries. Countries produce National Energy and Climate Plans (NECPs) every 5 years that are meant to detail how they will achieve their targets, though the quality and detail of NECPs vary. A new ETS 2 for the fuels for road transport, building and small industry sectors will be introduced in 2027, but if the price exceeds €45 per ton, additional emissions allowances will be released, weakening its impact on incentives to invest in reducing emissions in those sectors.

4. Better coordination and financing at the European level could help ensure the EU meets its emission reduction goals at lower cost, as well as improve its energy security.

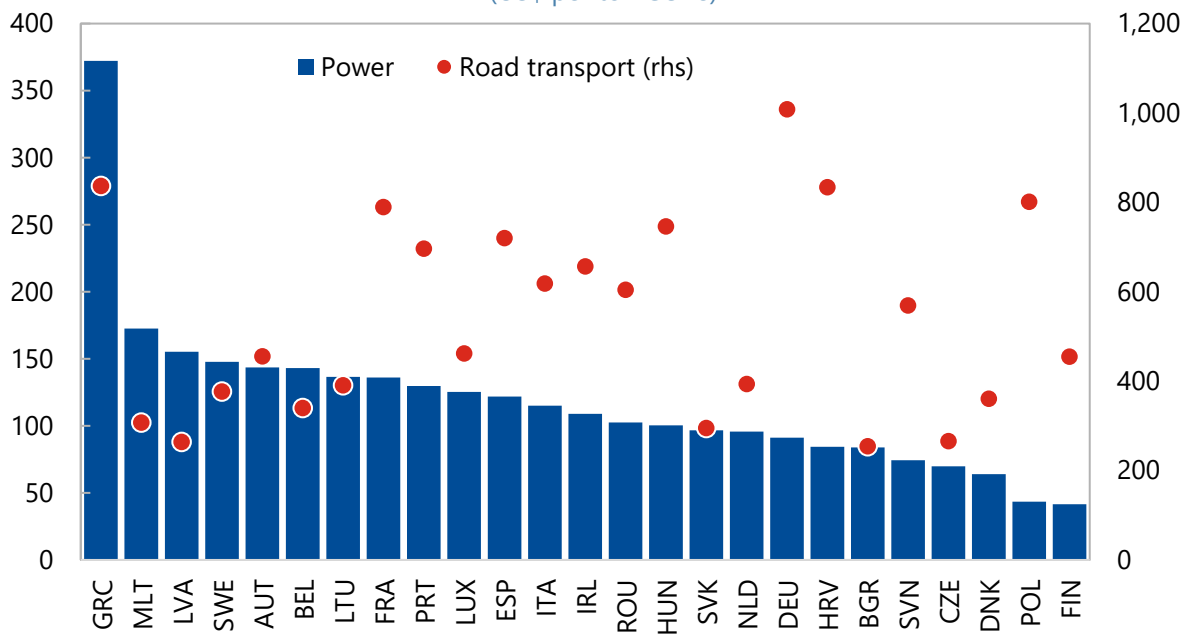
- *Information and coordination.* NECPs serve as a weak coordination mechanism for reducing emissions and they do not take a consistent approach to estimating investment needs and the impact of policy measures (Pisani-Ferry and others 2023). The EU needs a more comprehensive, cross-country consistent assessment of investment needs at the country-sector level, in part to identify where the most cost-efficient emission reduction investment opportunities are.
- *Investment needs and financing.* At the aggregate EU level, the EU's 2030 target is estimated to require additional public and private sector investments of around €480 billion a year until 2030 compared to average 2011-20 investments (European Commission 2023). Assuming about one-quarter of this would need to come from the public sector, this puts further pressure on budgets already strained by higher interest rates and growing aging related costs. Hence, devising a cost-efficient public investment strategy that can achieve progress toward the 2030 goals (and beyond) is paramount. An EU level instrument that could help to finance more cost-efficient emission reducing investments—and correspondingly reallocate emissions reduction targets across sectors and countries—could reduce the aggregate cost of achieving the EU's climate change mitigation goals.
- *Cross-border infrastructure and common public goods.* It is well known that reducing GHG emissions is a challenge beset by externalities, which is why climate policy is a shared competence between the EU and member states. However, there are other areas where coordination problems, economies of scale, and externalities suggest a need for a greater EU role. This includes cross-border electricity grid infrastructure, R&D, and public sector support for clean-tech industries under the Green Deal Industrial Plan (GDIP).
- *Energy security.* Europe is a net fossil fuel importer and, as the sharp cuts in Russian gas after the invasion of Ukraine showed, the EU is vulnerable to supply shocks in the oil and gas markets. Dolphin and others (2024) show that achieving the EU's climate goals would also improve its energy security, as energy production would shift from imported fossil fuels to domestic renewables. Increasing grid interconnectors between countries is an important part of improving energy security as well.

5. An EU Climate and Energy Security Facility (CESF) could help to address the challenges Europe faces in meeting its climate and energy goals, starting with information and coordination issues. The first goal of such a facility would be to close information gaps and improve coordination amongst member states with the aim of delivering a more cost-effective

green transition. This would require devoting sufficient resources at both the EU and national levels to developing more granular estimates of investment needs and abatement costs at the country-sector level, and potentially down to the project level. Identifying the most cost-effective investments for abating GHGs should inform NECPs and would be the foundation for other parts of the CESF. In particular, it would help determine how much scope there is for reaping gains from reallocating emission reduction targets across sectors and countries.

6. With a financing instrument, the CESF could help deliver the EU's green transition more cost effectively than strictly national funding. There can be significant differences in emissions abatement costs across countries and sectors (Figure 2). This can be exploited over a given time period to achieve a more cost-effective allocation of investments and emission reductions than current targets. These potential gains, especially across borders, are not internalized by national policymakers, which calls for an EU-level instrument. While there is technically an option to trade ESR emissions between countries, there is no mechanism to facilitate this, which the CESF could address.

Annex IV. Figure 2. Euro Area: Abatement Costs: Power and Road Transport Sectors
(US$ per ton CO2e)



Sources: European Environment Agency; Eurostat; IMF CPAT; Statista; and IMF staff calculations.
Note: Abatement costs for the power sector are based on the weighted average capital cost of replacing in a country all coal and one quarter of natural gas generation with the existing renewables mix. Road transportation abatement costs are estimated with the CPAT vehicles module and reflect the cost under enacted policies (e.g., fuel economy standards, fuel duties) in each country.

7. The CESF could help to finance investments that are cheaper per ton of CO2 abated, while facilitating the reallocation of emissions reductions across sectors and countries. This reallocation could give sectors/countries where abatement costs are higher due to supply constraints (e.g., skilled labor to renovate houses) or insufficiently developed alternative technologies (e.g., agriculture) longer to reduce their emissions, providing more time to overcome

constraints or develop new technologies. Importantly, in the absence of a single carbon price across sectors, it could effectively serve as a mechanism for reallocating emissions between the ETS and ESR sectors. Finally, as seen with the Recovery and Resilience Facility (RRF), CESF financing could be a carrot to incentivize national policies needed to meet emission reduction targets (e.g., cutting fossil fuel subsidies, streamlining permitting).

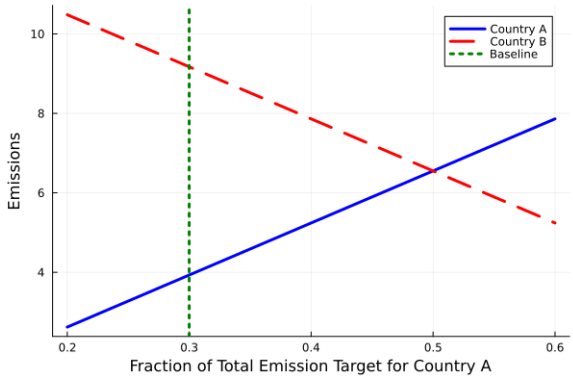
8. To assess the potential gains from introducing a CESF, we develop a simple multi-county model.[2] The model includes a power sector, where electricity can be produced by either renewables (capturing all non-GHG emitting technologies, including nuclear) or fossil fuels that create emissions. It also includes a final goods sector that produces using both electricity and fossil fuels (e.g., for transportation, heating, industrial processes), which is modeled with a constant elasticity of substitution (CES) function. As the emissions target becomes more stringent, initially most of it is met by shifting electricity production from fossil fuels to renewables. The "shadow cost" of emissions rises as the emissions target tightens, but in a linear fashion with a shallow slope. As the emissions target becomes more stringent, electricity is entirely produced by renewables and the final goods sector begins to quickly reduce its direct consumption of fossil fuels. Given the CES function for the use of electricity and fossil fuels in production, this implies a more rapidly rising cost of emissions reduction as the emissions target gets tighter. The "shadow cost" of emissions approximates a rising marginal abatement cost curve across the power and non-power sectors.

9. An EU CESF is then added to the model to assess the potential impact of having such an instrument to reallocate emission reductions across countries. In the simplest two country version of the model with an uneven allocation of the aggregate emissions reduction target across the two countries, the optimal allocation of emissions reductions is achieved at the point where the shadow cost of emissions is equalized across the countries (Figure 3). The CESF facilitates this by allowing the country with the tighter emissions reduction target (country A) to ease that requirement by making a payment to the CESF. The CESF in turn pays the country with the looser emission reduction target (country B) to accept a tighter one and reduce its emission more. Even when the countries are identical, given that they will be at different points on the curve for the shadow cost of emissions, which is non-linear for part of the emissions allocation, the price that country A is willing to pay exceeds the price country B would need to receive to reduce emissions more until the emissions allocation is equalized. This generates a surplus that can then be distributed between the two countries, making both better off (i.e., it is Pareto improving). Keeping the aggregate emissions constraint constant, if the emissions constraint for country A is eased without the CESF mechanism, then country B is made worse off.

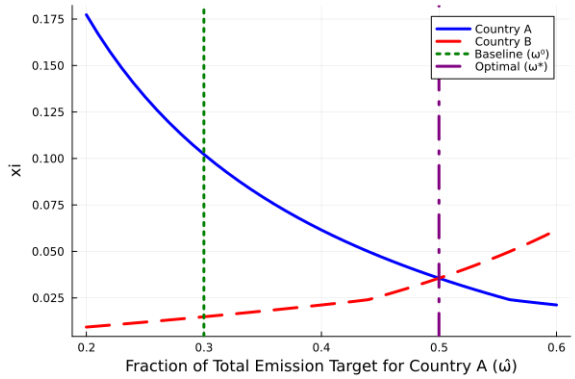
[2] For a full description of the model and simulations see Arnold and others (forthcoming).

Annex IV. Figure 3. Euro Area: Illustration of Model with Two Countries

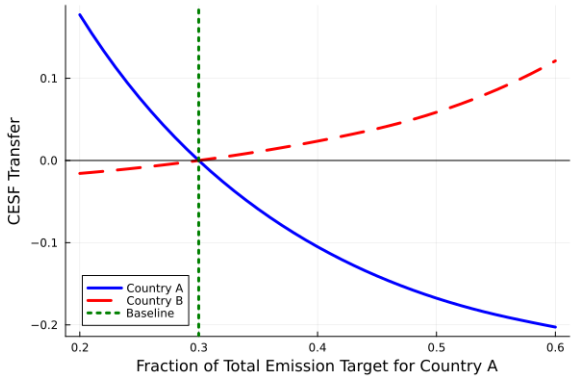
The initial allocation of emissions is uneven, with country A having less (0.3 of the total) than country B.



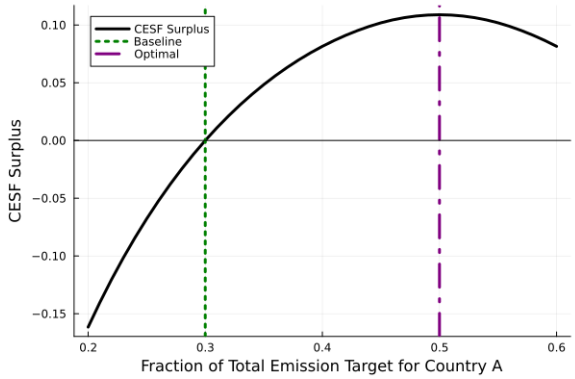
At this allocation the shadow cost of emissions is high for A and low for B, while they are equal at the optimum.



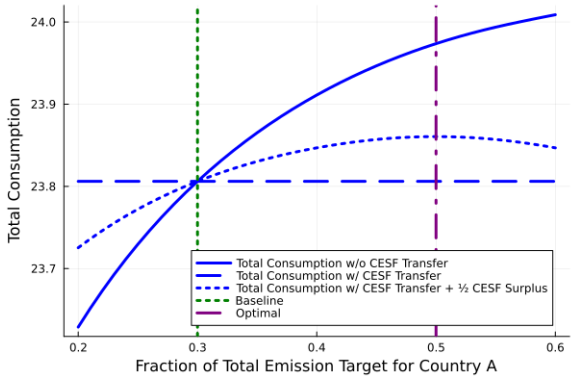
The curve represent what A (B) would be willing to pay to (receive from) the CESF to loosen (tighten) the emissions constraint and remain indifferent in terms of welfare.



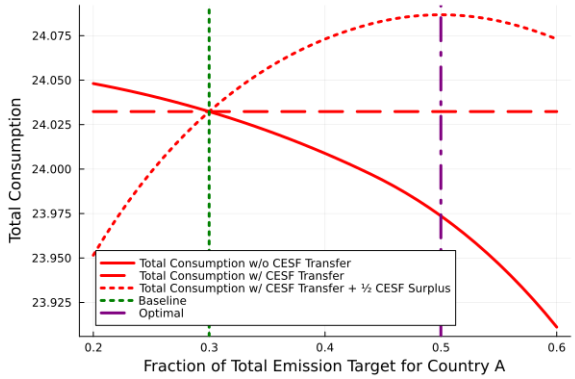
Since A is willing to pay more than B would need to receive, the surplus is maximized at the optimum.



Consumption remains constant for A where it pays the CESF as above (dashed line) but is improved when it receives part of the CESF surplus (dotted line).



B is indifferent if receiving funds from the CESF as in the third figure panel (dashed line), but consumption increases if it receives part of the CESF surplus.



10. The model is calibrated to the EU's aggregate 2030 emission reduction target for the four EU countries with the largest emissions and a block representing the rest of the EU. The calibration takes as a starting point the 2021 emissions of the four countries with the largest emissions and groups the rest of the EU countries into a single block. It then approximates their overall emissions reduction target for 2030. For the individual countries, the baseline emissions reduction targets are a combination of the country's ESR target and an estimated share of the target for the aggregate ETS emissions in 2030. The rest of the EU emission 2030 target is calculated as the difference between the aggregate EU target and the sum of the four individual countries emissions targets in 2030. There are differences in the stringency of the emission reduction targets for 2030 and in the starting positions of countries, particularly in terms of renewable vs. fossil fuel electricity generation. Hence, countries start off at different points on their abatement cost curves and, under the baseline, move to different points on the cost curves in 2030.

11. Illustrative simulations suggest potentially meaningful gains from the introduction of a CESF. Simulations of the calibrated model with the four largest emitters and rest of EU block find that introducing a CESF that allows for a more cost-effective allocation of emission cuts, reduces the total investment costs by 7 percent. Based solely on the *additional* annual investment estimate of €480 billion a year until 2030, this would translate into a reduction in costs of at least €235 billion over 2024-30. This result is derived from a fairly simple model, so should be considered an approximation of the potential size of the gains from a CESF. But the size of the benefits suggests that it would be worth exploring further how the CESF would work in a more sophisticated modeling framework.

12. The CESF could also be the overarching instrument through which the EU plays a greater role in cross-border energy infrastructure, R&D, and public support for clean-tech sectors. There is growing recognition of the need to upgrade the electricity grid to accommodate the increasing electrification of energy consumption and manage the intermittency of renewables across wider regions (IEA, 2023). Cross-border grid interconnectors are an important part of this and one area where the EU could play a greater role to help resolve coordination failures between countries and internalize externalities. As energy policy is primarily a national competence, being able to provide financing for new interconnectors or absorb some of the cost, may be critical to incentivizing member states. There is also a strong case for pooling more resources to invest in R&D, which has positive spillovers, at the EU level, particularly to develop new technologies for sectors where emissions abatement is currently very costly. In general, existing EU budget instruments focused on facilitating the green transition, including for investments and R&D, should be aligned with or brought into the CESF. Finally, the recent push to support clean-tech sectors with national level subsidies risks being fiscally costly and distorting the Single Market. Where warranted, it would be better to provide such support through an EU level instrument.

13. The CESF could also internalize energy security objectives of both individual countries and the EU as a whole when pursuing emission reduction goals. The energy security objectives of the EU as a whole would be improved by reducing its reliance on imported fossil fuels, which doubled to over 5 percent of GDP in 2022 due to the energy price shock following Russia's invasion of Ukraine. However, some EU members still rely on coal fired generation for a sizable share of their

electricity, so phasing this out might technically cause a modest reduction in the energy security index measure used in Dolphin and others (2024). However, simulations show that these countries' energy security would still be improved, and the prices of electricity would fall as long as there is sufficient electricity market integration (see Box 1 in Dolphin and others, 2024), which the CESF could help to ensure.

References

Dolphin, G., R. Duval, H. Rojas-Romagosa, G. Sher (2024). The energy security gains from strengthening Europe's climate action. IMF Departmental Paper No. 2024/005, International Monetary Fund, Washington, D.C.

European Commission (2023). EU Climate Action Progress Report 2023. DG CLIMA, European Commission, Brussels.

European Commission (2024). Impact assessment report for Commission communication "Securing our future: Europe's 2040 climate target and path to climate neutrality by 2050 building a sustainable, just and prosperous society." European Commission Staff Working Document (2024) 63.

IEA (2023). Electricity grids and secure energy transitions. International Energy Agency, Paris.

Pisani-Ferry, J., S. Tagliapietra, and G. Zachmann (2023). A new governance framework to safeguard the European Green Deal. Bruegel Policy Brief September 23, 2023.

Annex V. Data Issues

Annex V. Table 1. Euro Area: Data Adequacy Assessment for Surveillance

Data Adequacy Assessment Rating 1/
A

Questionnaire Results 2/

Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	A	A	A	A	A	A	A

Detailed Questionnaire Results

Data Quality Characteristics						
Coverage	A	A	A	A	A	
Granularity 3/	A		A	A	A	
			A		A	
Consistency			A	A		A
Frequency and Timeliness	A	A	A	A	A	

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.
2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see IMF *Review of the Framework for Data Adequacy Assessment for Surveillance*, January 2024, Appendix I).
3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.

A	The data provided to the Fund is adequate for surveillance.
B	The data provided to the Fund has some shortcomings but is broadly adequate for surveillance.
C	The data provided to the Fund has some shortcomings that somewhat hamper surveillance.
D	The data provided to the Fund has serious shortcomings that significantly hamper surveillance.

Rationale for staff assessment. Staff assesses the overall data quality to be adequate for Fund surveillance. The economic and financial statistics from the ECB and Eurostat are comprehesively, of high quality, and are provided in a comprehensive manner. The calenars of dates for main data releases are published well in advance.

Changes since the last Article IV consultation.
In February 2024, the European Strategy for Environmental Accounts 2024-28 and the corresponding implemenation plan were endorsed by the European Statistical System Committee in Feburary 2024.

In March 2024, the European Central Bank (ECB) and European Banking Authoritity (EBA) established Joint Bank Reporting Committee to make data reporting by the banking industry more efficient. The new structure will harmonise and integrate reporting of statistical, supervisory and resolution data with the aim of developing common definitions and standards, and the process will involve all relevant EU bodies, as well as national authorities and banking industry representatives.

In March 2024, the ECB, EBA, and European Insurance and Occupational Pensions Authority signed the Memorandum of Understanding (MoU) on the establishment of a common Data Point Model (DPM) governance framework – "DPM Alliance", aimed at upgrading and maintaining the DPM Standard and the related maintenance tools, bringing together and leveraging the existing expertise on methodologies and metamodels, developing and promoting more efficient processes for defining and communicating reporting requirements, identifying, sharing and promoting good practices in the definition and exchange of regulatory reporting data and information.

Corrective actions and capacity development priorities.
None.

Use of data and/or estimates different from official statistics in the Article IV consultation.
The staff report uses third-party indicators directly (e.g., Orbis, Bloomberg, Migration Policy Integration Index) and indireclty through citing existing work.

Other data gaps.
Staff encourages continued efforts to advance the release of the first estimates of quarterly compensation data and explore the possibility of releasing monthly wage indicators.

Annex V. Table 2. Euro Area: Data Standards Initiatives

By May 2024, 16 euro area countries had already adhered to SDDS Plus and 4 euro area countries adhered to SDDS.

Annex VI. Authorities' Response to Past Key Policy Recommendations

2023 Article IV Recommendations	Authorities' Reponses
Monetary Policy	
Continue to tighten monetary policy and keep a tightening bias to forcefully tackle inflation and avoid policy surprises to help anchor inflation expectations.	The monetary tightening cycle that started in mid-2022 continued through 2023, with the ECB's main policy rate increasing to 4 percent. The policy rate had remained unchanged since September 2023, before the first cut in June 2024.
Fiscal Policy	
A tighter fiscal policy stance will help support monetary policy efforts.	Continued discretionary fiscal tightening helped to improve the fiscal balance in 2023 compared to 2022, albeit less than initially projected. Covid-era support measures and some of the energy crisis support programs were appropriately unwound, but interest payments were higher and some energy support measures were extended.
An agreement on the EU economic governance reform is a priority given medium-term fiscal challenges.	An agreement was reached, and a new EU economic governance framework came into force in April 2024.
Financial Sector Policies (Refer to Annex VII)	
Financial stability risks associated with rapidly rising interest rates should be closely monitored. Expanding macroprudential tools that limit leverage and liquidity mismatches in the NBFI sector and improving cooperation (including with respect to data sharing) between national regulatory authorities would help reduce systemic risk.	Discussions and proposals are ongoing. While interest-rate risk for banks is frequently monitored, more progress is needed to bridge data gaps for the NBFI sector while continuing to develop a macroprudential toolkit.
Further strengthen the EU's financial architecture, including through the ESM treaty ratification, agreeing on a European deposit insurance scheme, and making progress toward the CMU.	While discussions on identified priorities on CMU have increased (see Eurogroup statement in March 2024), more progress is needed.
Structural Reforms	
Actions to boost productivity are needed, including through tackling skill gaps, and better integrating immigrants to support growth, productivity and improve social outcomes.	Discussions and proposals are ongoing, including through high-level officials who are tasked to contribute with their reports and proposals to the EU plan of raising productivity, as well as strengthening the single market.
Further efforts to deliver the green transition while strengthening trade. Aligning carbon prices across sectors, and widening the scope of CBAM will reduce potential distortions in emission reduction incentives and help support global emission reduction.	Reforms and proposals on all fronts are ongoing. An array of legislation was adopted as part of the Fit-for-55 package, including on renewable energy generation, the introduction of a Carbon Border Adjustment Mechanism, the extension of the Emissions Trading System to the building and transport sectors, and the development of a Social Climate Fund. The EU has also reallocated loans to the REPowerEU from the Resilience and Recovery Facility (RRF) initiative to accelerate green energy investments and reduce reliance on Russian fossil fuels.

Annex VII. Implementation of Previous IMF FSAP Recommendations

Recommendation*	Timing**	Actions
Supervision		
Reduce the fragmentation of national legal frameworks for bank supervision (EU)	MT	The **Banking Package** includes measures designed to ensure more consistent supervision across the EU. The transposition of the Capital Requirements Directive (CRD) 5 published in 2019 is completed. All member states have finalized transposition; the Commission is carrying out the conformity assessments. In the area of suitability assessments of banks' directors and key function holders, the ECB adopted a single Fit and Proper questionnaire for all banks under its supervision to ensure that a standard set of information is provided in all SSM countries. The ECB also published a Guide to fit and proper assessments to provide the industry with further clarity on fit and proper assessments while sharing its expectations on this supervisory matter. Furthermore, the ECB implemented the IMAS Portal—the IT tool allowing banks to submit standardized fit and proper applications—and Heimdall—an IT tool to automatically identify inconsistencies with the ECB methodology and flag them to the supervisors—to enhance consistency across fit and proper assessments of banks supervised by the SSM. To provide clarity to the market, the ECB has already published a guide on banking consolidation and will publish this year a guide on qualifying holdings. A guide on licensing is currently under preparation and will be published next year. On June 19, 2024, the Union adopted the third revision of the Capital Requirements Regulation (CRR3) and the sixth revision of the Capital Requirements Directive (CRD6). The CRR3/CRD6 include the rules that the ECB had been advocating for: (i) harmonized provisions for the assessment of banks' directors and key function holders (fit and proper assessments); (ii) a common set of rules for branches of third-country banking groups operating in Member States will replace heterogeneous national approaches and strengthen the single market; (iii) further harmonization of national powers related to the mergers, acquisitions, transfers of assets or liabilities, as well as to the sanctioning regime, to ensure the consistency and robustness of the framework.
Revise legal provisions to close regulatory gaps with international standards (EU)	MT	The final elements of Basel 3 have been finalized with the CRR3/CRD6 package published on June 19, 2024. The Basel 3-finalization related provisions will enter into force from January 1st, 2025. There are transitional provisions allowing sufficient time for banks to adapt. Some elements of the legislative package will be regulated in greater detail with regulatory legal texts (technical standards). The application of capital requirements for market risk will be postponed from 1 January 2025 to 1 January 2026 through a new delegated act from the European Commission (still to be adopted).
Improve planning of supervisory resources (SSM)	ST	ECB Banking Supervision was reorganized in October 2020. The reorganization aimed at making the structure more agile and integrated. The reorganization

Recommendation*	Timing**	Actions
		brought the creation of one new business area (D-SSR) with a focus on strategy, risk analysis, and a second line of defense. The D-SSR/Strategic Planning Office is responsible for the set-up, implementation, and continuous improvement of the SSM planning process and its monitoring, as well as for the development of a comprehensive overview of activities and resources vis-à-vis priorities. It is also in charge of ensuring that the SSM strategy and processes are embedded in the ECB strategic planning process, while promoting a coordinated operationalization of SSM priorities. It also conducts the organizational readiness exercise for implementing SSM priorities and proposes the allocation of the SSM resource pool. The resources used for the ECB's supervisory tasks are financed via supervisory fees borne by the supervised entities (banking groups or stand-alone entities). The calculation of the fees is based on the total costs of the supervisory function which are separately identifiable within the ECB's budget. For the determination of the supervisory cost (and consequently the income from supervisory fees), a cost calculation model is used based on the Eurosystem's common cost methodology. The latter is based on the actual expenses of the financial year, not on the planned supervisory resources. The cost allocation is based on the actual direct cost and the allocation of the actual indirect costs using cost metrics (allocation of the cost based on Eurosystem Functions Grid, ESFG). Nevertheless, the ECB in its annual budget planning exercise applies a lean process to cost allocation and provides an early estimation of the supervisory fees using a number of assumptions, including the full consumption of the allocated budget, while the cost metric types applied are based on latest available information (year-end metrics of the previous year). Furthermore, several other actions have been taken to integrate and simplify SSM processes. As regards staffing the NCA leg of Joint Supervisory Teams, several improvements have been introduced in the annual staffing process. As part of the supervisory planning process, several tools have been introduced to support the organization's readiness for the implementation of priorities, including capacity building on critical areas.
Raise standards for handling of loan classification and provisioning (SSM)	ST	There were improvements in supervisory expectations on loan loss provisioning through: (i) the publication of the Addendum for new NPEs as of April 1, 2018; (ii) the SREP recommendations for the stock of NPEs as of March 31, 2018; and (iii) a new automatic Pillar 1 backstop for NPEs from newly originated loans as part of the EU Banking Reform package approved in 2019. In addition, at the onset of Covid-19 pandemic, a set of "dear CEO" letters was published communicating supervisory expectations among others on classification and provisioning aspects, which was followed by extensive assessment of compliance at an individual bank level, issuance of specific recommendations to banks, and follow-up by off-site supervisory teams to ensure any gaps to supervisory expectations are closed. Moreover, deep dives in the areas of forbearance, UTP and IFRS9 implementation have been conducted over the last two years and will also continue going forward. Lastly,

Recommendation*	Timing**	Actions
		training on these topics was provided to JSTs and dashboards for the monitoring of asset quality and provisioning were enhanced.
Improve coordination and information sharing regarding AML/CFT (ECB, national authorities)	ST	The cooperation between ECB Banking Supervision and AML/CFT supervisors has improved significantly. Since 2019 ECB Banking Supervision exchanges information on a continuous basis with national AML/CFT authorities in the EEA. This structured exchange is based on the multilateral agreement signed between the ECB and the respective AML/CFT authorities in 2019 (the AML Agreement), which has now 51 signatories. In addition, the ECB currently participates as observer in around 64 AML/CFT Colleges. the ECB and the AML/CFT authorities exchange information that are relevant for the completion of their respective tasks either on their own initiative or upon request. The information shared by AML/CFT authorities concerns in particular the ML/TF risk assessment performed by AML/CFT authorities, information related to AML sanctions and information related to subsidiaries that are perceived as high-risk from an ML/TF perspective. The ECB in return inter alia shares relevant excerpts of the annual SREP decisions, of on-site inspection reports and of breach reports. The information provided by AML/CFT authorities to ECB Banking Supervision directly feeds into the different ECB supervisory processes, in the SREP analysis (for all relevant SREP areas like business model, governance, operational risk, liquidity risk and credit risk), fit and proper (FAP) assessments and authorization procedures etc. In this context the ECB has, among others, taken SREP measures targeting the prudential root causes of ML/TF concerns, has imposed ancillary provisions to deal with ML/TF concerns in FAP and common procedures. The ECB has updated and enhanced its process and methodologies in line with legislation setting on how prudential supervisors should reflect ML/TF risks (e.g., EBA guidelines on the Supervisory Review and Evaluation Process – SREP GL) and applies since 2019 the "vigilant" approach in SREP and ongoing supervision. Thus, as a first step it identifies ML/TF concerns based i.e., on exchanges with AML/CFT supervisors, and as a second step it shares identified concerns with the relevant AML/CFT authority and where necessary it imposes remedial actions to address the prudential concerns (e.g., strengthen governance, reassess board members etc.).
Transfer supervision of systemic investment firms and third country branches to the SSM (EU)	ST	As regards systemic investment firms, the Investment Firms Regulation (IFR, Regulation (EU) 2019/2033) and the Investment Firms Directive (IFD, Directive (EU) 2019/2034) have been adopted by the European co-legislators on November 27, 2019. Both texts are in application since June 26, 2021. The new Investment Firm Regulation (IFR) and Directive (IFD) have introduced a multi-tiered regulatory regime for investment firms. Among other things, they require that the largest and more systemic investment firms (above €30 billion at solo- or group-level) and engaging in specific activities (dealing on own account or underwriting or placing financial instruments on a firm commitment basis) are authorized as credit institutions and, if the criteria for significance are met, fall under the direct supervision of the ECB. The new regulation entered into application in June 2021. Class 1 investment firms that have been authorized as credit institutions since then can be found in the list of supervised entities published on the ECB Banking Supervision website. A dedicated section for ECB's new permanent tasks in relation to the supervision of investment firms has been established within the Directorate General Systemic and International Banks.

Recommendation*	Timing**	Actions
		As regards third country branches (TCBs), a multilateral memorandum of cooperation between the ECB and NCAs of SSM participating Member States on the supervision of TCBs was finalized in January 2024.It will allow supervisors to exchange information on TCBs and credit institution subsidiaries of third country groups that are active in more than one SSM participating Member State and/or whose entities are supervised by different supervisors. CRD6 (published in the official journal on June 19, 2024) introduces a common set of rules for branches of third country banking groups operating in Member States to replace the heterogeneous national approaches and to strengthen the single market. Supervision of branches will remain the responsibility of national competent authorities as branches can only operate in the Member States where they are registered. CRD6 will further enhance supervisory cooperation by including those TCBs with a larger EU footprint under EU supervisory colleges and with a specific role for the EBA. CRD6 may also allow supervisors to require systemic TCBs to become subsidiaries, following a case-by-case assessment.
Ensure the availability of a full set of borrower-based macroprudential instruments (EC, ESRB)	MT	The ESRB amended in 2019 its recommendation on closing real estate data gaps. It aims at establishing a more harmonized framework for monitoring developments in real estate markets in EU countries through the adoption of harmonized definitions and methods for measuring indicators related to both residential and commercial real estate markets. It has also done a detailed survey on the availability and usability of borrower-based tools in the EU countries and asked for borrower-based measures to be incorporated into the EU legislation. In addition, the ESRB has issued a recommendation on vulnerabilities in the commercial real estate sector highlighting the need for enhanced monitoring and sound CRE financing practices. With this recommendation the ESRB has also initiated the process of information gathering and exploring policy initiatives both at national and EU level concerning the commercial real estate sector, including the design of activity-based tools or borrower-based measures for the commercial real estate sector. The Commission adopted in January 2024 the report on the macroprudential review which identifies several main areas of further work to enhance the capacity of the macroprudential framework to absorb shocks and tackle emerging and conventional risks (e.g., from real estate markets), increase its effectiveness as well as reduce administrative burdens, where possible, through the simplification in the application of macroprudential tools. Regarding borrower-based measures - which have been increasingly used in recent years by Member States to tackle vulnerabilities stemming from real estate markets - the Commission is currently exploring further policy options including the possibility to include in EU law a minimum set of borrower-based measures while preserving at national level sufficient flexibility regarding their activation and design.
Preparations for the U.K. Exit from the EU		
Accelerate discussions on action to ensure continuity of service and data access (ECB, ESAs, SSM)	I	Conditional recognition of U.K.-based CCPs until June 2025. ESMA has reduced regulatory costs of moving uncleared derivative contracts to EU-27 counterparts. It has also specified ~~s~~ the EU-27 dual-listed stocks that would need to trade in an EU-27 trading venue to meet the share-trading obligation requirements under MiFID II. Regarding clearing in the UK, cliff edge effects from derecognition of UK CCPs were avoided. UK CCPs were (temporarily) recognized for the purposes of

Recommendation*	Timing**	Actions
		providing clearing services in the EU. Cooperative arrangements between the Eurosystem/ECB, the Bank of England and the relevant UK CCPs were adapted due to the UK's withdrawal from the EU. With the adoption of EMIR 3, a requirement to clear a representative number of trades in key derivatives markets through an "active account" at an EU CCP will be introduced, in order to reduce excessive reliance on UK CCPs. In March 2019, the ECB and the BoE announced the activation of the currency swap arrangement for the possible provision of euro to U.K. banks and of GBP to euro area banks. ECB Banking Supervision cooperates and exchanges confidential supervisory information with the UK prudential authorities on the basis of the MoU concluded in 2019 for the period after Brexit.
NPL Resolution		
Prescribe rules for valuation of immovable loan collateral, including repossessed collateral (EU)	MT	The 2017 EBA guidelines on PD estimation, LGD estimation and treatment of defaulted assets (EBA/GL/2017/16) require some level of prudence for the purpose of LGD estimation, to reflect that the value of repossession does not always reflect accurately the market value of the asset. Furthermore, the 2018 EBA Guidelines on management of non-performing and forborne exposures defines several requirements for banks around the valuation of immovable properties pledge as collateral for NPE (see Section 9). The Banking Package contains requirements for determining the property value, a concept which is more prudent than the market value, and which should remove the divergence between jurisdictions using either market value or mortgage lending value.
Set consistent NPL definitions and reporting standards (EC, EBA, SSM)	ST	Regulation (EU) No 630/2019 amended Regulation (EU) No 575/2013 and introduced a clear set of conditions for the classification of NPEs, leveraging on the EBA work on the Implementing Technical Standards on reporting and forbearance.
Establish minimum standards for insolvency and creditor rights regimes (EU)	MT	The June 2019 Directive on Preventive Restructuring established minimum standards in certain areas, including for preventive debt restructuring mechanisms and debt discharge for entrepreneurs. In December 2022, the Commission proposed a Directive harmonizing certain aspects of insolvency law. It covers rules on transaction avoidance, asset tracing, pre-packs, directors' duties, micro enterprises, creditors' committees, and measures to enhance transparency.
Crisis Management and Financial Safety Nets		
Strengthen the early action framework and advance resolution preparation (SRB, SSM, EC, NRAs)	I	The ECB crisis management framework is regularly revisited and continuously improved. For example: (i) in 2018, by refining the escalation procedures with a set of qualitative and quantitative indicators of deterioration of bank conditions; and (ii) in 2021, by incorporating the lessons learned from the application of the EAP and the COVID-19 experience, by adjusting to new regulatory requirements (e.g., LR, MREL/TLAC) and by reflecting changes through the reorganization of the ECB banking supervision. So far, the EAP has been proven as an effective tool for ensuring a risk-based escalation process (including the need for an assessment of early intervention when triggered) and a timely preparation of a failing-or-likely-to-fail (FOLTF) determination

Recommendation*	Timing**	Actions
		while ensuring all necessary coordination needs, internally and externally (namely with the SRB). In addition to the legislative improvements, the Single Resolution Mechanism (SRM) has also continued improving the cooperation at institutional level. The cooperation between SRB and SSM is set up in the MoU, which was signed in 2015 and revised in 2018 and 2022. The 2022 revision (December 16, 2022) enhanced the cooperation before and in crisis on different aspects: 1. Early intervention (assessment on EI conditions and measures shared at the same time of the ECB SB). 2. Moratorium (ECB and SRB should agree on a consultation period on a case-by-case basis prior to the consultation). 3. Cooperation between JSTs and IRTs (formal and informal interactions in the recovery and resolution planning phase and sufficiently in advance in crisis). 4. FOLTF (ahead of a crisis and at the time of a specific crisis case, the ECB and SRB agree on timelines and steps for the ECB/SRB FOLTF assessment). 5. Cooperation in resolution (especially when the bridge institution is chosen and on the business reorganization plan). The cooperation with the NRAs is set in line with the Cooperation Framework (/1), according to which the NRAs are invited to pro-actively notify the SRB on any Less Significant Institutions under their direct responsibility that show early signs of financial distress or demonstrate suspicious behavior (e.g., money laundering suspicion, negative media publicity). Finally, the CMDI reform proposed by the Commission in April 2023 will further enhance crisis preparedness, in particular as regards the use of early intervention measures and cooperation between supervisors and resolution authorities in the run-up to a potential resolution. In March 2024, the European Parliament's Committee on Economic and Monetary Affairs (ECON committee) adopted their position on the CMDI package, and the dossier will be followed up by the new Parliament after the European elections in June 2024. 1/ Decision of the Single Resolution Board (SRB) of 17 December 2018 establishing the framework for the practical arrangements for the cooperation within the SRM between the Single Resolution Board and National Resolution Authorities, amending the SRB Decision of 28 June 2016. The text is published on the SRB website.
Proceed quickly with the buildup of MREL and internal MREL, prioritizing large banks (SRB)	I	The regulatory framework for MREL has been significantly revised in 2019 through amendments to the EU Bank Recovery and Resolution Directive (BRRD), the CRR, and the CRD. The SRB has applied the new regulatory package from 2020 (the policy is published on the SRB website) by setting for all banks in its remit intermediate MREL targets to be complied with from 1 January 2022, and final MREL targets from 1 January 2024. The SRB reports that all significant institutions met their MREL targets as of 1 Jan 2024, with a few cases where a longer transition period was granted accounting for all of the remaining MREL shortfall. All EU GSIIs continue to comply with TLAC.

Recommendation*	Timing**	Actions
Ensure availability of liquidity in resolution (SRB, EC, Eurosystem)	ST	In December 2018, the Eurogroup mandated the Eurogroup Working Group (EWG) and the Task Force on Coordinated Action (TFCA) to work on solutions for the limitations in the current framework. The TFCA discussed various solutions (SRB issuing debt, SRB guarantees to ECB, public guarantees) but the work is currently suspended. However, tailored improvements in requirements for monitoring of liquidity in recovery planning and resolvability guidance were introduced. The SRB has put the liquidity in resolution as a priority for SRB banks (banks' own capabilities). This is to ensure they can estimate liquidity needs, identify, and mobilise collateral, measure and report their liquidity situation in resolution. As concerns other sources, EU Institutions acknowledge limitations in the current framework regarding "liquidity in resolution" (LiR). The SRB has repeatedly stated publicly that the SRF can contribute to liquidity provisioning to institutions in resolution, but it should not be deemed as the only solution considering its capacity in case of liquidity needs post resolution concerning large banks (based on the target size of the SRF – even with the Common Backstop by the ESM (after its final ratification)). Recent crisis cases in other jurisdictions have shown the importance of appropriate funding in resolution. The availability of additional funding would facilitate the resolution outcome, and would not necessarily imply that funding would be used, but rather its mere availability could strengthen market confidence.
Crisis Management and Financial Safety Nets		
Designate and make operational the SRF backstop (such as the ESM) (EU, SRB, ESM)	ST	At the December 2018 summit, EU leaders agreed that the ESM will serve as the SRF backstop. In November 2020 the Eurogroup agreed on the introduction of the backstop by the beginning of 2022 (instead of 2024), based on its assessment that risk reduction in the banking union banking system had been sufficient for this purpose. All the various necessary operational steps have been taken and the legal documents necessary to introduce the backstop have been prepared; however, the establishment of the backstop is legally embedded in the revised ESM Treaty, with entry into force still pending as one signatory has not ratified the revised ESM Treaty yet. The backstop will have the form of a revolving credit facility initially amounting to €68 billion (such cap could be in principle revised by the ESM Board of Governors).
Establish an EDIS with a backstop (EU)	ST	The Eurogroup noted in 2022 that, as an immediate step, work on the Banking Union should focus on strengthening the common framework for bank crisis management and national deposit guarantee schemes. Setting up EDIS remains to be addressed. The review of the crisis management and deposit insurance (CMDI) reform in the short term has been given priority. In their Euro Summit meeting statement of March 24, 2023, Heads of State called for continued efforts to complete the Banking Union in line with the Eurogroup statement of June 16, 2022, in which the Eurogroup committed to—following the adoption of the CMDI review—review the state of the Banking Union and identify possible further measures regarding the other outstanding elements to strengthen and complete the Banking Union.

Recommendation*	Timing**	Actions
Ensure consistency of triggers for action such as resolution, liquidity assistance, and precautionary recapitalization (EC, ECB, SRB)	ST	In 2018 the ECB Banking Supervision has adopted a new definition of solvency to be used in the context of: (i) precautionary recapitalisation; (ii) state guarantees on newly issued liabilities; and (iii) state guarantees to back central bank liquidity facilities. The new methodology is based on a forward-looking assessment of compliance with Pillar 1 and Pillar 2 capital requirements. It ensures alignment with the FOLTF assessment (which is one of the three conditions for resolution). The proposed CMDI reform clarifies the continuum of possible crisis management tools, including precautionary recapitalization, preventive measures, and resolution. On April 18, 2024, the ECON Committee of the European Parliament, adopted a draft report on the Commission's 2015 EDIS proposal. The report introduces a liquidity-only EDIS (a European liquidity fund combined with mandatory lending from national DGS) that would only involve loans which need to be paid back by the national DGS.
Align the relevant State-aid loss-sharing requirements (in resolution) with the BRRD/SRMR, while introducing flexibility through a financial stability exemption subject to strict criteria (EU)	ST	The Commission is carrying out an evaluation of its State-aid framework for banks. The outcome of this evaluation will inform a subsequent potential review of the State-aid framework for banks. Given the interlinkages between the CMDI framework and the State-aid framework for banks, such potential review would aim at ensuring consistency between the two frameworks, taking into account final outcome of the legislative negotiations on the CMDI framework.
Further harmonize the hierarchy of creditor claims in bank insolvency (EU)	MT	The proposed CMDI reform includes further harmonization of creditor claims as regards the ranking of depositors in insolvency (all depositors ranking in a single tier with a general depositor preference).
Introduce an administrative liquidation tool for the SRB (EU)	ST	The approach taken with the proposed CMDI review is to ensure that the already harmonized resolution framework can also be applied to small and medium-size banks. As a longer-term project, the Commission is also following and contributing to the work of expert fora, such as UNIDROIT, where the design of a possible administrative liquidation tool is being discussed.
Pare back State-aid oversight of the use of the SRF and deposit insurance funding on a least-cost basis (EC)	ST	The Commission's CMDI proposal envisages a targeted simplification of the process to be followed by the Commission and the SRB in case of use of Fund or State-aid in resolution while maintaining the assessment of compatibility of such aid with the single market. For the time being DGS funds remain national and any further changes to the State-aid oversight and a more streamlined or centralized process for use of SRF and other industry-funded safety nets in resolution will only be possible once a European Deposit Insurance Scheme (EDIS)is in place and depending on its final shape.
Buttress SRB independence and powers (for example, by granting permanent observer status at the	I	The revised version of the SSM-SRB MoU signed in 2022 sets forth that "*the Supervisory Board will invite the Chair of the SRB to participate as an observer in its meetings for items relating to the tasks and responsibilities of the SRB*."

Recommendation*	Timing**	Actions
SSM Supervisory Board) (SSM, EC)		The MoU lists such tasks and includes that such items could entail "*upon agreement between the ECB and the SRB, any other item necessary for the performance of the tasks and responsibilities of the SRB.*" In practice, an SRB Board member is already being invited to attend the SSM Supervisory Board meetings as an observer if a topic is discussed that is relevant for SRB tasks.
Liquidity Management		
Articulate an explicit financial stability mandate for the ECB/Eurosystem (ECB)	MT	The ECB/Eurosystem already has a financial stability mandate under the EU Treaties, insofar as Article 127(5) TFEU already provides that: *"The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."* See also Article 25 of the ESCB Statute. The primary objective of the ECB is to maintain price stability. Following the latest Strategy Review, the ECB has taken decisive steps to integrate the financial stability analysis into the monetary policy-making process. Current arrangements ensure preserving the focus on the primary objective to maintain price stability while duly taking into account any spillovers or interactions with financial stability matters.
Intensify "horizon scanning" involving supervisory and operational functions (ECB, SSM)	I	The ECB has taken note of the recommendation regarding the 'horizon scanning' arrangements to better detect emerging liquidity strains. Elements of horizon scanning are, however, already built into processes on the supervisory and monetary policy sides of the ECB. Additional elements will be considered in future work. With respect to the *euro area* CCPs' access to the CCP credit facility within the TARGET framework, there is ongoing work which covers, to the extent feasible, the possible harmonization of conditions across euro area CCPs as well as considering potential safeguards and enhancements of cooperation/information-exchanges (with relevant CCP supervisors). With respect to *non-euro area* CCPs, the internationally agreed "No Technical Obstacle" principles are considered to provide sufficient basis for possible establishment of arrangements between the ECB and non-euro area central banks.
Further harmonize and ultimately centralize ELA arrangements (ECB)	ST	The ECB together with the NCBs regularly review the rules and procedures surrounding the provision of ELA, as laid down in the ELA agreement (driven by transparency considerations, the ELA agreement was first published in June 2017; the last ELA review was finalized in Q4 2020, and the current review will most likely be finalized in Q3 2024). The ELA framework has evolved and expanded over the last years with more elements being covered by the ELA agreement to ensure that the provision of ELA by NCBs does not interfere with the Eurosystem monetary policy. Moreover, and with a view toward a consistent approach within the euro area, topics related to communication and disclosure, solvency definition, supervision and regulation, are also being looked at in the context of regular ELA reviews. Whether centralization should be the ultimate goal needs to be carefully assessed in view of the legal competences of the Eurosystem, as well as financial structure and the regulatory environment in the respective euro area jurisdictions.

Recommendation*	Timing**	Actions
Manage the transition from crisis-related policy settings and develop the future operational framework to reflect regulatory and market developments (ECB)	MT	The Eurosystem is continuously engaged in work on its future monetary policy implementation framework. In March 2024, the Governing Council of the ECB announced changes to the operational framework for implementing its monetary policy. This announcement confirmed that the deposit facility rate (DFR) will remain the steering rate for money markets. The rate on the main refinancing operations (MROs) will be adjusted such that the spread between the rate on the MROs and the DFR will be reduced to 15 basis points from the current spread of 50 basis points. This narrower spread will incentivize money market activity while also limiting the scope for money market volatility. Liquidity will be provided through a broad mix of instruments, ensuring an effective, flexible, and stable source of liquidity to the banking system, thereby also supporting financial stability. It is intended that MROs play a central role in meeting banks' liquidity needs and continue to be conducted through fixed-rate tenders with full allotment against broad collateral; at a later date, liquidity will also be provided via a structural portfolio and structural longer-term refinancing operations. The operational framework is intended to be robust to different monetary policy configurations as well as different financial and liquidity environments, and consistent with the use of the monetary policy instruments set out in the ECB's monetary policy strategy. The Governing Council will review the key parameters of the operational framework in 2026 and stands ready to adjust the design and parameters of the framework earlier, if necessary, to ensure that the implementation of monetary policy remains in line with the established principles.

[1] The RTS specify (i) the criteria to evaluate the risks arising from potential changes in interest rates and (ii) the modelling and parametric assumptions and the supervisory shock scenarios complemented by an Implementing Technical Standard (ITS) on Pillar 3 disclosure of banks' exposure to IRRBB, which is applicable since June 2022. The GLs provide criteria for the identification, evaluation, management, and mitigation of IRRBB in banks' internal systems.

* In this table, EU will refer to the Council of the EU, the European Parliament, and the European Commission.

**I: Immediate, within one year; ST: short term, within 1 to 2 years; MT: medium term, within 2 to 5 years.

Statement by Mr. Buissé, Executive Director for France
on behalf of the Euro Area Authorities
July 22, 2024

In my capacity as President of EURIMF, I submit this Buff statement on the euro area consultation on Common Euro Area Policies. It reflects the common view of the Member States of the euro area and the relevant European Union Institutions in their fields of competence.

The authorities of the euro area Member States and the EU Institutions are grateful for the open and fruitful consultation with staff and their constructive policy advice. The authorities are in broad agreement about the need to strengthen fiscal sustainability, improve productivity, reduce labour market shortages and mismatches, promote investment and reforms, and deepen the single market while avoiding distortive industrial and trade policies.

The euro area is among the most open economies and is thus especially exposed to the risks of trade fragmentation. It has been particularly affected by the Russian war of aggression in Ukraine and the subsequent energy crisis. In a context where managing potential risks linked to external dependencies, including on fossil fuels, is key, investment is needed to accelerate the green transition, boost productivity, and reinvigorate growth.

More specifically, we have the following comments on the Staff Report:

Economic outlook and risks

The authorities broadly share the Fund's overall assessment of the euro area's macroeconomic outlook. Economic growth is expected to remain steady in 2024 and to slightly strengthen in 2025. This is mainly supported by consumption and investment. Robust employment, unemployment rates at historically low levels and recovering real incomes support private consumption, while the easing of financing conditions as well as Next Generation EU funds help investment. At the same time, medium term growth is expected to be limited by subdued productivity growth and population ageing.

The authorities share the Fund's overall assessment of recent inflation dynamics. Euro area headline inflation has declined strongly from its peak in October 2022 to 2.5% in June. Looking ahead, it is expected to move sideways over 2024, before moderating to the ECB's 2 per cent medium-term target in the second half of 2025. The strong downward impact from unwinding energy inflation has faded, but the petering out of past upward shocks and the impact of tight financing conditions should lead to a further gradual easing of inflationary pressures. Domestic price pressures have been slower to ease, also reflecting strong wage growth driven by inflation compensation amidst tight labour markets. Wage growth is likely to remain high in 2024, but profits are expected to partly buffer the still strong labour cost pressures.

The authorities agree that risks to growth are tilted to the downside. The main downside risks to growth are external and related to geopolitical tensions and policy uncertainty, with potential negative

effects on the energy market, confidence and in terms of trade fragmentation. These downside risks more than offset upside risks to growth, which comprise positive surprises on foreign demand and a faster decline in the household savings rate. As regards inflation, there are also downside and upside risks. The disinflationary process could accelerate if growth underperforms. Services inflation and firms' smaller profit margins could prolong above-target inflation, in particular in a context of tight labour markets and if demand holds up better than expected.

Macroeconomic stabilisation

Restrictive monetary policy has eased somewhat recently and contributes to the ongoing disinflation process. After having held key interest rates steady for nine months, the ECB decided to lower them by 25 basis points on 6 June, reflecting the tangible progress toward a timely return of inflation to its medium-term 2 per cent target. However, the ECB is not pre-committing to a particular rate path; it will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim and will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In parallel, as of July 2024, the ECB is reducing its portfolio of pandemic-related asset holdings (PEPP) at a measured and predictable pace, intending to discontinue reinvestments in full at the end of 2024. The ECB remains attentive to the smooth transmission of its monetary policy.

The authorities broadly agree on the need for a gradual and sustained fiscal adjustment in many – although not all – Member States, to reduce the high levels of deficit and debt. The current contractionary fiscal stance may have a limited negative impact on output as a substantial part of the fiscal adjustment was an anticipated discontinuation of temporary measures. With the new economic governance framework having entered into force on 30 April, attention has now turned to the implementation phase and Member States are preparing their medium-term fiscal-structural plans to be submitted in autumn. Strengthening public finances while preserving or increasing investment and enhancing productivity remain essential for a competitive, dynamic, and resilient economy and are key concerns for Member States to consider when preparing their plans. Countries with higher public debt and deficit should ensure a credible fiscal adjustment over the medium term in line with the revised governance framework, but this should be carried out in a way that minimizes the impact on growth.

The authorities concur on the need to closely monitor risks to financial stability. Euro area banks have proved resilient to the increase of interest rates. Bank profitability is likely to have peaked but is expected to remain above pre-pandemic levels in the medium term. While uncertainty has diminished since late 2023, some risks remain, including as regards corrections to asset valuations, commercial real estate, as well as unmitigated liquidity mismatches and leverage in nonbanks. In addition, the uncertainty over the implementation of international standards by other jurisdictions increases the risk of regulatory and financial fragmentation. As for macroprudential policy, appropriate countercyclical capital buffers and adequate flexibility in using them in crisis periods should ensure resilience of credit flows at all times. Borrower-based macroprudential measures serve as structural backstops against risky loan origination, tackle risks stemming from the real estate sector and build financial sector resilience over time. Concerning nonbanks, the authorities agree on the need to assess the adequacy

of existing policy frameworks, ensure effective implementation of microprudential tools, close data gaps and improve data access and data sharing.

Structural reforms

The authorities agree on the need to boost productivity growth and investment in view of the twin transition. A number of conjunctural factors has recently widened economic divergence between the US and the euro area. Still, there is also a more structural productivity gap to address, explained inter alia by subdued capital deepening, sectoral misallocation, lagging innovation, and slower adoption of innovative technologies. Member States reforms and investments in the context of the RRF will support growth and productivity. Activation policies, investments in up-skilling and re-skilling the labour force, measures to improve working conditions, to support fair intra-EU labour mobility and legal migration can alleviate labour and skills shortages, in line with the European Commission's Action Plan on labour and skills shortages in the EU. Skills policies can also promote the adoption of new technologies. In addition, the recent migrant inflows, including from Ukraine have contributed to an easing of labour shortages, supporting labour supply. This was also due to policies that were put in place to integrate people fleeing the war in Ukraine in the labour force, most notably the adoption of the Temporary Protection Directive. However, further reforms are still needed in areas like housing, access to childcare, transportation, and healthcare.

A successful implementation of climate policies to meet the 2030 emissions target is key. The Fit -for -55 package comprised policies aimed at reducing EU net greenhouse gas emissions by 55 percent by 2030, relative to 1990 levels. Those, together with measures at the national level should achieve the goal. Member States have revised their National Energy and Climate Plans in order to achieve the targets. In addition, to mitigate the distributional impacts of the climate transition, the Just Transition Fund and Social Climate Fund were created. The Carbon Border Adjustment Mechanism (CBAM) is being put in place to avoid "carbon leakage" to countries with less stringent climate policies, and it is designed to be compatible with WTO rules. It has entered its transitional phase, during which only reporting obligations apply. Financial adjustment will gradually enter into force as from 2026. Engagement with trading partners will continue to ensure a successful and WTO-compatible implementation. The authorities take note of staff's recommendation for an EU Climate and Energy Security Facility.

The authorities share the staff's assessment that the increased risk of geoeconomic fragmentation requires a response that strengthens the single market. The EU remains committed to a rules-based, free, fair, open, sustainable, inclusive, and transparent multilateral trading system, with the WTO at its core, while acknowledging that progress in certain areas, such as environment, state intervention and agriculture, has been limited. EU industrial and trade and environmental policies are carefully designed to avoid distortive effects and are not a driver of fragmentation risks globally. The EU has developed analytical tools to identify and address potential vulnerabilities. The EU acknowledges the need to manage strategic dependencies, including by diversifying supply sources, with the objective to de-risk supply chains rather than to de-couple from some partners. The EU's Economic Security Strategy aims to strengthen its toolkit along several dimensions, including

investment screening and export controls. The EU is focused on reinforcing its sovereignty in strategic sectors and making Europe a technological and industrial powerhouse, while promoting an open economy. The EU's state aid rulebook, which has been streamlined and updated to take account of green transition priorities, can help limit subsidies with detrimental effects on the single market and trade partners, while supporting the economy in the new context. The authorities take note of staff's input on priorities for the EU budget and related considerations on the advantages of EU-level instruments and common procurement in areas such as the green transition and defence.

Developing the Capital Markets Union (CMU) is essential for strengthening competitiveness and innovation and for achieving policy priorities. Integrating capital markets would boost productivity and promote the much-needed investment, scaling up the European market and allowing for better risk-sharing. The EU has made substantial progress with legislative measures towards the CMU and the Eurogroup has identified a comprehensive set of further measures to be undertaken. Options such as "enhanced cooperation" and "28th regime" -style arrangements come with their own specific challenges and risks and may need to be carefully considered in each specific case. The authorities also agree on the need to complete outstanding Banking Union initiatives, in particular the reform of the Crisis Management and Deposit Insurance framework, as well as ratification of the ESM Treaty, notably to enact the common backstop for the Single Resolution Fund. CMU and the Banking Union together are critical for improving opportunities for investors, businesses, and citizens and promoting sustainable growth and financial stability.